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News Release

ENFORCING THE SECURITIES LAWS: A SEARCH FOR PRIORITIES

Address to

The Sixth Annual Ray Garrett, Jr. Corporate and Securities Law Institute

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Commissioner

ENFORCING THE SECURITIES LAWS:

A SEARCH FOR PRIORITIES[1]

I am honored to be here today to address the Sixth Annual Ray Garrett, Jr. Corporate and Securities Law Institute. Although I never had the privilege of meeting Ray Garrett, I have had the benefit of the counsel of many of Ray's friends, and can assure you that Ray Garrett's legacy and reputation endure at the Commission.

Ray Garrett set a high standard for the Commission. Joel Seligman, in The Transformation of Wall Street, wrote that "at no time in SEC history, including the New Deal, was the Commission served by five more able commissioners than it was during the 1973-75 period, when Chairman Ray Garrett * * * led the SEC."[2] It's hardly my place to suggest how Commissions since Ray Garrett's measure up to the standards he set in the 1970's, but it's clear to me that a high level of professionalism and dedication is necessary for any Commission to match the performance attained by the SEC in the Ray Garrett years.

The subject of my remarks today, "Enforcing the Securities Laws: A Search for Priorities," is one with which I believe Ray Garrett would identify. In an early speech as SEC Chairman, Ray Garrett spoke of four components that are essential to the functioning of our predominantly self-enforcing securities regulatory system: First was the appearance of fairness; second, adequate notice of what is necessary for compliance; third, adequate penalties to stimulate proper behavior; and fourth, high standards of conduct among professionals practicing in the area.[3] Chairman Garrett focused in that speech on the fourth factor, proper standards of professional conduct. Today, I will focus on a subject related to the third factor Ray Garrett mentioned that day--strategies for setting priorities in the enforcement of the securities laws.

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[1]This address was prepared by Commissioner Grundfest with the assistance of Gerald J. Laporte, Counsel to the Commissioner.

[2]J. Seligman, The Transformation of Wall Street 441 (1982).

[3]Address by SEC Chairman Ray Garrett, Jr., New Dimensions in Professional Responsibility, American Bar Assoc. Nat'l Inst., at 10 (Oct. 11, 1973).

The Need for Priorities

At the outset, I would like to make a relatively simple observation. Not all violations of the securities laws are created equal, and not all violations of the securities laws are equally harmful. If given a choice between pursuing a violation that is relatively harmless and pursuing one that is substantially more damaging, of course it makes sense to focus resources on the more harmful violation. This observation is common to all Government agencies charged with law enforcement. Experience also teaches that prosecutors and constables have to define priorities with the knowledge that they cannot be everywhere, and cannot detect and prosecute every violation of every provision of every statute or regulation.

As long as law enforcers are conscious of the need for a sense of priorities, they can rationally allocate their efforts to those areas where enforcement will do most good and prevent most harm. Dangers arise, however, when enforcers lose sight of a need for priorities and engage in enforcement activities either on a catch-as-catch-can basis, or on a sequential basis, pursuing every violation they uncover until their resources are expended. When that happens, society does not get as much "bang for the enforcement buck" as it would if resources were marshalled with clear perspective as to a sense of priorities.

The observation that not all violations of the securities laws are created equal leads to a simple but fundamental question: How can priorities for securities law enforcement be set? However, to answer this question, we must first consider an even more basic query: What is the harm caused by violations of the securities laws, and how can we measure the relative harm caused by different sorts of violations? Only after we have articulated the harm done by violations of the securities laws can we proceed to rank and prioritize those violations for purposes of allocating enforcement resources.

A Violation Is A Violation: The Legalistic View

At a purely legalistic level, questions that seek to draw distinctions among various securities law violations may make relatively little sense. Congress enacted the securities statutes and charged the Commission with the duty to enforce those statutes. If the elements necessary to establish a violation can be demonstrated, the violation exists, and it can be argued that the Commission should pursue the violation.

This sort of reasoning, however, begs the underlying question. Moreover, if accepted literally, such legalistic reasoning would totally remove from the securities laws any sense of proportion, or hope of guidance as to a sense of priorities. To make the same point in a perhaps more familiar context, I suspect that every practitioner in this room has faced the need to curtail litigation so that clients pursue only those lawsuits where the payoff is worth the expense. It is simply unfeasible and contrary to a client's best interest to pursue every conceivable lawsuit that might lead to recovery. The Government is no different. Just as in private litigation parties first pursue those cases where their expected gains are greatest, the Government should in its enforcement efforts focus on those proceedings where the expected social benefits resulting from enforcement actions are also greatest.

Fairness and Investor Confidence: A Moralistic View

In the search for a sense of priorities, it is also possible to take a moralistic view of the securities laws. This perspective emphasizes the need to maintain "fair" securities markets and to preserve investor confidence in the marketplace.[4] I agree fully that the Commission must maintain fair markets and that its enforcement efforts should strive to preserve investor confidence. If our markets are perceived as unfair and if they do not garner substantial investor confidence, they will attract fewer investors and thereby lose liquidity and efficiency.

The problem I have with this moralistic approach, however, is that it is a highly elastic and subjective yardstick by which to measure enforcement priorities.[5]

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[4]Among the many stated purposes of the Securities and Exchange Act of 1934 are the need "to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and the need to insure the maintenance of fair and honest markets * * *." 15 U.S.C. 78b.

[5]Philosophers, theologians, and economists have long struggled to define "fairness," but no single definition garners widespread support. For an example of the intellectual history of attempts to define "fairness," consider the controversy that followed John Rawls' suggestion in the early 1970's that principles of "justice as fairness" compel a just society to maximize the well-being of its most disadvantaged members. J. Rawls, A Theory of Justice (1971). As numerous scholars have demonstrated, the Rawlsian "maximin" principle is subject to serious criticism, and in the course of criticizing this principle the flaws of many competing definitions of "fairness" are readily revealed. For a

Remember, one man's unfairness is another man's profit incentive. If we try to make the market perfectly fair in the sense that every investor has an equal opportunity to profit from each investment opportunity, then we will destroy some of the most powerful incentives for innovation and competition in the marketplace.

In the extreme, in such a perfectly fair market, there would be no winners or losers. The swift would be so saddled with regulatory weights designed to assure fairness in the outcome of the market process that the slow could keep pace without ever exerting themselves. Moreover, even if the swift are also clever and figure out a way to shed their regulatory handicaps, a system that seeks to protect equality of outcomes

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sampling of this debate, see the works collected in Reading Rawls: Critical Studies of a Theory of Justice (N. Daniels, ed. 1974).

For additional explorations of nonutilitarian notions of well-being and fairness, see B. Williams, Ethics and the Limits of Philosophy (1985); Dworkin, What Is Equality? Part 2: Equality of Resources, 10 Phil. & Pub. Aff. 283 (1981); Scanlon, Preferences and Urgency, J. Phil. 665 (1975); Sen, Well-Being, Agency and Freedom: The Dewey Lectures, 1984, 82 J. Phil. 169 (1985). Much of this research has a decidedly economic bent. See, e.g., A.K. Arrow & T. Scitovsky, Readings in Welfare Economics (1971); Economic Justice (E. Phelps, ed. 1973); Inequality (A.B. Atkinson, ed. 1973); Sen, Collective Choice and Social Welfare (1973).

Interestingly, despite the outpouring of philosophical and economic research exploring various definitions of "fairness," there have been no attempts rigorously to define what "fairness" means in the context of a securities market, or how one conceives of "investor confidence" with any meaningful sense of precision. In the absence of any such rigorous explications, I am left with the uncomfortable impression that proponents of "fairness" in the securities laws are dealing with highly subjective and individualistic assessments, and that proponents of "fairness" might well disagree vigorously among themselves about what is, and what is not, "fair." To paraphrase Justice Stewart's observation about pornography in Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring), proponents of fairness might believe they "know it when they see it," but they probably can't explain what it is, or why it is what they say it is. Such reasoning hardly provides a firm foundation upon which to build a stable, predictable securities enforcement policy.

will only feel compelled to write a new set of regulations so that all competitors again cross the finish line simultaneously.[6]

This "moralistic view" of the securities laws was exemplified in the "parity-of-information" rule, which would have construed the securities laws so as to establish conditions that give all traders equal access to information before trading. That position was fortunately rejected by the Supreme Court in United States v. Chiarella, 445 U.S. 222, 233 (1980) ("neither the Congress nor the Commission has ever adopted a parity-of-information rule"), and again in Dirks v. SEC, 463 U.S. 646, 657 (1983) ("We affirm today that '[a] duty [to disclose] arises from the relationship between parties * * * and not merely from one's ability to acquire information because of his position in the market.'").

Thus, while it is absolutely essential that our markets be fair and that they inspire investor confidence, I doubt that we can use "fairness" and "confidence" as guiding stars in establishing priorities for a securities enforcement program.

Efficiency As A Guide

Without rejecting the moralistic view that places primary emphasis on fairness and investor confidence, I suggest that clearer guidance for enforcement priorities can be found by looking at the efficiency effects of securities law violations. Many types of securities law violations are harmful because they are economically wasteful or, in a word, inefficient. Let me give you a simple example. Suppose a promoter seeks to raise $10 million for a retail venture. The promoter raises $10 million based on a prospectus that falsely inflates past revenues, overstates current inventory, and exaggerates profit margins. This fraudulent promoter competes for capital with honest businessmen. To the extent that the fraudulent promoter attracts resources away from honest enterprises, his fraud causes an inefficient allocation of capital in the economy, and thereby harms society at large, not just the investors unfortunate enough to be victimized by the fraud.

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[6]For an example of an argument in favor of extreme equality in information among participants in the securities market see Seligman, The Reformulation of Federal Securities Law Concerning Nonpublic Information, 73 Geo. L.J. 1083, 1115 (1985) (Securities laws should be interpreted so as "to make investors confident that they can trade securities without being subject to informational disadvantages. The goal is to guarantee the integrity of the market.")

But that's not the end to the inefficiency of such frauds. Investors who are aware of the possibility of fraud will spend money trying to detect, uncover, and avoid investing in fraudulent enterprises. They invest in these monitoring activities not because they value a fair marketplace, or because they want to protect investor confidence. They invest because they want to earn a profit by allocating their capital as efficiently as possible. As we all know, investing in a fraud can seriously damage an investor's effective rate of return. In the aggregate, these monitoring costs are quite substantial and the entire auditing industry--thousands of accountants--can, from a certain perspective, be viewed as a social investment in monitoring against certain types of misstatement and fraud.

Further inefficiencies occur on the other side of the fence, where the perpetrator of the fraud is aware that investors are trying to uncover his ruse. The perpetrator spends money trying to conceal his dishonest activities. If uncovered, he spends still more money on lawyers in an effort to protect his ill-gotten gain. This game of concealment and detection could be avoided totally if fraud did not exist, and the costs of this game are a net loss to society attributable directly to fraud.[7]

In sum, dishonesty in connection with the purchase and sale of securities generates at least three types of efficiency costs for society: (1) it misallocates capital, (2) it causes investors to spend money on monitoring activities, and (3) it requires that those who would be dishonest spend money concealing their lies. These efficiency consequences provide rough yardsticks that can be used to prioritize enforcement efforts. All other things being equal, an enforcement policy targeted at frauds generating the clearest and largest inefficiencies will do most to promote a vigorous capital market. As a critical by-product, such a policy will also do most to promote fairness and investor confidence in the marketplace.

In other words, I suggest that the most effective means by which the Commission can promote fairness and confidence in the marketplace is for it to promote efficiency in the marketplace. There is absolutely no conflict between efficiency on the one hand and fairness and confidence on the other. In fact, I would suggest that more efficient markets

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[7] See, e.g., Easterbrook & Fischel, Optimal Damages in Securities Cases, 52 U. Chi. L. Rev. 611, 621-22 (1985).

are also fairer markets, and that more efficient markets will inspire greater investor confidence than less efficient markets.[8]

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[8]This proposition is not self-evident and deserves careful explication. A complete explanation of the relationship between efficient markets and fairness is, however, the subject of many book-length works. See, e.g., K.J. Arrow, Social Choice and Justice (1983); I. Little, A Critique of Welfare Economics (1950). In this footnote I can do little more than summarize the main points of the argument.

One of the basic conclusions of modern welfare economics is that, given a sufficiently competitive and complete market (assumptions that probably describe capital markets better than any other markets), the unregulated market process reaches what is called a "Pareto-optimal" state. In a Pareto-optimal state, it is impossible to make anyone better off without making someone else worse off. (A Pareto-superior transaction is one that leaves at least one participant better off, and no one worse off.) For a relatively accessible explanation of this result, see Samuelson, Economics 461-62 (10th ed. 1976); Bator, The Simple Analytics of Welfare Maximization, 47 Amer. Econ. Rev. 22 (1957).

It follows that if the initial endowment at the outset of a market process is fair (i.e., if the allocation of wealth, talent, intelligence, motivation, and any other factor that influences the outcome of the market process is fair--however "fairness" may be defined) then the outcome of the unregulated market process can only make everyone better off as a result of the gains from trade. "Fairness" in the sense that I use the term in this address thus refers to the Pareto-optimality of the competitive process, and the Pareto-superiority of individual transactions among voluntary market participants.

The securities market does not influence initial endowments. It is only a mechanism through which individuals invest and reallocate risk. Accordingly, voluntary transactions in the securities markets are likely to lead to Pareto-superior outcomes. Whatever unfairness there might be in the outcome is thus attributable primarily to unfairness in initial endowments. Unfairness in initial endowments is better addressed through policies that have nothing to do with the operation of securities markets, such as tax policy, education, or laws against racial or gender-based discrimination. Thus, to the limited extent that fairness can be promoted through the securities market, it can probably be best promoted through rules that promote efficiency and Pareto-superior outcomes.

Now, this is not to suggest that all violations of the securities laws have equal potential for generating efficiency costs. As an example, I would point to the soft dollars area, which is the subject of a recent Commission interpretive release.[9] As you know, persons who exercise investment discretion over the brokerage accounts of others owe a fiduciary duty to the account holders.[10] Section 28(e) of the Securities Exchange Act provides a "safe harbor" to such advisers with respect to research services provided in return for brokerage commissions that are higher than the lowest

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I must concede that this thumbnail sketch of the welfare economics of securities markets cuts some important corners, and that the concepts of Pareto-optimality and Pareto-superiority are subject to substantial criticism. Nonetheless, my conclusion that efficiency in the securities markets best serves the goal of fairness would remain unchanged even if I dealt in depth with the subject.

Moreover, dwelling on the shortcomings of efficiency and Pareto-optimality as measuring rods for fairness does nothing to provide an alternate, superior approach. Thus, at a minimum, unless and until a superior and workable alternative is provided, efficiency may well be the best guide toward fairness in the securities markets. This conclusion is also recognized by strong critics of Pareto-optimality. See, e.g., Sager, Pareto Superiority, Consent, and Justice, 8 Hofstra L. Rev. 913, 929, 937 (1980). Although Sager agrees that a "perfectly just state of affairs would be Pareto-optimal," he sees many fundamental problems with the notion of Pareto-optimality as a guide for policymaking. Nonetheless, he concludes, "One unfortunate aspect of the role of critic is that one is left at the end of the enterprise with propositions that sound only in the negative. Here I can claim no more."

Propositions that sound only in the negative are valuable reminders that improvement may be possible and necessary. They are not, however, useful as guides for action and policymaking. Thus, the burden currently appears to be on opponents of efficiency to articulate a coherent, superior, and workable alternative goal for achieving fairness in the securities markets. Until this burden is carried, efficiency appears to be the most reasonable guide.

[9]Sec. Exch. Act Rel. No. 23170, 51 Fed. Reg. 16004 (1986).

[10]See id.

available rate.[11] These services can be purchased with "soft dollars" paid to the broker. Section 28(e) provides that a fiduciary will not be deemed to have breached his fiduciary duty, whether under State or Federal law, if he receives soft dollar research benefits and determines in good faith that the total commission paid is reasonable in relation to the value of the brokerage and research services provided.[12]

In general, in cases involving potential soft dollar violations, the evidence is that the payments for brokerage services are in a competitively reasonable range. The evidence also suggests that there would have been no violation, and that the client would likely not have shifted its business to a competing adviser, had the adviser simply paid the same commissions and foregone the soft dollar benefits. In some situations, evidence also suggests the client would have consented to the soft dollar practices had he been informed.

In other words, while the adviser may have received a benefit that, absent section 28(e)'s safe harbor, would have belonged to the client, the client may have suffered no harm relative to the position he would have been in had the adviser not accepted the soft dollar services, or had there been full

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[11] Id.

[12] Section 28(e)(1), 15 U.S.C. 78bb(e)(1), provides: "No person using the mails, or any means or instrumentality of interstate commerce, in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law unless expressly provided to the contrary by a law enacted by the Congress or any State subsequent to the date of enactment of the Securities Acts Amendments [of] 1975 solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion. This subsection is exclusive and plenary insofar as conduct is covered by the foregoing, unless otherwise expressly provided by contract: Provided, however, That nothing in this subsection shall be construed to impair or limit the power of the Commission under any provision of this title or otherwise."

disclosure and consent. Moreover, if one believes that the markets for brokerage and advisory services are competitive, then the elimination of soft dollars benefits could conceivably force an increase in advisory costs charged to clients. A reduction in soft dollar practices could also cause a harmful decrease in the extent of nonprice competition among brokers. Accordingly, there is reason to question whether soft dollar practices cause material efficiency losses.

Soft dollar practices may thus fall in a class of activities that generate relatively ambiguous efficiency effects, despite the many protestations of unfairness and claims of loss of investor confidence that accompany these arrangements. Given a choice between spending resources in pursuit of frauds with tangible efficiency effects, or spending resources in pursuit of soft dollar practices with ambiguous efficiency consequences, it makes good sense to me to focus on the frauds.

Although most attorneys and investors might not use the vocabulary that I've employed in reaching this conclusion, I suspect that most attorneys and investors would agree with the conclusion I've reached. I think they would concur that, if forced to choose, they would rather prevent a $10 million fraud than prevent $10 million in soft dollar practices.

This same efficiency analysis can be applied to every provision of the securities laws, and to every violation of every provision. In each case, it's possible to ask, "What's the efficiency loss?" and to target practices in descending order of their efficiency consequences.

Dangers of An Efficiency Approach

This efficiency-oriented enforcement approach is not, however, without its own dangers and shortcomings. Over time, some market participants engaged in marginally harmful activities may become comfortable in the knowledge that they are unlikely to be prosecuted under a pure efficiency-priority regime. To address this danger, it may be useful on occasion to target pockets of such "fringe frauds," and to do so without prior warning. A little bit of randomization in the process can work wonders in shaking up complacent violators, and can substantially increase the risks associated with "fringe fraud" activities.

Another danger of this approach is that it can lead to a false sense of precision, and can place greater emphasis on quantifiable measures of harm than on equally valid but less measurable forms of efficiency loss. Perfection in this area is, however, too much to ask. The Commission operates in a complex environment and must foremost strive to be practical. An enforcement strategy that emphasizes efficiency effects is, I submit, the most practical, albeit imperfect, means of prioritizing Commission enforcement efforts.

Efficiency As A Guide for Regulatory Policy

Efficiency also has an important role to play in Commission rulemaking proceedings. The list of new rules to be written, old rules to be suspended, and existing rules to be modified is potentially endless. Where do you start? How do you decide which project to undertake this week, and which project should wait until next year? How do you decide which rules make sense and which rules need to be improved or eliminated? And, in overseeing the thousands of regulatory provisions under Commission jurisdiction, how do you assure that the rules are consistent and don't work at cross purposes? Again, although it is a topic for a separate speech, I suggest that efficiency is likely to be the best, albeit imperfect, guide in the rulemaking process. Thus, just as the Commission should look to efficiency for guidance in setting enforcement priorities, the Commission should also look to efficiency for guidance in setting its regulatory agenda.

Conclusion

I would like to conclude by observing that complicated problems do not have perfect or easy solutions. Efficiency may not be a perfect guide in setting priorities for an enforcement program, but I submit that efficiency is a far better yardstick than any other available to the Commission. Adherence to an efficiency-oriented enforcement policy also does not signal an abandonment of equity or investor confidence as major goals of an enforcement program. Because efficiency promotes equity and confidence, a policy that seeks to maximize efficiency will simultaneously further fairness and confidence in the marketplace. Over the coming years, I hope that we will witness a move in a direction towards efficiency as a measure of enforcement priorities, and that, as a result of such an emphasis, we will see greater fairness and investor confidence in our markets.