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RUMINATIONS AND ACTION ON ENFORCEMENT

An Address By

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I am pleased to participate in this conference on the securities laws. I am impressed by the range of enforcement problems making up the program of this conference and the experience and talent you have marshalled to tackle them. It seems to me that the best way for me to contribute to this conference is to give you something of the Commission's concept of enforcement in the scheme of things and to tell you what we have been doing to make enforcement more effective and satisfactory and to make regulation, compliance and enforcement mutually supportive in achieving the objectives of the securities laws.

Now I have often said and will have occasion to say it again here today -- that the Commission and the private bar are engaged in a cooperative endeavor. Yet there are certain differences in perspective. Men primarily engaged in representing private clients cannot always be expected to look at things in precisely the same way as those whose sole client is the public interest or their conception of the public interest. I know from my own experience that my approach to many issues and problems as a government administrator in

Washington is quite different from my approach to those same issues and problems back in the days when I was a working lawyer. Its our mutual task to comprehend these differing perspectives and work to bring them closer together. It seems to me that the Commission and the lawyers who practice before it are married to each other. And that reminds me of what the great sociologist William Graham Sumner said about marriage. He described it as "a state of antagonistic cooperation." Conferences such as this can, I think, do much to mitigate antagonism and to make cooperation smoother and more fruitful.

We're here today to talk about "enforcement." But what is enforcement anyhow? I looked the word up in the dictionary before I came here and found it defined as "compulsion or attempted compulsion, especially by physical violence." Physical violence is remote from our concerns this afternoon. I see nothing on the program dealing with racks, thumbscrews, or the third degree.

Enforcement can also be viewed much more broadly so as to encompass not merely formal proceedings in which

allegations of misconduct are made, proved, or disproved; legal rules applied to sets of facts; and sanctions imposed where appropriate -- but the entire process by which abstract standards in the United States Code and the Code of Federal Regulations become social realities, the process by which law in books becomes law in action.

I prefer to think of enforcement in that broader sense. Important though the work of the courts is, there is far more to the law and to the legal process than that which transpires in courtrooms. Similarly, there is far more to the implementation of the investor protection policies embodied in the securities statutes than the relatively small number of formal judicial and administrative proceedings under those statutes. An important--perhaps by far the most important--part of SEC enforcement in this broader sense consists of what lawyers, accountants, and compliance people do in their offices to educate the business and the financial communities as to what the law requires of them. Essentially this is an education in ethics.

A great legal philosopher, the late Edmond Cahn who, like myself was a tax lawyer who wandered into other fields,

often spoke of what he called the "pedagogic function of law." The securities field illustrates his point excellently. When one compares the Wall Street of 1972 with its predecessors of 1922, 1932, or even 1942 (the year in which Rule 10b-5 was promulgated), one sees that immense progress has been made with respect to the adequacy and the accuracy of the information available to investors and that the ethical standards of the marketplace have risen greatly. We lawyers can claim a good deal of the credit for that. Our educational efforts have done much to make the American capital markets the envy of the world and to engender the investor confidence in the fairness of the game essential to the optimal functioning of an advanced private enterprise system in the world of today where we cannot hope to implement the Jeffersonian ideal of a property-owning democracy of small farmers and independent craftsmen literally but where we can retain its spirit through the wide diffusion of security ownership.

Merely preaching sermons and simply exhorting people to sin no more are not wholly ineffective. But sermons become much more effective than they would otherwise be when they are backed up and dramatically illustrated by vigorous and effective enforcement. Each so-called "big" case in this field (whether a proceeding initiated by the Commission as in Texas Gulf or a private action as in BarChris) has been a great teacher. Each of them has reminded those involved in the investment process of the standards to which they must adhere if investor confidence in the fairness of the marketplace is to be warranted and sustained. Each of them had a radiating effect that has taken us a step forward toward attaining the ideal of a free, open, and fair marketplace in which professionals who know are inhibited from overreaching the general public that does not know.

Enforcement in the very broad sense in which I have been speaking of it embraces what is generally called "compliance," i.e., voluntary adherence to prescribed norms. It also spills over into and overlaps with "regulation," which might be defined for present purposes as the process of

formulating and articulating the standards that are to be complied with and enforced. Now, of course, the process of making law by statute or rule differs materially from the process of enforcing and applying that statute or that rule in a formal, adversary proceeding against someone who is alleged to have violated it. And the realm of voluntary compliance, which involves the situation of the man who is honestly trying to find out what the law is for the purpose of conforming his conduct to its dictates, is something else again.

These distinctions are basic in legal thought. Certainly that is so for us Americans who live under a constitutional order that has separation of powers as one of its basic concepts.

Significant though these distinctions are, they are at times overstressed. Lawmaking, formal adjudication, and voluntary compliance are all parts of the same seamless web that we call law. Much has been written and said by legal thinkers over the years about the relationships among these elements and about their interaction with each other. To that voluminous jurisprudential literature one of my most

distinguished predecessors as Chairman of the SEC, the late Judge Jerome Frank of the Second Circuit, contributed significantly. One need not go nearly as far as Judge Frank and other so-called legal realists did in their skepticism about the extent to which general rules and high-level abstractions actually control the outcome of particular cases to see that, under our system at least, law grows and develops as it is applied to factual situations.

An audience trained, as this one is, in the common law certainly finds nothing novel in that thought. Indeed, it verges on the trite. Hence rulemaking and adjudication are not watertight compartments. General propositions in statutes and in rules take on meaning and are fleshed out in detail as they are applied to concrete cases. That is one reason for writing opinions. Conversely, statutes and rules often do no more than codify prior case law.

From a realistic sociological perspective, compliance (how people actually play the game in practice) is undoubtedly a good deal more significant than either the statements of the rules that appear in the books ("regulation")

or the collected decisions of the umpires and the referees ("enforcement").

In the securities field compliance is a significant source of law. The interpretative releases that the Commission issues from time to time, the letters of comment that its staff writes, and the staff's responses to requests for no-action letters all represent efforts to assist those who seek in good faith to comply with the law. These documents also become part of the law in that they become part of the store of materials referred to and studied by lawyers, compliance people, Commission employees, the Commission itself, and the courts.

The resources that society can afford to devote to law enforcement and the legal process are necessarily limited. Because of that elementary economic factor and because of the inherent difficulty of enforcing standards with which the community is not in sympathy, it seems to me that all law depends in overwhelming measure for its effectiveness on voluntary compliance. Voluntary compliance and ethical sensitivity are clearly basic in the securities sphere.

After all, it is a good deal harder to figure out whether there has or hasn't been a manipulation than it is to figure out whether there has or hasn't been a burglary or a theft. This complexity and the scope of securities activity in all parts of this nation on the one hand, and the Commission's small staff and limited resources on the other, is enough in itself to show that formal enforcement proceedings can't possibly begin to do the job that has to be done. We will never have enough people, we will never have enough resources, to begin to do the whole job -- if the whole job depends entirely on us.

But it does not depend entirely on us. It depends very largely on those whom we regulate, and I am most pleased to see an increasingly widespread recognition of that responsibility by the financial community. The development of systematic compliance programs and the rise of the still new profession of "compliance men" has been a most beneficial development.

Of course, as in all human activity there are negative aspects and something of a gap (sometimes much too wide a gap) between appearance and reality. Some compliance

programs are far more impressive on paper than they are when viewed at closer range. Indeed, some of them don't amount to much even on paper. And there are firms in which compliance men are mere ornamental figureheads who have to speak very softly indeed when they talk to the "producers" with whom the real power rests. I am well aware of all that. Nevertheless, I disagree with those cynics who say that compliance programs have only two functions:

(1) The construction of paper trails for dazzling and befuddling SEC investigators; and

(2) The creation of alternative and somewhat more remunerative employment opportunities for people who are dissatisfied with their progress and prospects at the Commission's New York Regional Office.

I think that compliance programs have already done a good deal -- and are, if properly developed, capable of doing much more than they have done to guard against transgressions and to elevate the securities industry's standards.

If this potential is to be realized, the Commission must play its part. There must be much more emphasis on the prevention of wrongdoing than there has been. Although there is much in securities regulation that can never be reduced to rigid black letter rule -- after all, courts have traditionally shied away from precise definitions of "fraud" for obvious reasons -- the Commission and its staff must be active, candid and forthright in working with the industry to define guidelines and rules of proper practice. Of course, the burden of complying with the law is always on the registrant. But registrants are entitled to know what the SEC thinks the law is.

To that challenge the present Commission is resolved to respond.

We think that the recent reorganization of the Commission will facilitate that response. Among the principal responsibilities of our new Division of Market Regulation are the formulation of clearer standards under the securities statutes and the rendition of greatly enhanced assistance to people who seek to comply with those statutes. For example, the Division will soon begin work on a model Compliance Manual

suggesting systems and procedures to assure compliance with the securities law. Regulation to be effective should be accompanied by education as well as compliance and enforcement. On inside information, trading practices, obligations to customers, research and recommendations, supervision of personnel and in other areas where more light is sorely needed we intend to do what we can to supply it -- with a minimum of heat.

Over the last several months the Commission has been reviewing its enforcement program to see what steps should be taken to refine, strengthen and improve it. We started with the Wells Committee Report submitted to us in June. In scope and quality it gives ample testimony to the knowledge, keen insights and diligence of its members. The Committee's 43 recommendations covered not only enforcement in the narrowest sense of investigations, criminal references and formal enforcement proceedings -- but also the Commission activities designed to identify emerging regulatory problems, come to grips with them through rulemaking or other action and educate the investment community to the standards we require.

Since receiving the report, we at the Commission have been sifting through these recommendations to determine in what manner and to what extent they should be implemented. I want to report to you today on the steps we have taken, those that we have under active consideration, and some that we have concluded would be inadvisable. As a first step toward focusing and strengthening our regulatory and enforcement capabilities we reorganized our operating divisions along functional lines. By concentrating regulatory and enforcement responsibilities into two separate divisions, we expect to get a sharper focus on both regulatory and enforcement tasks. By concentrating all enforcement under the direction of Irv Pollack and Stan Sporkin we expect to improve our identification of enforcement targets and selection of cases, refine our investigative techniques, make enforcement policies more consistent and provide better training and supervision for our younger personnel.

We are reordering our priorities so that more of our resources can be devoted to the collation of market

information and the surveillance of various securities markets. While the self-regulatory bodies have primary responsibility for surveillance of their respective markets, we do maintain oversight of these activities. Apart from intensification of our work in this area, we are now in the process of expanding ability to collect intelligence of all kinds relevant to securities fraud from all sources. We are a small agency and for us to achieve maximum effectiveness we have learned that it requires the cooperation of all organizations charged with responsibilities in this area. We are working to improving our programs to enlist the aid of the state and local prosecutory quthorities around the country in order to utilize their ability to spot and quickly act against securities violators. The program is a comprehensive one and embodies both a training of local officials and a dissemination of pertinent intelligence concerning illicit securities conduct and securities laws offenders.

We believe that it is important that we have some central depository for significant information on questionable

securities activities and that there be a mechanism for disseminating this information to all interested parties. Our interest is two-fold. First we believe it is extremely important to keep track of the chronic securities violators so that not only we but local officials, where they might be operating, become aware of these activities and are able to step in quickly and prevent the bilking of large numbers of investors. Our second effort is to detect at an early stage emerging illicit securities practices so that we can stamp them out -- and to stamp them out before they become nationwide problems. Unfortunately we have in the past too often been reacting to problems after they have attained sizeable proportions. Dealing with them at a late stage places a substanital impact on the resources of our agency, as well as resulting in large-scale losses to the investing public.

As a further part in this program we have developed communication channels with the other federal bodies and are expanding this to include other cooperating enforcement

authorities. Our efforts to date have been particularly successful in the organized crime area where we have been assisting the U. S. Attorneys and local prosecutors throughout the United States in bringing to trial persons affiliated with organized crime where their activities involve illegal securities activities.

While we have had recent important successes against pyramid schemes, off shore funds, spin offs and shell promotions, oil and gas promotions, real estate syndication and other areas, we still want to cope with new and old species of securities fraud much more quickly. It is hoped that with a comprehensive intelligence gathering and dissemination program will not only improve our own enforcement effort but also generate more enforcement assistance from local prosecutors increasingly concerned with white collar crime. We have already launched a pilot training and cooperation program along these lines with local authorities in Los Angeles and have been requested to duplicate it in San Francisco.

Our new operating structure will also allow us to devote more attention to the special problems of investment companies and investment advisers. Under the two 1940 Acts, as amended and supplemented by the 1970 amendments, the Commission is charged with extensive regulatory and supervisory responsibilities over these entities. The 1970 legislation required for the first time that advisers to investment companies register with us under the Investment Advisers Act and subjected them to the performance fee and other standards of that Act. Prior to our staff reorganization supervision over the activities of investment advisers was handled by the Division of Trading and Markets in conjunction with its surveillance of brokers and dealers. Because the Division of Corporate Regulation was primarily concerned with investment companies themselves and advisers to those companies were not required to register, an undesirable gap in our regulatory oversight became evident. Under our new structure the Division of Investment Company Regulation will have responsibility over both types of entity. We are confident that this will enhance our ability to oversee the activities of these important elements of the investment community and enable us to deal comprehensively with problems involving the economics, distribution methods and services in the growing money management field complexes.

The Enforcement Committee properly laid heavy stress on the importance of developing and improving our communication with participants in the securities industry in order to promote voluntary compliance. By making the requirements under the securities law clear and precise through regulations, guidelines, interpretative releases and statements of policy, the Commission can elevate professional standards in the industry and minimize unwitting violations. The Committee specifically recommended the publication periodically of a summary of significant interpretative positions taken by the staff and the increased use of compliance checklists which would be available to broker-dealers and other members of the investment community. As you know, in December 1970 the Commission in response to suggestions both by staff members and by persons outside the Commission determined to make publicly available all no-action and interpretative letters. While this policy has led to greater public awareness of current staff positions, it has also resulted in a mass of material being available which few practitioners have been able to digest. Rather than restrain the flow of these letters, we

have concluded that the benefits obtained by making them generally available can be significantly increased in two ways.

Our staff will soon begin to specifically designate those letters which may involve a matter not previously considered or a change in a previous staff position. Second, we are going to publish on a quarterly basis a summary of significant no-action or interpretative positions taken by the Division of Corporation Finance, the Division of Market Regulation and the Division of Investment Company Regulation during the preceeding three-month period. I am confident that by making these summaries available, we can promote greater awareness on the part of all persons affected by the securities laws of the standards to which they must adhere and at the same time substantially reduce the number of requests for no-action or interpretative letters that, if issued by the staff, would merely duplicate positions already published elsewhere.

I want to move now from steps we are taking to improve voluntary compliance to our actions in connection with our enforcement procedures.

On occasion, to aid in its deliberations, the Commission has requested a submission from counsel for the person whom the staff has recommended be charged with a violation. On other occasions briefs or other materials have been submitted by counsel apart from any request by the Commission in an effort to persuade us that a proceeding should not be brought. Thus an informal practice has developed under which the Commission sometimes does and sometimes does not consider material that presents the position of a person who may be charged with a violation.

The Enforcement Committee recommended that we formalize the practice so that consideration of these materials would become the rule rather than the exception,and they strongly urged that, in any event, we give public notice of availability of the opportunity to submit a statement as to why a proposed enforcement proceeding should not be instituted. This week we have announced informal procedure to implement this recommendation. Submissions of this kind can be particularly helpful to the Commission where the practice involved may have gained some acceptance in the industry or where there may be a

substantial difference of view on the proper interpretation of a statute or rule. These submissions are of doubtful value, however, where they purport to question the accuracy or sufficiency of the evidence obtained during the course of the staff investigation. In authorizing an enforcement proceeding the Commission does not attempt to resolve disputed issues of fact. If a person under investigation has evidence that he believes will demonstrate that a violation has not occurred, the proper procedure is to tender that information to the staff for its consideration. Under the procedure described in our release a person who believes that an enforcement proceeding should not be authorized by the Commission may make his views known by submitting a letter or memorandum to the appropriate Division Director or Regional Administrator and sending a copy to the staff members conducting the investigation. These papers will not be forwarded to the Commission until such time as a recommendation is made by the staff that an enforcement proceeding be commenced against that person. I believe that this procedure will achieve the objective of the committee recommendation by giving the

Commission the benefit of the views of the person being charged with a violation without detracting from our ability to act rapidly when the public interest requires it.

The Committee further recommended that the Commission adopt the practice of notifying a person who has been under investigation but against whom no further action is contemplated that the staff has completed its inquiry and has decided not to recommend a formal proceeding. Advice that an investigation has been concluded could be misleading, since a dormant investigation may be reactivated if new evidence turns up or some unforeseen development occurs. Also, any statement that an investigation has been concluded might be misconstrued as indicating that the persons investigated have been cleared by the Commission of any violation when in fact no determination one way or the other may have been made. Because of the difficulty of adopting a hard and fast rule that would be applicable in every case, the Commission has instructed its staff that in appropriate cases it may advise a person under inquiry that its formal investigation has been terminated.

The Committee also recommended that the Commission return to the practice that existed several years ago of permitting settlements to be negotiated by the staff before the matter is presented to the Commission for authorization of a proceeding. As you probably know, there has been considerable debate on the pros and cons of following one approach or the other. The power to authorize a formal enforcement proceeding, with all the consequence that that may entail for the private party concerned, is a responsibility vested in the Commission by statute. The decision whether or not to authorize a proceeding often involves a number of policy considerations that the Commission itself should make. In my view, the Commission should be in a position to weigh these considerations prior to the time the staff takes affirmative action, such as the negotiation of a settlement, which may be construed as indicating the Commission's position on the matter. Although a settlement generally is desirable from the point of view both of the Commission and the respondent since it avoids the necessity of a possible protracted proceeding, we have decided that for the time being at least it would be inadvisable to alter the existing practice in this area.

In response to several recommendations in the Enforcement Committee's Report, we have taken a hard look at the rules of practice in our administrative proceedings. We are conscious of the delays sometimes encountered in these proceedings and have determined to adopt several of the Committee's suggestions. Rule changes announced earlier this week are designed to encourage an early exchange between the staff and the respondent of the proof and legal theories which the parties intend to rely on at the hearing. We intend to achieve this by clarifying and enlarging the authority of our hearing officers. The Civil Service Commission recently called for the renaming of agency hearing examiners as administrative law judges, a step in the evolution of the role of these officers that we have supported. The changes which we have adopted in our practice rules will give these officers express authority to order pre-hearing discovery and, with the consent of the parties, to express their views on the merits of any proposed settlement. We have also given them the power to dismiss the proceedings at the conclusion of the presentation of the staff's evidence if it appears that the