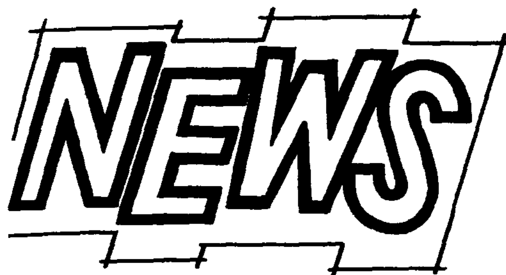

SECURITIES AND EXCHANGE COMMISSION
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PROFESSIONAL RESPONSIBILITY AND THE SECURITIES LAWS

An Address By

Ray Garrett, Jr., Chairman

Securities and Exchange Commission

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STATE BAR OF TEXAS

Hilton Palacio del Rio Hotel
San Antonio, Texas

I cannot quite claim to be a naturalized Texan, but I do have strong ties to the state. The U.S. Army can claim credit for starting it all. In early 1943, I was sent to Camp Swift, near Bastrop, some 35 miles east of Austin, to help form a new field artillery battalion. Naturally, we went to Austin whenever there were sufficient time and gasoline rationing coupons, and there I met my wife, whose family home was Rockdale, up in Milam County.

Virginia's mother still lives in Rockdale, and we will be visiting her there tomorrow evening. Members of Virginia's family live in Houston and Corpus Christi. One of our daughters married into a family in Kingsville. All of this has given us occasion for many happy days in Texas, including dove hunting around Rockdale and quail shooting on the King Ranch. My efforts in this regard characteristically do more to increase the revenues of the manufacturers of shells than to decrease the supply of flying wildlife, but they have provided great moments. I have never been quite sure why I didn't settle here when I returned from the war. Bad judgment and lack of foresight, I imagine.

But even though I think I know Texas and Texans pretty well, I was surprised to learn that your bar association would be meeting on the 4th of July. I realize, now, that this has been your custom, but it seemed somehow a bit inconsistent with the heroic patriotism of your soldiers -- A & M supplied more field artillery officers in World War II than any other institution, and they were magnificent -- and with the way the day is celebrated up in Rockdale with a great barbecue, a local rodeo, and a good, tub-thumping, run-up-the-flag oration by some local political leader under a huge tent fly. I can't remember anything any of those fellows said as they pointed with pride and viewed with alarm, but I can remember well their organ tones rolling across the sun-baked fields as we sat there sipping a Pearl, swatting flies, or dozing off -- conscious that we were somehow doing our duty to the day.

Virginia, knowing better, has set my mind at ease. It's really all right to talk law on the 4th of July. After all, she said, it isn't as though it were San Jacinto Day. Indeed it's not. So if you are willing to sit inside for these few minutes and listen to me, and to Carl, I am quite happy to be here.

I am accused by some of the staff of the Commission of giving 4th of July speeches throughout the year when I get wound up, as I occasionally do, in reminding people that the principles of the federal securities laws are central to the maintenance of our free enterprise system. They are devoted to fostering a system which permits the allocation of our capital resources to be determined by the free and informed decisions of the multitude of investors, not by government dictation except indirectly through tax and fiscal monetary policy. And this system can survive, as I think we all know and believe, only if investors believe that they are being fully informed and fairly treated.

This is a profoundly conservative policy, fully consistent with the principles announced in the Declaration of Independence, but the price of preserving it, like liberty itself, is eternal vigilance. We must bear in mind that the realistic alternative to our present system of securities regulation is not less regulation but more. If investors will not supply the capital for industrial growth because of distrust of our corporate management and securities markets, then the government will. One can observe this in countries

where private sources of adequate capital are not available. The demands for industrial expansion in many critical areas are too strong to be left unsatisfied for very long.

Revisionist criticism of the whole system has gained a new popularity in recent years. There have been studies tending to show that fundamental analysis is of little value in selecting investments -- one does as well with a dart board or some other random walk or perhaps chartist device. The argument then runs that if fundamental analysis is essentially useless, the requirement for all of this elaborate disclosure cannot be justified by cost-benefit analysis. One critic of this school wrote a whole book a few years ago to argue that trading on inside information by corporate officers is socially and economically desirable -- the people on the other side of the insider's market transactions are not really hurt and the corporate officers deserve the reward of market advantage.

Interesting as some of these studies and arguments are -- and the re-examination of fundamental postulates has a refreshing quality -- I cannot believe that they will prevail in the Congress, or, needless to say, at the Commission. While

changes and improvements in our present system are certain to occur from time to time, and are desirable, I repeat that the alternative to our system is not no system but something far more oppressive with respect to individual decision-making in our capital markets. If this is true, then we all have an interest in making our system work, however much we may disagree on specific matters.

Parenthetically, we at the Commission are also well aware that a free market capital system requires more than fairness and full disclosure. Many informed and concerned persons are calling attention to the unprecedented demands for new capital by U.S. industry over the next decade, and the dismal prospects of raising especially the equity component of these estimated several trillions of dollars, unless equity investments are made more attractive to investors and the sale of stock to companies. While the low multiples at which all but the glamour stocks have been trading -- and recently, especially after this week, at which even the glamour stocks are trading -- was first perceived to make the raising of equity capital virtually impossible for smaller, less well known, companies, it is now apparent that the problem is becoming industry-wide.

I'm not going to take the time this afternoon to add my own efforts to analyze the causes of this market depression. I accept the fact that they go well beyond the reach of full and fair disclosure. But there is good reason to believe that trust in our markets has something to do with it -- at least so I am told by many people in various parts of the country. Of course, some of this mistrust is not of issuers themselves but of broker-dealers, which is a somewhat different matter.

I also know that some of this mistrust is based on nothing more than the fact that many persons have lost a lot of money in the stock market in the last few years. This, without more, is quite enough to discourage early re-entry. However, there is also a widespread propensity, when things don't work out the way we would like them to, to suspect chicanery. Despite all warnings and, indeed, intellectual awareness of the sad fact that stock markets go down as well as up, when they go down and stay down, there is an emotional urge to seek a villain, some sort of dirty conspiracy by a vague "they." To the extent that we can truthfully convince people that there is no sinister "they" rigging the market to fleece the small investor, we should encourage his return.

This is not easy. There is dramatic evidence to the contrary, in the minds of many people. They point to the distressing list of major frauds or cases of mismanagement that have filled our headlines in recent years -- Equity Funding, Sharpstown, Four Seasons, Penn Central and, very recently, Home-Stake Production and the wine fraud in the Washington area -- and they ask, how can you tell me that I can get a fair shake in the stock market? Business is full of crooks, and your enforcement program isn't worth a damn.

In fact, the sharply divergent evaluations of our enforcement efforts among the many different groups I talk with is quite dramatic. When I meet with business executives, accountants, and securities lawyers, it is clear that they find our enforcement efforts are too tough. We sue too many people who didn't really do anything wrong. Even more, our rhetoric is too purple. We are told that if Al Sommer and I keep making speeches about fraud in business and aiding and abetting by accountants and lawyers, naturally the ordinary citizen is going to think crooked managers and professionals are typical and the stock markets are therefore not to be trusted.

But when I get together with other groups and general news reporters, quite a different picture comes through. What good is our system of securities regulation and your enforcement program, they ask, if it permitted innocent investors -- who trusted our capital markets -- to lose hundreds of millions of dollars in Equity Funding before you caught it. And when you do get around to suing some malefactor who has caused all this cheating of the public, you slap his wrist by agreeing to a consent decree in which the crook merely promises not to do it again. In the opinion of much of the public, our full disclosure system is not working very well and our enforcement program is obviously inadequate. It is disturbing to be asked what are we doing to assure that there won't be another Equity Funding and have to admit that, whatever our efforts, there is no assurance it won't happen again.

Our reliance on voluntary compliance is not just a philosophical proposition -- it is reflected in dollars and people. Our present authorized staff strength is 1919, the largest in our 40 year history. Of these, approximately 27%, or 518 people, are devoted to disclosure -- the policing and processing of material under the '33, '34 and '40 Acts.

And about 34%, or 652 people, are devoted to fraud prevention -- that is, enforcement. But this doesn't mean we have 652 cops on the beat -- that number includes enforcement's full administrative slice. We have, at best, half that number of lawyers and investigators, nation-wide. Bob Watson, our Fort Worth Regional Administrator, has 15 professionals devoted to investigation and enforcement. His region includes Texas, Oklahoma, Kansas, Arkansas and Western Louisiana. Our total budget for the fiscal year just closed was $36,000,000, also the largest ever.

As most of you surely know, we process filed materials almost exclusively by office review. The examiner and the staff accountant sit at their desks in Washington and read what comes in for formal compliance with our forms and to see if it makes sense to them. They have information in our files and library to check on the plausibility of some statements, and they can and do ask the registrant for additional information and documentation. The good ones become pretty shrewd and hard to fool, but it can be done. Why? Because the staff does not make its own field examination or its own audit. This is what we mean by the legend that the Commission has not passed on the adequacy or accuracy of a prospectus.

It was urged in 1933 that the federal government should audit all registrants. It was a fight to persuade Congress to rely on independent public accountants. Thank God, the latter view prevailed. Think what it would mean if we had to maintain a staff actually to audit the over 9,000 companies now registered under the '34 Act. Not only would this impose a heavy burden on the taxpayer, it would also probably impose an impossible administrative burden to maintain competence and honesty. It would also put the government in a funny position if the audit later proved to be deficient.

But don't think the idea is dead. A prominent Senator has, within the last year, urged that the SEC staff regularly audit all defense contractors. We have resisted the idea. This is the sort of thing I have in mind when I say that the only realistic alternative to our present system is more and heavier regulation, not less. If there should develop a deep and widespread loss of faith in our present system of audit by independent public accountants, the solution is not going to be simply to forget about an audit and rely on company figures. The solution is going to be a government audit.

So it is with our enforcement work. To the surprise of some members of Congress -- whose surprise surprises me -- and of the general public, we do not even pretend to examine, investigate or even spot check at random all '34 Act registrants. We do not begin to have the manpower for that, and we don't want it. Except for investment companies, investment advisers and broker-dealers, we move in only for cause -- meaning we have some reason to suspect that something is amiss, based upon examining a filed document, a news item, market activity, or a tip.

I go into this only to emphasize the degree to which we do rely, and want to continue to rely, on voluntary compliance.

What does all this have to do with professional responsibility? A great deal -- and I realize when you asked me to talk about professional responsibility you probably really meant "how many lawyers are we going to sue, and for what?"

We know, and you know, the key roles that professionals -- lawyers and accountants -- play in business life in general and particularly in matters concerning compliance with the securities laws. In fact, any well organized scheme of

violation almost surely involves cooperative participation by such professionals. Simply as a matter of enforcement technique, if we can induce the professionals to be less cooperative, we will prevent many violations that would otherwise occur. And what are the available means to bring this about? Exhortation, injunctive actions and Rule 2(e) disbarment proceedings. The Commission has adopted a conscious program to improve professional performance by the use of these means. Even if certain businessmen are not moved to full compliance by ethical considerations or the fear of punishment, they will do far less damage if their lawyers and accountants won't play. This is our policy objective. But, of course, we must seek it only through already supportable means as provided by law.

You will note that I did not include as part of our objective providing an additional source of compensation for injured investors, but we recognize that this is an inescapable consequence. When we bring what we regard as essentially a disciplinary action against a professional, we know that plaintiffs' actions for money damages will probably not be far behind.

This matter of professional liability for money damages is still one of dispute and uncertainty. When the Ultramares barrier was broken with respect to accountants, it opened the way for truly horrendous damages assessable against professionals, and even the settlements agreed to by some major accounting firms have been in quite large amounts -- $1,000,000 or more in some instances. Even the insurance approach, so attractive a means of spreading the risk in other areas, is not available so long as the carriers exclude liabilities arising under the federal securities laws, including Rule 10b-5.

I don't see the answer clearly. Ultramares was bad law, or at least an anachronism, in defining the professional duty of accountants in certifying the financial statements of publicly-held companies. In considering our enforcement actions, we think it quite clear that the accountant's responsibility reaches to public investors and is not satisfied simply by the complicity or non-objection of the management of the issuer. But I don't think Judge Cardozo was fooling himself or lacking in insight -- he seldom was. He simply thought that opening up the exposure of accountants to compensate public investors for their losses would create a quantum of liability wholly disproportionate to the fee received and to the accountant's resources.

I am still inclined to agree with Cardozo on the liability aspect, but, frankly, I don't know what to do about it. While there is not unanimity within the Commission's ranks on the subject, I am not pleased with the prospect of lawyers and accountants being subjected to millions of dollars of liability -- a sort of nuclear overkill, at least in the absence of insurance -- for mistakes in transactions for fees measured in thousands of dollars. But I think we must attack the liability question directly -- possibly legislatively or through group insurance measures -- not by denying the professionals' responsibility.

Of course, I loaded my statement by speaking of millions of dollars of liability for mistakes. I don't think it is a fair characterization of the Commission's actions or statements to say that we are taking enforcement action for simple mistakes. In enforcement actions, if we seek an injunction, unless the professional is also a principal -- which should never be the case as to independent accountants but may be so as to lawyers -- we must proceed on the theory of aiding and abetting. Aiding and abetting is most clearly established as a matter of law where it is proved that the defendant knowingly and intentionally participated in the violation. But this sort of *mens rea* is

frequently difficult to establish forensically and nasty to assert. For this reason, we have argued, successfully, that negligence is sufficient to constitute aiding and abetting. Negligence in the sense that we don't have to allege and prove state of mind, but negligence to the degree that the accountants at least knew they weren't following adequate professional procedures to guard against the commission of a violation by their clients. In fact, most actions against accountants have been directed at their auditing procedures, not their judgment in accepting accountant principles adopted by their clients.

With respect to lawyers, we are also concerned primarily with their knowing or careless and indifferent compliance with their clients' non-compliance with our laws. We have not acted against lawyers who have simply not done a lawyer-like job in research, etc. We have not attacked simple professional incompetence. We might encounter a case in which the lawyer was such an inept professional technician that he should be held responsible, but that is not the kind of case we are worried about. What kind of case are we worried about?

We are worried about the lawyer who knows the disclosures being made are false or incomplete, or where he has good reason to know they might be and fails to check, out of sheer indifference

or because he consciously prefers to remain ignorant. We are worried in general about the lawyer who is retained to represent the corporation, paid with corporate funds, but regards himself as primarily devoted to the personal welfare of the chief executive officer. In fact, client identification is the key to much of the difficulty we perceive.

Our own Code of Professional Responsibility says that a lawyer retained to represent a corporation owes his loyalty to the corporation -- not to the individual officers or directors or even shareholders, but to the legal abstraction. Even this, I realize, runs against human nature. It is in fact the officers, or the chief executive officer, who retains the lawyer and agrees to his fee and can fire him. Human nature says he is the man to be pleased. But if canons of ethics did not run counter to human nature, they would not be necessary. We don't believe that a lawyer representing a corporation is performing his duty when he cooperates, actively or passively, in misinforming shareholders or public investors because that is the game the officers want to play.

As in all other areas of law enforcement, it is important, if not essential, that the persons affected believe the law is just and is fairly and impartially enforced. I don't mean that each

defendant at the time he is being sued should have the detached attitude of Socrates. That would be asking too much. But I do mean that it is important to us that the bar as a whole believe that we are acting fairly and in accordance with sound policy with respect to lawyers, as well as in other respects. We don't want the bar to think we are cockeyed or vindictive or intent upon destroying the profession. Four of our five commissioners are lawyers. Most of the staff persons involved are lawyers. I, at least, expect to return to the practice at an appropriate time and I want my brethren to be willing to speak to me.

I was still in practice two years or so ago when the Commission filed its complaint in National Student Marketing. One of the defendant law firms had offices just down the street from me in Chicago, and I knew and respected the principal partner involved. I can tell you that, when I first heard the news, the chill that ran down my back was at least as icy as the one that ran down yours.

It reminded me of a remark of Milton Freeman, a Washington lawyer, at an ABA National Institute on the famous Bar Chris case, when that case was still fresh. Milt said, "The real lesson of Bar Chris is clear. Don't work on the registration of debentures for a company that goes bankrupt within a year!"

I was also reminded of my initial reaction to the National Student Marketing case when I had dinner with the heads of some 30 or more large companies on the West Coast. I made some profound remarks about the capital and other problems of the securities industry and the looming problems of capital adequacy for U.S. industry at large. When I was through, it was apparent that they were interested in other matters -- like why were we trying to stick our cotton-picking nose into their annual reports to shareholders, and if the SEC wants every shareholder to have a 10-K, why doesn't the government pay for it? It was that kind of evening.

My dinner companions also expressed some interest in the Commission's enforcement activities. One gentleman was particularly critical of one of our cases in which several years had elapsed between the time when the alleged unlawful activities had occurred, and the date on which the Commission

filed its complaint. I agreed that any delay in bringing our cases is unfortunate, but pointed out that it often takes many months to obtain information and accumulate sufficient details for the Commission to consider before determining who to sue and on what basis. My friend responded, "See! It's all second guessing. A policeman is in a dark alley and sees a figure coming at him. He has an instant to make a decision. He decides to shoot and kills the man. Now you spend a year or whatever trying to decide whether he made the right decision." I could only answer that we weren't suing anyone for an instantaneous decision made in a dark alley. We were complaining about things done or not done over a period of years. But I am sure my friend still describes our action in his terms, and I think this is terribly unfortunate. It generates unnecessary fear, particularly among the business and financial community, and an attitude of hostility toward the SEC and toward government.

We have had meetings with members of the American Institute of Certified Public Accountants on enforcement policy and procedures and I believe they are proving constructive to both sides. Some of the heads of major firms come in with attitudes like that of my dinner companion. Whenever a company gets in financial difficulty,

sue the accountants. Second-guess dark alley decisions. And, so on. We observed that when a publicly-held company suddenly goes belly-up to the surprise of investors generally, there is some suspicion that the published financial statements and information in the period preceding the public recognition of debacle may not have fairly presented the situation and the way things were going, but we certainly weren't suing for wrong guesses in dark alleys.

I invited the group to audit, in a sense, our enforcement actions against accountants. I reminded them that they had to look at the cases as they looked to us at the time we had to decide whether to sue or not, not as they ultimately evolved in litigation. If they were interested, our staff could furnish them with all of the information that we had before us at the times of decision, to the extent it could properly be divulged, and would explain our reasoning. After they had done this, we could meet again and go over their findings. I hope they go forward with this, but I think the results can be informative to all of us.

Something of the same might be fruitful with respect to lawyers. If so, a subcommittee of the ABA's Committee on Federal Regulation of Securities would seem the appropriate vehicle, or

some other committee of the Section of Corporation, Banking and Business Law. Of course, there aren't as many completed cases against lawyers to work on, but we could make a start.

I have skimmed over a host of more technical questions, and I am aware of this. I think I can count on Carl Schneider to explore some of these, and we can get into them during the question period.

Now I yield to Carl.