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SETTING THE COURSE FOR THE SEC'S RELATIONSHIP WITH ITS PRACTISING BAR

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> "One of the great attributes of this nation is it learns from its mistakes. . . . If the lessons are learned well, we will have gone a long way in preventing these abusive activities from recurring in the future."

That is a portion of the final paragraph of the Opinion rendered last August by Judge Stanley Sporkin, the distinguished former Director of the SEC's Division of Enforcement, in Lincoln S & L v. Wall, Director of the Office of Thrift Supervision.[1]

In the matter of the savings and loan fiasco, we as government officials are learning very well, with the apparent approbation of the citizenry and their elected representatives -- and we are taking substantial steps to prevent recurrence not only in the sphere of S&Ls but with respect to all depository institutions, and not only with respect to depository institutions but throughout the financial markets generally. In fact, in 1990-91, federal government officials seem to be dominated by the need to demonstrate that, whatever our particular sphere of responsibility, we'll see to it that nothing like the conduct underlying the S&L fiasco has the opportunity to germinate in the particular area committed to our concern.

Item: in the administration of FIRREA,[2] the chief counsel of the Office of Thrift Supervision has recently articulated the interest of the federal government (as insurer) in the soundness of insured depository institutions to be "the paramount interest"[3] -- to which the institution's fiduciaries (including, of course, its lawyers) owe their ultimate allegiance.

Item: in the Lincoln opinion Judge Sporkin stressed his concern that the top officer of Lincoln "and those individuals working with him" [including, of course, its lawyers] "at times impeded the regulatory authorities" and "thwart[ed] and frustrate[d] the regulatory process"

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1 Lincoln S & L v. Wall, Director of the Office of Thrift Supervision, 743 F. Supp. 901, 921 (D.D.C. 1990) (footnote omitted).

2 Financial Institutions Reform, Recovery and Enforcement Act of 1989, P.L. 101-73, 103 Stat. 183 (1989) ("FIRREA").

3 Weinstein, Remarks Delivered at Southern Methodist University (Sept. 13, 1990), reprinted in 55 Banking Rept. (BNA) 510 (Sept. 24, 1990).

via "tactics ... [that] delayed the [regulators] from taking prompt action."[4] (I can assume, for present purposes, that His Honor would have had ample reason, on an appropriate record, to write even more damningly about the particular individuals, but it is the quoted language that draws my attention.)

Item: the SEC in its recent legislative requests has justified some of its proposals in part, and some in whole, by pointing to Congressional grants of new authority to the bank regulatory agencies in FIRREA.[5] For example, our broad new cease and desist authority is available against any person or entity (not merely regulated or registered persons or even persons who were required to be registered or regulated) engaged in conduct found to be violative of the federal securities laws, and is also available against all other persons (including, of course, their lawyers) who "contribute"[6] to the violative conduct.

Item: the Congress, in the Committee Reports accompanying the Enforcement Remedies Act, has pointed to its prior FIRREA responses, "outraged by widespread fraud,"[7] as justification for bestowing on the SEC new authority to levy civil fines on regulated persons and entities that violate the federal securities laws and on those (including, of course, their lawyers) who "aided, abetted, <u>counseled</u>, commanded, induced or procured"[8] the violations. (emphasis my own)

One is disposed to wonder whether in the learning of the lessons of the immediate S&L crisis we are unawaredly surrendering privileges and protections that took long-term struggle to attain,

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4 <u>Lincoln</u>, 743 F. Supp. at 920-1 (footnote omitted).

5 <u>See</u>, <u>e.g.</u>, Testimony of Richard C. Breeden, Chairman of the Securities and Exchange Commission, Before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, United States Senate, Concerning S. 647, at 4, 6, 15 n.15, 32 (Feb. 1, 1990).

6 Securities Exchange Act § 21C(a), 15 U.S.C. § 78uC(a), added by § 203 of the Securities Enforcement Remedies and Penny Stock Reform Act, P.L. 101-429, 104 Stat. 931 (1990) ("Enforcement Remedies Act"). Parallel provisions were also added to the Securities Act, the Investment Advisers Act and the Investment Company Act.

7 H.R. Rep. 101-616, 101st Cong., 2d Sess. 16 (1990); Sen. Rep. 101-337, 101st Cong., 2d Sess. 9 (1990).

8 Enforcement Remedies Act, <u>supra</u> n.6, §§ 201, 301 and 401.

and the loss of which would be far more costly to Americans than is the failure of the regulatory oversight system for thrift institutions. One is even disposed to wonder whether we regulators, as "honest and dedicated" as we are (to use Judge Sporkin's words),[9] haven't forgotten that the very power delegated to us for the particular defense of the governed -- whether in preventing fires or in detecting espionage or in combatting securities fraud -- is a power against which the law-abiding citizen requires protection -- and that we don't know for sure who is law-abiding and who is a violator on the basis of our instincts alone. (Heaven knows, life would be a lot easier if we did have that knowledge.)

To translate these general musings into something worthwhile, I'll take two examples that the graybeards among you will remember well.

Example 1: the virtual proscription by the SEC of non-institutional private placements in the early '70s.

The preceding years had seen the expansion of venture-capital-type placements to individual investors. Practitioners had been and were doing their best to deduce, from the law and lore of earlier decades, legal justifications for a species of §4(2) offering that, within the broad parameters of Ralston Purina,[10] would legitimize the offering of new-venture start-up securities to the entrepreneurs themselves, to their co-workers, to prospective customers and suppliers, and to some friends/neighbors/acquaintances with money to risk and the faith to do so.[11] The bulk of all clients -- and the bulk of all lawyers -- engaged in these transactions were honest and dutiful, and sincerely intended to comply with the federal securities laws (to the extent that they knew there were federal securities laws). In the courts, there was an occasional encouraging opinion[12] amid a flock of decisions finding violation of §5 primarily on burden-of-proof grounds; the defendant had been unable to circumscribe the relevant group of

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9 Lincoln, 743 F. Supp. at 921 n.33.

10 S.E.C. v. Ralston Purina Co., 346 U.S. 119 (1953).

11 For a retrospective view, see Schneider, Section 4(2) and "Statutory Law", Sixth Annual Institute on Securities Regulation (PLI) 157 (1975).

12 See Livens v. William D. Witter, Inc., 374 F. Supp. 1104 (D. Mass. 1974).

offerees.[13]

At the SEC, against a mindset that exemptions from the registration requirements are to be construed narrowly, the grist for the daily mill was comprised of a series of scam artists piggybacking on the new legal justifications -- and obviously scams are to be met with every weapon in the Commission's arsenal. So, when a flim-flam peddling shares of a company named Continental Tobacco appeared on the scene, the Fifth Circuit was presented with a brief propounding the position, by the Commission out of Ralston, that only a relationship to the issuer "tantamount to that of an 'insider'"[14] would meet the prerequisites of the Ralston-required ability to "fend for themselves."[15]

The SEC was monofocussed: in the face of the evident evil, stress the §5 violation -- make it so difficult to achieve § 4(2) status that the scams can be stopped and the savings of the innocent can be protected. As to the effect on legitimate capital-raising transactions that were also caught short by the newly articulated standard, they were just not the SEC's concern; besides, the people involved could always register (which is after all what the Act contemplates) or they could rely on the Commission's sense of what should be prosecuted and what shouldn't. And, by the bye, as to the lawyers out there structuring and giving opinions on these transactions, the good ones -- the conscientious ones -- could be coopted as an auxiliary police force to help administer the law.

Example 2: the virtual rupture by the SEC of issuer-analyst communications in the early '80s.

The preceding years had seen the blossoming of awareness on the part of corporate press-relations and stockholder-relations officials of their responsibility to deal even-handedly with analysts (whether buy-side or sell-side) and with the mass of public securityholders. Practitioners had been and were doing their best to deduce, from the law and lore of SEC complaints, SEC opinions and the speeches and responses of SEC senior staff, the legal analysis that, within the broad

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13 See, e.g., Lively v. Hirschfeld, 440 F.2d 631 (10th Cir. 1971).

14 Brief for Appellant Securities and Exchange Commission at 28, S.E.C. v. Continental Tobacco Company of South Carolina, Inc., 463 F.2d 137 (5th Cir. 1972).

15 S.E.C. v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

parameters of Dirks,[16] would legitimize both the frequent day-to-day analyst-to-corporate-officer inquiries and the occasional casual corporate-executive-to-analyst conversations that merely acknowledge the special insight of the particular analyst into the operations of the issuer itself or of its industry.[17] The bulk of all clients -- and the bulk of all lawyers -- concerned with these conversations were honest and dutiful, and sincerely intended to comply with the federal securities laws (to the extent that they could ascertain what were the requirements of those laws). In the courts, what Professor Loss calls the Supreme Court's "paean to the analyst"[18] stood apart from the spate of decisions that had each found a violation of § 10(b) primarily because the disclosure had gone beyond "interstices in analysis":[19] performance of the analytical function was to be promoted, but each particular corporate-official-and-analyst pair had crossed the permissible line by selective disclosure of material non-public information.

At the SEC, against a mindset that disclosure without general dissemination evokes a near-presumption of insider tipping, the grist for the daily mill was comprised of a series of deliberate tippers (including but by no means limited to irresponsible corporate officers) seeking to take advantage of any chink afforded by Chiarella or Dirks -- and obviously tipping in general is to be met with every weapon in the Commission's arsenal. So, whenever the context of an alleged tip involved corporate officials' conversations with analysts, the relevant district court was presented with a complaint seeking to reinforce the perception, articulated by the Second Circuit in Bausch & Lomb, that corporate executives with an eye to avoiding SEC prosecution should treat every conversation with an analyst like a "fencing match conducted on a tightrope".[20]

Again, the SEC was monofocussed: in the face of the

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16 Dirks v. S.E.C., 463 U.S. 646 (1983).

17 For a retrospective view, see Phillips, Insider Trading After Dirks, 16 Rev. of Secs. Reg. 841 (1983).

18 Loss, Fundamentals of Securities Regulation 769 (2d Ed. 1988).

19 Dirks v. S.E.C., 463 U.S. 646, 658 n.17 (1983) (quoting from the Brief for the S.E.C.).

20 S.E.C. v. Bausch & Lomb, Inc., 565 F.2d 8, 8-9 (2d Cir. 1977).

evident evil, stress the § 10(b) violation -- make it so difficult to avoid the monetary, psychic and publicity costs of investigation and prosecution that insider tipping can be stopped and simultaneous disclosure of all information to the public can be assured. As to the effect on legitimate disclosure-productive analytical inquiries and corporate responses that were suppressed by reinforcement of the "fencing match ... on a tightrope" perception, they were just not the SEC's concern; besides, the people involved could always publicize any questionably-material disclosures (public disclosure is after all what the Act prefers) or they could rely on the Commission's sense of what should be prosecuted and what shouldn't. And, by the bye, as to the lawyers out there overseeing and giving guidance on those conversations, the good ones -- the conscientious ones -- could be coopted as an auxiliary police force to help administer the law.

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"Members of this Commission [goes the oft-quoted footnote] have pointed out time and time again that the task of enforcing the securities laws rests in overwhelming measure on the bar's shoulders. . . . [T]his Commission with its small staff, limited resources, and onerous tasks is peculiarly dependent on the probity and the diligence of the professionals who practice before it. . . . [A securities lawyer] doesn't work in courtrooms where the pressure of vigilant adversaries and ale[r]t judges checks him [or her, but rather works in an] office where he [or she] prepares. . . opinions of counsel, and other documents. . . . This is a field where unscrupulous lawyers can inflict irreparable harm. . . . Hence we are under a duty to hold our bar [-- both the scrupulous and the unscrupulous--] to appropriately rigorous standards of professional honor." (emphasis added)[21]

I know that, read in full and placed in context, the subject matter of the Emanuel Fields footnote can be limited to the process of eliciting formal disclosure, but the attitudinal bias is clear -- a bias elicited by and directed at the scams and Ponzi schemes and tips and manipulations that are in fact the grist for the SEC's daily mill. So it is not surprising that the securities Bar, naive in its own remoteness from the scams and tips that the SEC saw every day and anxious to retain a great distance between itself and the few unscrupulous practitioners, quietly explored ways to ameliorate the Commission's Continental Tobacco and Bausch & Lomb positions and loudly applauded its own enlistment in the SEC's version of a sheriff's posse.

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[21] In the Matter of Emanuel Fields, 45 S.E.C. 262, 266 n. 20 (1973).

The intervening years have seen no sea-change in any of this, just a gradual rising of the tides.

- The SEC as always has been dominated by its enforcement role -- the scams and Ponzi schemes and tips and manipulations don't grow less attractive to con artists or get-rich-quick swindlers, and unhappily (although not unprecedentedly) some well-known members of the Wall Street community have engaged in flim-flammery and tipping of a more subtle but not less destructive kind.

- The SEC as a result has taken interpretive and litigating positions, e.g., on disclosure matters as basic as the definition of "materiality," on substantive questions as central as the extent of "duties" any breach of which will transmute innocent trading into insider trading, and on liability issues as determinative as the scope of "aiding and abetting" and "reckless disregard" -- positions that, if literally applied across-the-board, would bring virtually all capital-raising transactions and virtually all informal disclosure practices to a halt, and would subject virtually all but the most casual of securities traders to judicial injunction.

- The Bar, accepting what former Commissioner Sommer dubbed its "passkey"[22] role and concomitant responsibilities, has stretched ever further to reconcile its primal obligations (to give legitimate advice to its clients responsive to the professional requirements of competence and zealousness) with its evolving role as auxiliary enforcer and its growing concern that legal advice with which the SEC disagrees will not only expose the client but will expose the advising lawyer as well.

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Do the following five sentences sound familiar?

> "[T]he Committee does not intend to subject attorneys to agency enforcement actions for those good faith activities falling within the traditional attorney-client relationship. Specifically, providing advice in good faith to a client. . ., by itself, should not lead to an enforcement action. For example, an attorney who provides legal advice or other legal services in good faith to a [client] may counsel the [client] that a particular course of action is lawfully justifiable,

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22 Sommer, "The Emerging Responsibilities of the Securities Lawyer", reprinted in [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,631, at 83,689.

> because of unclear law or regulations or because the [client] may succeed on a legal challenge to the law or regulation during an administrative or judicial proceeding. That such advice or services may conflict with the position of the Federal [regulatory] agency and that a court may determine that position to be wrong would not usually or necessarily show bad faith. Also, the legal advice provided under these circumstances would probably not be considered 'counseling' a violation of law. . . ."[23]

Perhaps they are familiar because we all take for granted that their substance is true. But it took a petition by prominent banking lawyers and specific repetition by a Congressional Committee in a formal Committee Report to make it true: the House Banking Committee Report accompanying FIRREA last year. Under FIRREA, as many of you know, an "institution-affiliated party" may be subjected to cease and desist orders and may be sanctioned, fined, barred, etc. for prohibited practices and violations of law,[24] and an "institution-affiliated party" can include an attorney "who knowingly or recklessly participates in" a violation of law, a breach of fiduciary duty, or an unsafe/unsound practice.[25]

By contrast, under the SEC's new Enforcement Remedies Act, though nowhere mentioned in the Committee Reports, the extent of the cease and desist authority encompasses "any person that is, was or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to the violation",[26] and the applicability of the money penalty authority in administrative proceedings encompasses any regulated person who "has wilfully aided, abetted, counseled, commanded, induced or procured a violation by any other person".[27] But the Enforcement Remedies Act does not have language, anywhere in the bill, in the reports, in the materials sent by the SEC to Congress, or in the ABA submissions, that limits the SEC's use of these new powers against lawyers acting as advisers or opining to their clients. Nor do I think anyone ought to be overly sanguine in expecting the Commission to act as if knowing or at least reckless participation in a violation is required for prosecution of a lawyer; the statutory words

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23 H.R. Rep. 101-54 Part I, 101st Cong., 1st Sess. 467 (1989).

24 FIRREA, supra n.2, §§ 901(b)(1), 902(a) and 903(a).

25 Id., at § 204(a).

26 Enforcement Remedies Act, supra n.6, § 203.

27 Id., at § 202(a).

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<u>all</u> point the other way.

The SEC <u>knows</u> what attenuated meanings

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have been given by the courts. The SEC <u>knows</u> how much deference in the interpretation of its own new statutory powers the courts are commanded to give it by the Supreme Court's <u>Chevron</u> decision.[28] The SEC <u>knows</u> how much bang it can get for its buck when it prosecutes, or threatens to prosecute, lawyers.

So when you see in <u>The Washington Post</u>[29] that SEC Chairman Breeden has said, "The SEC simply has no choice [but to expand its oversight]. That's our job." -- don't doubt that he's talking to you.

And when you read in BNA[30] that Chairman Breeden has said that law firms, or at least the responsible members of law firms, may be charged as controlling persons -- though as yet none has been -- don't doubt that he's talking to your partners-at-law.

And when you see that Judge Sporkin has written in his <u>Lincoln Savings</u> opinion that "this Court believes far too little scrutiny has been focussed on the private sector. . . . Here it is clear the private sector was not willing to cooperate with the public oversight regulators. . . ." "Perhaps what is necessary is some due diligence on the part of counsel to assure that the steps it has been asked to take are not designed to frustrate the public interest"[31] -- don't doubt that he's talking to your colleagues in this Bar Association.

For I put it to you that we are all being asked to learn <u>too well</u> the immediate lessons of the savings and loan fiasco, namely, that unscrupulous individuals surrounded by rationalizing accomplices and served by lawyers who are seen as no more than hired verbal gunslingers, necessarily evoke governmental retaliation by way of discretionary authority to identify the evildoers, to eliminate their ability to harm their fellow

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28 <u>Chevron, U.S.A., Inc. v. Natural Resources Defense Council</u>, 467 U.S. 837 (1984).

29 Day, "Tough Cop at the SEC", <u>The Washington Post</u>, Oct. 14, 1990, at H1, col. 2.

30 "SEC Finding Law Firms Lack Safeguards to Deter Insider Trading, Breeden Says", 5 Corporate Counsel Weekly (BNA) No. 39, at 3, 4 (1990).

31 <u>Lincoln</u>, 743 F. Supp. at 921 and 922 n.31.

citizens, to deprive them of their defensive capacities, and ultimately to punish them to the full extent of the law. We are being asked as well to forget that the protections abused by those evildoers also protect every other citizen of this republic, to forget that discretionary authority vested in agencies of government has always sought to cover itself in the cloak of "protection of the citizenry" -- and has been fought by the yeomanry of common law countries for near 800 years, persistently, except during those brief periods (unlike today) when the exigencies of strife potentially destructive of the whole social fabric were perceptible to the vast majority. We -- I as well as you -- are being asked to deliver the securities Bar into a form of regulatory cooptation that far exceeds the Bar's admitted responsibility to uphold the law.

Now, no lawyer, any more than any other citizen, is immune to liability if he or she becomes an active participant in formulating policy decisions intended to violate the law. (I take that truism from a recent Ninth Circuit decision in a wholly different area of the law, applicable here and elsewhere nevertheless.[32]) But I disagree with those who call on lawyers to put clients' interests second to the "public interest" as the "public interest" may from time to time be interpreted, rightly more often but sometimes wrongly -- and always through the looking glass of the scams and schemes that are the grist for the agency's daily mill -- by a nonaccountable fourth-branch regulatory agency. After all, while every lawyer's responsibility to individual clients is imbued with that lawyer's responsibility as an "officer of the court", neither of those responsibilities (nor the self-discipline that prompts every securities lawyer to remember the Second Circuit's "crowbar" image[33]) justifies passive acceptance by the securities Bar of expansive application of the provisions of the new Act at the cost of long-fought-for protections. I trust that, despite its concern for its longstanding mutually supportive relation with the SEC, the securities Bar will not severally succumb to the seductive temptations of self-protection first, last and always.

Two years ago I took an occasion to summon the securities Bar to challenge the SEC if only for the SEC's own sake, to initiate, to re-think, to insist, to persevere, and to assert standing of the Bar to advise the affected public and the SEC what the Bar believes the law is, and ought to be.[34] In the context of the

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32 Pinhas v. Summit Health Ltd., 880 F.2d 1108, 1116 (9th Cir. 1989), cert. granted on other issues, 110 S. Ct. 3212 (1990).

33 U.S. v. Benjamin, 328 F.2d 854, 863 (2d Cir. 1964), cert. denied, 377 U.S. 953 (1964).

34 Fleischman, "...And Not To Yield", Address to the Federal Regulation of Securities Committee (Nov. 18, 1988).

administration and practice of securities law, I thought then, and I am even more convinced now, that the broader common weal of course includes the values expressed in the federal securities laws, as administered by the SEC, but always in admixture to political and constitutional values addressing the protection of individual rights against untoward use of Government authority. Particularly at a time when not only Congress but the SEC and the general public are "outraged by widespread fraud", I think it urgent to recall the particular and peculiar function the Bar performs in our American society:

The unique calling of the American legal community, both Bench and Bar, is as barrier to the encroachments of the agencies of Government -- no matter how convinced of their own rightness those agencies may be. I trust that -- nay, I urge that -- the securities Bar will not easily or quickly abandon that high calling.