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A PERSPECTIVE ON THE ROLES OF THE SEC AND THE BAR

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The views expressed herein are those of Commissioner Fleischman and do not represent those of the Commission, other Commissioners or the staff.

Alan Levenson's invitation to speak at this Institute was accepted with more boldness, I fear, than discretion. Jim Hewitt had invited me once before, perhaps a dozen years ago, so I am well familiar with the Institute and the sophistication of all of you who participate year to year. In the spirit of the discussions you've heard this week, I'd like to talk to you somewhat critically, and at the same time encouragingly, about the Agency I now serve.

This morning's session on legislative, regulatory and judicial developments serves to emphasize the rate and velocity of change in law in the securities field. This afternoon's session on insider trading underscores a changing emphasis by the Agency itself. Against that background it seems to me once again that it's time, as it is always time, to take stock -- to seek to ascertain whether the SEC has in fact kept its head when all about it are losing theirs and blaming it on the SEC. Or, to put the matter a different way: it's time to put into focus, from my perspective, what the SEC has become some 53 years after it was created.

It is easy to perceive what the SEC's role is on paper. The statutory provisions with which we are all familiar -- Sections 19 to 21 of the 1933 Act 1/, Sections 21 to 23 of the 1934 Act, 2/ and the analogous provisions of the other laws administered by the Commission, together with specific authorizations throughout the statutes, empower the SEC to investigate violations past, present and anticipated; to sue or to bring administrative proceedings for compliance with the statutes; to hold hearings; to issue orders in particular instances; to make rules "necessary or appropriate," in the statutory language, to implement the statutory provisions; and generally to administer the laws entrusted to its care. In sum, it is an Agency of statutorily limited and specified powers.

In practice, as you well know, things are somewhat different. The Division of Corporation Finance has the function of reviewing and accelerating or denying effectiveness of registration statements, and the additional function of interpretation of the statutes and rules. The Division of Market Regulation has the oversight and inspection function, as well as interpretation. The Division of Investment Management administers two statutes of a different kind, both all-embracing, and has a review and interpretative and an investigative function. The Division of Enforcement conducts investigations,

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1/ 15 U.S.C. §§ 77s-u (1976).

2/ Id. §§ 78u-w.

negotiations and prosecutions. In sum, these several functions make the SEC an Agency of broad discretion.

Then, if you look at the people who presently constitute the Agency, the care, the quality and the professionalism of the Commission at this point is in large measure a tribute, I think, to John Shad. One judges managers, in important part, on the basis of the individuals whom they appoint to executive functions, and I don't remember there being a higher overall calibre of senior staff serving the Commission as division directors, general counsel, etc., than at the present time. I think you will agree that Corporation Finance, under Linda Quinn, is as imaginative and as responsive as that division has ever been, and I think you will agree that, under Rick Ketchum, Market Regulation is as forward-looking and as flexible in a rapidly changing arena as that division has ever been. Investment Management, under Kathy McGrath, is adaptive and thorough in a very difficult area of the law. And, as to Enforcement under Gary Lynch, there is a care and a zealousness, coupled with a fairness that Gary himself embodies, that I found surprising and extraordinarily encouraging when I came to the Commission. And lest I be seen simply to reflect the age-old prejudice that the Commission is only its Washington headquarters, there are at this Institute at least four Regional Administrators (Mike Wolensky, Doug Scarff, Bill Goldsberry and Irv Einhorn) and the Director of Regional Office Operations (Jim Clarkson), who reflect so creditably upon the Agency. In sum, the Agency's staff is extraordinarily capable, and potent as well.

How does this combination of specified powers, broad discretion and staff capability apply itself in practice? That is to ask: accepting all the strengths of the Agency, what are its institutional and human failings now, in 1987? I don't think that's an inappropriate question to ask, and in one word I would summarize the response as "conviction". The word "conviction" carries with it a very positive meaning of strength, but I would suggest to you that it also has a negative meaning, a dark side, to the extent that there is an institutional conviction in the justice, purity and correctness of the Agency's own judgment.

This conviction in both its positive and negative senses has a perfectly legitimate evolution, it seems to me, out of the acknowledged successes of decades past -- the 1930's, the 1960's, the 1970's -- bringing regulatory order and certainty to our capital markets, and achieving great success in the development of public confidence; an evolution out of the strength of its giants of the past, including those here today (former Commissioners Sommer and Pollack, Judge Sporkin, Alan Levenson, and Harvey Pitt), among others; an evolution out of the stimulus of constructive criticism from giants who had left the Commission -- Homer Kripke (now resident here in San Diego), Milt Freeman (participating in this Institute) and Milton Cohen, among others; and also an evolution out of constant interaction with the

regulated entities, in large part through the practising Bar, which you represent here today.

This conviction in its negative sense manifests itself, it seems to me, in a number of ways, and I'd like to highlight a few.

One manifestation I would call "the inertia of interpretive positions". Remember the old legal maxim: "when the reason for the law ceases, the applicability of the law must be reassessed." Reason for the law, in our field, is found in the underlying economics of the market context to which the law relates. Those economics and that context change and evolve continuously. That should evoke a recurrent reassessment -- not simply a stretch to reapply accepted doctrine to different circumstances. A good example came up in this Institute's discussions on Release 4708 3/, specifically on the Commission's position regarding the flow of securities back into this country from abroad. We have had twenty years of seismic change in international markets and in telecommunications science. The earth has moved (or, as used to be said in the Pogo comic strip, "the dam has bust"), but somehow the agency's inability to adapt, at least until very recently, has had the effect of stimulating the flow of investment funds away from rather than toward our nation's capital markets.

Another manifestation I would call "the friction of size and separation of function". The administration of a body of market-oriented law by our multifunctional Agency requires a high sensitivity to the impact of the Agency's position, under one statute or rule, on the practices prevalent under similar provisions of other statutes or rules (not unlike the sensitivity required within a large law firm or a large corporation). The Agency's refusal to come to terms with market parallelisms, or its failure to recognize market implications, creates confusion and unnecessarily impedes legitimate business transactions. Lawyers frequently see that effect by juxtaposing different statutes -- the 1933 and 1934 Acts on one side and the two titles of the 1940 Act on the other -- but perhaps a current and more discrete example is the use of the "firm commitment" criterion (carrying with it so much freight from its use in a totally different context under Rule 10b-9) in the proposed amendment to Rule 174. 4/

3/ SEC Securities Act Release No. 4708, 1 Fed. Sec. L. Rep. (CCH) ¶ 1361 (July 9, 1964).

4/ See SEC Securities Act Release No. 6682, [Current] Fed. Sec. L. Rep. (CCH) ¶ 84,049 (Dec. 18, 1986).

A third manifestation is what I would call "the isolation of Fifth Street, N.W." The staff and the Commissioners react to others' submissions, and that reaction is far removed from participation in transactions. (John Huber, talking to me in the corridor yesterday, said he was delighted no longer to be a "midwife" but to create and to be responsible for his own "children.") A knowledge of the structure of transactions -- of the why's and how's of transactions and of documents -- has to be deduced by the SEC after the fact, and then can only be deduced if there is incentive and if there is time. An understanding of transactions is far better learned from doing than from reviewing or investigating, but the absence of day-to-day hands-on familiarity with the techniques and technicalities of such items as "financing outs" (discussed earlier at this Institute) or omnibus proxies or analysts' meetings tends to refract and distort the rulemaking, interpretive and enforcement process. A recent example related to the mechanics of the shareholder voting process -- close to the core of the one-share one-vote issue, but brought up somewhat to the surprise of Commissioners and staff at the hearings held in December.

A further manifestation I would call "the temptation of multiple roles". On concededly bad facts, reflected in the adjectives and adverbs of an injunctive complaint or a Section 15(b) or 15(c) order, the Commission often condemns law violators, draws broad principles from their actions and then retires from the field to the applause of spectators. No doubt the wrongdoers have been brought to the bar of justice; no doubt other prospective law violators have been alerted to the watchful eye of the federal marshal. But that kind of rulemaking (for rulemaking in essence it actually is), narrowly focused and prosecutorial throughout, affects the conduct of myriad others than the law violators themselves. And it carries none of the safeguards of APA rulemaking, none of the subtle adaptations to legitimate behavior characteristic of rules, none of the compromises inherent in quasi-legislative action. In fact, too frequently it reflects the substitution of a broad ax for a surgeon's scalpel. It's simple, it's easy, it's quick; if anything, it's more effective than was desired, because an entire no-man's land of conduct in the penumbra of the decision becomes off-limits for some period of time. The best example of this must be Continental Tobacco 5/ and its progeny -- essentially antifraud cases that, disguised as Section 4(2) interpretations, still loom as unexplored shoals around the legitimate Section 4(2) safe harbor.

Another manifestation is what I would call "the heresy of resistance". Of course a settlement should elicit a lesser penalty than a trial fought through and won by the SEC -- that's only sensible allocation of agency resources. Of course it's

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5/ SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972).

hard to hold one's temper and persevere, limited by Marquess of Queensberry rules, when the opposition is using every cognizable maneuver to get an advantage in the ring. But, for all its Model T character, the government, once in gear, has enormous power to do ill to guilty and innocent alike. And our adversary system elicits -- no, it commands -- opposing counsel to be zealous in defense. There should be and often is a premium of respect paid to the most professional opposition counsel, but staff members wouldn't be human if they didn't let real opposition get to them, or if they didn't let their anger show. The staff may succumb occasionally; the Commission should never do so. The Agency must resist allowing the very process of fighting back, and fighting back hard, to be penalized in the enforcement process. Gary Lynch resists, and the Commission resists, but, try as we may, there must be times when we fail. You'll pardon me for not giving examples of that one.

Another manifestation is what I would call "the myth of unanimity". The Commission and its staff are taken as speaking with one voice. It's not true. I know that, like you, I have to go to Institutes like this one to hear Kathy McGrath, Rick Ketchum and Dan Goelzer address the applicability and interpretation of statutory provisions and Commission releases and rules; but that's exposition of law and legal practice at a different, if no less important, level. The essence of Commission decisionmaking, at least currently, is the stimulation and provocation that arises out of backgrounds, attitudes and conclusions that are diverse -- and should not be expected to be, and often are not, harmonious. Whether in rulemaking or adjudication in the "sunshine", in prosecutorial decisions that are properly confidential, or in determinations on amicus matters (which partake somewhat of the characteristics of each of the prior two), unanimity may deserve a premium when it happens -- but its absence should not be a cause of concern, embarrassment or discount in the public eye. The Commissioners agree to disagree, and to go on trying to persuade their less perspicacious colleagues to a more insightful point of view. (We might even some day get up the courage to disagree with the staff.) Again, you will pardon me if I give you no examples.

A final manifestation, from among my choices, is what I would call "the arrogation of authority". Not every regulatory decision need be made at the federal level -- not even every Commerce Clause decision or every securities-market-oriented decision need be made by the SEC, nor are they all. Prosecutorial discretion intervenes, allocation of Agency resources intervenes, Agency priorities intervene. The underlying question, however, is the same: where are the limits of the Agency's specified powers? You may know that I disagreed with my colleagues on the requirement that issuer tender offers

be federally mandated to be open to all. 6/ It seemed to me then, and still seems to me now, that the state courts were handling that issue well and needed no stretch of assistance from the Securities and Exchange Commission. (I should add that Linda Quinn said to me, in a corridor one day, that a focus on lack of authority is usually an excuse for a policy decision; I think she was right, and so in the future I won't say "no authority" without attacking the policy issues head on.)

I fear governmental power. I'm a devotee of the judicial process; that should come as no surprise to you. In the policy arena I generally find neither "necessary" nor "appropriate" the extension of federal authority into areas being addressed by the state courts or which otherwise lie outside the areas explicitly, or with persuasive logic implicitly, delegated to the Commission. The extent of deference shown by the Supreme Court in its recent McFadden Act decision, 7/ for example, only aggravates my concern in this area. As difficult as it is to endure pervasive review by Congress and the press on a daily basis, I believe irreverent and even misinformed criticism of a strong and active government Agency is better than an awesome or even informed deference to the Agency's own determination of the limits of its authority.

Why do I pick this time to criticize? At a time when the Agency, by my own acknowledgement, is staffed with absolutely top people? At a time when it is adapting dexterously to rapidly changing circumstances (as you have heard throughout this Institute)? At a time when its enforcement policies have deservedly won wide public support? Because, like you, I care a great deal. Because, like you, I have labored all my professional life in these particular vineyards, and I share the belief that the SEC is the best of federal government regulatory agencies -- and I want it to remain so. And because I presently occupy a position giving me the opportunity to see the Agency both when it is putting on its public performance and when it is unobserved and off-guard; the opportunity to require some people on some occasions to consider at least some of my most pressing questions. Perhaps that is only a marginal opportunity, but it is exactly the opportunity for which, I think, these past twenty-five years of law practice have prepared me. And if in fact these be criticisms, please put them in a context like the one John Harkins postulated yesterday for corporations and corporate boards: the Agency's ability to remain viable and strong must ultimately depend on its capability for self-criticism and self-

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6/ See SEC Securities Act Release No. 6653B, [Current] Fed. Sec. L. Rep. (CCH) ¶ 84,016 (Sept. 4, 1986).

7/ See Comptroller of the Currency v. Securities Industry Association, No. 85-971, slip op. at 14-20 (U.S. Jan. 14, 1987).

discipline, and on its capability, based on that self-discipline, to use its own resources to set standards for its continuing behavior.

In any event, always remember that in this country one of the key loci of resistance to and discipline of government is the organized Bar. I needn't remind you that the Bar's responsibility to individual clients is accompanied by its status as a cadre of "officers of the court". But the "crowbar" that the Second Circuit has credited to the Bar's members 8/ has far less potential for evil, I think, than does apathy to or nonparticipation in the processes of government.

You, as members of the practicing securities Bar, are requested to comment on rule proposals. Do so, for goodness sake; don't just trust that someone else will.

You are requested to make your presentations to the Agency forcibly, thoughtfully, constructively, in lawyer-like fashion. (Kathy McGrath made this point earlier at one of this Institute's panels.) Do so; don't just expect the staff to do the analysis for you, or to turn you down.

You are requested to encourage good young people to do a stint in Corporation Finance or Investment Management or Enforcement or Market Regulation, not to harm their careers but to deepen their knowledge and, incidentally, to spice the Agency with the iconoclasm of the private Bar. Do so; don't assume that the Agency will maintain it's longtime high calibre despite the market for its young professionals.

You are mandated to hold the Agency to just as solid and well-rooted an administrative or litigative posture as it can possibly have. Do so. I know there are times when that mandate is served by quick acceptance of staff positions -- but not always. Don't make the excuse of time or cost without contemporaneously assessing the price, in rigidification of the administrative process, that you and your clients will pay another day.

You are given the opportunity to listen to the staff and the Commissioners make their pronunciamentos. It's crucial that you listen so that you may advise your clients responsibly, but it's equally crucial that you be heard when you disagree, that you make the Agency's people listen to the arguments and the implications overridden in Agency decisions. Do so; don't mistake Agency position for prescience.

8/ See United States v. Benjamin, 328 F.2d 854, 863 (2d Cir. 1964), cert. denied, 377 U.S. 953 (1964).

You always have the right to initiate proposals. Joe McLaughlin has done so; 9/ Bill Harman has done so; 10/ Carl Schneider has done so; 11/ Bar committees frequently do so; 12/ Jesse Brill does so all the time. 13/ Write, ridicule, thunder if you must, but make yourselves heard. You could just be right. Not all knowledge resides in the Securities and Exchange Commission.

And, finally, you have the privilege of entertaining convictions of your own, even when at variance with those of the SEC. Keep in mind the deep-seated belief, conveyed with both humor and perseverance, that underlies Milt Freeman's oft-repeated tale about how Judge Haley, all those decades ago, leaned over the Commission table and instructed the then-general counsel and his staff not to argue their particular case on a "substantial basis" standard for review but rather to tell the Circuit Court judges that, if they concluded the Commission had acted improperly, "Tell us so, so we won't act that way again."

It is my conviction that government is to be respected and watched and limited, particularly when convinced of the correctness of its own judgment. I urge you to raise the level of your suspicions whenever the SEC, or any of its Commissioners

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9/ See McLaughlin, "Ten Easy Pieces" for the SEC, 18 Rev. Sec. & Comm. Reg. (Standard & Poor's) 200 (1985).

10/ See Rulemaking Petition from the Federal Regulation, Syndicate and Corporate Finance Committees of the Securities Industry Association (Jan. 21, 1986 & Supp. Apr. 18, 1986) (concerning prospectus delivery).

11/ See Schneider & Zall, Section 12(1) and the Imperfect Exempt Transaction: The Proposed I&I Defense, 28 Bus. Law. 1011 (1973).

12/ See, e.g., Letter to the SEC from a Task Force representing the Subcommittee on Employee Benefits and Executive Compensation of the Committee on Federal Regulation of Securities and the Subcommittee on Securities Regulations of the Committee on Small Business of the Section of Corporation, Banking and Business Law of the American Bar Association (Oct. 22, 1986); see also Committee on Federal Regulation of Securities of the Section of Corporation, Banking and Business Law of the American Bar Association, Report of the Task Force on SEC Rules Relating to Investigations (Tent. Version Nov. 15, 1986).

13/ See, e.g., Our Wish List for 1986, Corp. Counsel, Nov-Dec. 1985, at 5.

or staff personnel, is not only right (or wrong), but righteous about being so. And in that suspect category, for now, I unreservedly include myself.