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"POLICY-MAKING AND ENFORCEMENT AT THE SEC"

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Talking to this group about the enforcement process at the SEC is surely carrying coals to Newcastle. There is more accumulated experience, lore and wisdom held by lawyers in this room who have been on both sides of the enforcement process -- in addition to the presence of current members of the enforcement staff and my distinguished Chairman -- than I could accumulate in two full terms as a Commissioner, no less the two months I have served to date.

Nevertheless, I hope it is something more than hubris or bad judgment that has led me to talk about this subject. There is some value to the fresh eye, for it brings a different perspective to old questions. Indeed, my eye may be exceedingly fresh, for my experience as a private lawyer with enforcement proceedings was limited.

My thesis is a simple one: the Commission has an affirmative obligation to establish appropriate standards for issuers, broker-dealers, those who prepare and audit financial statements, and others -- usually in conjunction with self-regulatory groups. These standards are often elaborated and given content in enforcement proceedings. I believe there are some characteristics of Commission enforcement proceedings that make them a less effective forum for the elaboration of policy than one might suspect. This is not just the old debate of adjudication vs. rulemaking; rather, I think we may be denied some of the advantage of both.

First, though, I would like to spend a few minutes on the traditional concerns about the enforcement side of the SEC's work that were considered by the Wells Committee in 1972: procedual due process, staff attitudes, and the like. I think that great progress has been made in those areas since the Wells Committee Report. Wells submissions have been a great help to me in coming to balanced enforcement decisions in close cases. That is particularly so with the difficult judgments concerning the less central defendants: for example, members of management much higher, or marginal participants much lower, than the real wrongdoers, and professionals. And while the Commission often follows staff recommendations even in those close cases -- since it is the staff who have operated most closely to the facts that often govern the exercise of prosecutorial discretion -- I think that the cumulative effect of such submissions on Commission decision-making is significant.

As for concern expressed by some about the attitude of the staff, there is a sense in which the bar will never be entirely satisfied with the enforcement process, and the enforcement staff will never be fully satisfied with the attitudes of the bar. There is an inevitable tension that arises from the differing perspectives that a private lawyer with a broad range of business clients and a vigorous enforcement unit will bring to the meeting ground of an investigation.

The private lawyer views his client as basically honest and well-advised, struggling to cope with a regulatory climate which somehow manages to be at the same time increasingly complex and detailed on the one hand, and pitted with the vague outlines of antifraud quicksand on the other.

In contrast, those charged with enforcing the securities laws function in a world which is, in fact, filled with a substantial quantum of genuinely fraudulent conduct -- in large companies as well as small -- a world in which the market rigging activities of the 1920's still appear from time to time and in which the desire to make a quick buck at the expense of the gullible still produces outrageous behavior. It is true that this is, happily, only a very small part of the financial community, but it is a large portion of the part with which enforcement officials work. I might say in passing that I have been very impressed with the quality of the factual investigations at the Commission.

With these differences in perspective and assumptions, it is no wonder that private lawyers and the SEC enforcement staff tend to resolve the inevitable ambiguities and mixed motives of human conduct in very different ways. It is no wonder that the private bar is concerned with the attitude of the enforcement staff -- and vice versa.

Another area of traditional concern has been the public nature of our enforcement proceedings. For some, it is less the fact of an enforcement proceeding than its publicity that gives cause for alarm. They point to the banking

regulators as a more appropriate regulatory model. While there is close supervision of banks, they say that it takes place more quietly and that the banking regulators recognize and embrace their responsibility to enhance public confidence in the banking system. In my judgment, the analogy is not a good one. The functions of the two systems are quite distinctive.

First, the banking regulators are basically in the business of economic regulation -- of assessing the riskiness of an institution's assets and the quality of its liability management. Within broad parmeters, they are reviewing matters of business judgment. They have been traditionally concerned with protecting depositors rather than investors. I am confident that the securities industry would not want broad economic regulation of this character, and I hope the Commission would not want to impose it. There are analogues, of course, in the net capital rule and its endless series of haircuts, but the differences are very substantial. One has only to talk to a bank examiner about the nature and extent of his bank examination reports to have a sense of the difference.

Second, when all is said and done, there is nothing in the securities markets quite like the "run on the bank" problem and the danger it poses to the monetary system and the economy. Indeed, when the problem with a securities firm is large enough to really pose a danger to the financial

markets, as some believe to have been the case during the silver debacle, confidential treatment is out of the question anyway.

Accordingly, I agree with the proposition that public confidence in the securities markets is best served by a combination of disclosure and vigorous public action against violations of the law, at least in the case of broker-dealers and issuers. The considerations applicable to proceedings against professionals under Rule 2(e) may be different.

It is the very importance of the enforcement role that raises the principal question I would like to discuss this afternoon. It can be asked in a number of ways:

- how to fix the contours of the legal standards the Commission applies in enforcement proceeding.
- how to prevent hard cases -- i.e., highly inappropriate behavior of a character that "should" be reachable under the securities laws -- from making bad law.
- more broadly how to reconcile the Commission's general responsibility to set standards with its role as an enforcement agency.

There are a number of reasons why this question is important. First, the role of the private bar in the administration of the federal securities laws is of overwhelming importance. Yet the bar cannot perform that function effectively unless the Commission states standards that are

relatively clear and consistent. To the extent they are found only in settlement orders the standards may be obscure and distorted, even to their authors.

Second, the Commission should bring to its judgment about particular enforcement actions a generalized understanding of the application of the principles in question for everyone impacted by the standard. More is at stake than "getting the bad guys." We should seek a genuinely collective maturing of our understanding of the shape and reach of the prescriptive rules we elaborate.

Third, the Commission's enduring obligation to the laws it administers implies the need for caution in straying beyond their apparent confines as well as a duty to enforce their prohibitions. This is particularly important at a time when the courts are construing the securities laws strictly and the Commission has been set back in some respects. We may have more to lose from reaching too far than from pushing ahead cautiously.

Some have said that the answer to this challenge is clear: the Commission should not "make policy" in enforcement actions, it should only do so in rule-making proceedings. That position simply ignores the complexity of modern financial transactions and the rich variety of human conduct.

There are many important standards that are not susceptible of general rule-making because of their inherent nature or because their contours are not yet well fleshed out. The

case-by-case approach of the common law is a more considered -- indeed, a more conservative -- way of testing the logic of a standard and avoiding its pitfalls. I would place in that category, for example, the definition of a security for various purposes, the underwriter's duty of investigation, an accountant's obligation as to recognition of income and expense, and the like.

Although rule-making may not be appropriate, the Commission's consideration of these standards would benefit by an intellectual process similar to what happens in a rulemaking proceeding, or at least the strong adversary process of an adjudication. In many cases, we have neither. Without rule-making proceedings we lose the generalized consideration. And there are factors inherent in the functions and powers of the Commission that make the case-by-case approach less useful than would otherwise seem to be the case. In brief, those factors are

- the SEC's role in enforcement proceedings,
- the posture in which enforcement cases come to the Commission, and
- the importance of settlements to the enforcement program.

The SEC's Role

Let me begin with the SEC's role in enforcing the federal securities laws. What is the proper attitude for the Commission -- the five commissioners -- when the staff comes to the table to request authorization of an

enforcement action? We are not judges. Our primary responsibility at that stage is to protect the integrity, fairness and stability of the securities markets, not to be an arbiter between the staff and private parties. Many enforcement cases involve genuine malefactors who have engaged in a broad range of improper conduct. They should be the subject of vigorous enforcement proceedings. Others involve violations of technical rules that raise serious regulatory concerns even though they are committed by well-meaning people. But in both cases, other concerns beside enforcement are also present -- the elaboration of generalized standards of conduct.

The point is well illustrated by the case of a broker-dealer that has exhibited net capital violations, a failure to keep adequate books and records, inadequate supervision and a failure on the part of salesmen to observe the suitability rules. The net capital and books and records violations are clear cut and very technical. The failure to supervise and the suitability standard involve much broader questions of a broker's obligation to the outside world.

What a specialized arena for the Commission to consider the scope of a broker-dealer's obligations to its customers! What a narrow context in which to elaborate a prescriptive rule about a broker-dealer's obligation to understand its customers needs! One inevitably tends to focus on what <u>this</u> broker failed to do, rather than what <u>all</u> brokers <u>should</u> do.

When Enforcement Cases Come to the Commission

Prior to commencing a formal investigation (which is required for subpoena power), the staff must seek authority from the Commission. That is such an early stage of investigation that the Commission cannot provide the staff with meaningful guidance. It can do little more than decide whether there is reason to believe a violation may have been committed, express its judgment on the allocation of resources represented by the investigation and suggest those matters which deserve special emphasis. This stage does not lend itself to the development of generalized rules.

At times, consideration has been given to whether the staff should come to the Commission at a later stage, so that the Commission can make a judgment about whether the investigation should go forward or be aborted. The Wells Committee recommended that the staff be authorized to commence "routine" formal investigations without Commission approval. Others think that Commission involvement at an early stage provides more assurance of central direction and coordination of effort.

There is another technique, which I understand to have been used from time to time, that deserves careful consideration: that is for the Commission to instruct the staff to report to it at length at stated intervals during the investigation so that the Commission can participate in shaping the investigation through its view of the applicable law. In fact, the staff now

provides summary status reports to the Commission which give commissioners the opportunity to ask for a more lengthy review.

In any event, in the ordinary case, the Commission does not see the outcome of the investigation until it has been fully developed by the staff and is the subject of a staff recommendation to commence a formal proceeding -- either injunctive or administrative. More than a year may have passed.

Generally, the Commission receives the staff memorandum, together with any Wells submissions, ten days to two weeks before it is considered by the Commission. It will be considered along with five to ten other enforcement matters at various stages and one or more policy issues in the rule-making area. The recommendation to commence a proceeding may well be coupled with a request for authority to negotiate a settlement. Indeed, the other party's willingness to settle is sometimes suggested in the Wells submission itself.

Again, I submit that this is a singularly difficult context in which to develop general rules of conduct. The Wells submission may not be directed to the problem the Commission has in mind. We can, of course, ask for a further brief on stated issues from the prospective defendant as well as the staff, but that is quite unusual and disruptive to the enforcement process. Moreover, these refinements may be of little interest to a party who has clearly violated the core of the prohibition being considered.

Settlements

On some occasions, the broader issues of Commission policy do not emerge in the order commencing formal proceedings, but only in the settlement papers. In many ways, a settlement is an even less congenial setting for the consideration of legal issues than the prior stages. If a Wells submission has not been made before, it will not be made then. The private parties have no incentive to sharpen the issues. To the contrary, they have decided to settle and usually want the proceeding to be over as soon as possible.

Moreover, it may be counter-productive to its enforcement functions for the Commission to act at this point. If the Commission acts on its own initiative in a way that changes the language of a settlement that has been negotiated, it is in the position of retreating from a statement of violation to which the private party has already agreed. That practice is demoralizing for the staff and lends an air of uncertainty to the Commission's processes.

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What to do? The Wells Committee, dealing with similar concerns, suggested formation of an office of policy planning to identify issues and frame them for consideration. Such an office was created, but it was merged with the economic directorate and has evolved in a quite different direction.

In the past few years, the Commission has experimented, I am told, with placing on the calendar for general discussion broad issues that often appear in an enforcement context. I think further experimentation along these lines would be useful, perhaps even with the participation of academics, lawyers and members of the investment community.

Conclusion

Finally, because so many of you have worked at the Commission, I might add a personal note. The SEC is a marvelous company of men and women. It is filled with bright, deeply committed people who work hard and share a high sense of purpose. We are embarked on a common enterprise, and for all the intensity of feeling and internal pulling and tugging that inevitably accompanies the resolution of difficult issues, it is a warm and companionable fellowship. With me, those of you who have shared it are fortunate.