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News Release

Address

to the

Committee on Federal Regulation of Securities
of the
Section of Business Law
of the
American Bar Association

(edited and annotated)

Washington, D.C.
Friday, November 18, 1988

". . . AND NOT TO YIELD"

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Commissioner
Securities and Exchange Commission
Washington, D.C. 20549

The two institutions that bring us together tonight are the SEC and the organized Bar. We are all active members of the Committee on Federal Regulation of Securities of the American Bar Association's Section of Business Law. We enjoy that membership because we all practice in the area of law administered by the SEC.

From the perspective of the Bar, one need only look at the agenda for this Annual Fall Meeting of the Committee to appreciate the diversity that makes securities practice such a vibrant area of the law. Aside from normal subcommittee meetings devoted to grist-for-the-mill issues, two Task Forces are presenting highlight programs:

- The Rule 19c-4 Task Force has done more, in my view, than any other group in or out of the regulatory organizations to analyze problems in administration of the SEC's new "anti-disenfranchisement" rule, and to educate the Bar and listed companies generally on that subject;

- The Task Force on Supervision and Compliance has prepared a thorough and thoughtful draft report that I think will become a necessary reference document for all broker-dealer lawyers;

two other Task Forces are meeting to push toward completion of the important studies assigned to them:

- The Section 15(c)(4) Task Force is grappling with the expansive implications of a form of SEC administrative proceeding that has the undoubted potential to overwhelm a great portion of the traditional SEC enforcement effort;

- The Task Force on Arbitration is dealing with one of the two or three most highly visible topics in the whole securities field at present, with potential implications for every buyer and seller of securities;

and among the standing Subcommittees special and meaty topics are everywhere apparent:

- Legislative proposals for SEC authority to require large-trade reporting and total-entity risk assessment, in the Subcommittee on Broker-Dealer Matters;

- Initiatives seeking to reach the quasi-rulemaking effects of consent judgments, in the Subcommittee on Enforcement matters;

- Rule 12b-1 fees, evoking all the questions that relate to the economics of intermediation in the securities markets, in the Subcommittee on Investment Companies;

- Proposed Regulation S and the implications of "territoriality" and "reciprocality" for international offerings, in the Subcommittee on International Matters; and

- The long-awaited private placement resale proposal, Rule 144A, in one quadrant of the Joint Disclosure Subcommittees.

In short, the Committee is involved with an exciting variety of subjects, of issues and of efforts to educate the Bar, and to educate the SEC and its staff as well.

From the perspective of the SEC, the agenda to look at is the Semiannual Regulatory Agenda, most recently published in the Federal Register of October 24, 1988. 1/ I won't dwell on "Completed Actions" (that range from immediate publication of no-action letters to efforts to discourage opinion shopping among accountants) because they are over and done with. But, apart from Regulation S and Rule 144A (both of which I've already mentioned), the Pre-Rule and Proposed Rule Stages include projects addressing problems under all the SEC-administered statutes save for the Trust Indenture Act (which was the subject of a long-overdue legislative reform proposal just this year):

- Reports by issuer managements concerning their own responsibilities for financial and non-financial reporting;

- Independent auditor involvement with quarterly financial data;

- Section 16 rule reform and Form S-8 revision, both long-rumored;

- Section 16(a) compliance, arising out of substantial Commission-perceived and publicly-reported failures to observe the filing requirements of the statute;

- Regulation 13D-G revision, labelled "Agency Priority";

- Disclosure of block repurchases by issuers and their affiliates;

- Securityholders' rights to obtain securityholder lists;

1/ See Securities Act Release No. 6794 (Aug. 19, 1988), 53 Fed. Reg. 42,867 (1988).

- Disclosure of significant equity participants in change-of-control transactions;
- Rights offering exemptions for non-reporting issuers;
- Diversification by exempt public utility holding companies;
- Relaxation of prohibitions relating to advertisements by investment advisers; and
- Relaxation of reporting requirements for mutual fund access persons who are deemed "interested" by virtue of their affiliation with a broker-dealer.

In short, there is an equally exciting variety of matters bubbling below the surface at the SEC.

As the variety and excitement of securities law practice increase, so the demands on, and the responsibilities of, securities lawyers also develop. It is a particular subset of those demands and responsibilities that I choose to address tonight, assuming (as I have always assumed) this Committee's role -- <u>your</u> role -- as representative of the larger securities Bar. By way of introduction, may I explain only that the perspective I bring to this subject is that of a longtime practitioner, a toiler in vineyards much like your own, who has been privileged to serve for these past three years (and has still 3-1/2 years to serve) in a responsible regulatory role.

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Let me start from a subject that is acknowledgedly at the core of administrative law and practice under the Securities Act: underwriting and distribution of securities. It has been classic SEC learning and lore, from 1933 forward, that the term "distribution" (crucial to the definition of "underwriter" in the 1933 Act, but itself undefined) is equivalent to the term "public offering" used in Section 4(2) of the Act and is therefore an antonym of "private placement" (as that phrase is used popularly by lawyers and investment bankers). 2/ It is the more surprising, therefore, that the SEC departed from that fundamental position in a 40-line footnote to its 1985 Rule 3b-9 Release ("It is the Commission's view . . . that the fact that an offering is exempt from registration pursuant to [Section 4(2) or 4(6), among others] does not necessarily mean that no

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2/ <u>See</u> 15 U.S.C. § 77b(11) (1982) (defining "underwriter"); <u>id</u>. § 77d(2) (exempting "transactions by an issuer not involving any public offering").

'distribution' has occurred . . . .") 3/ and in the letter by its General Counsel 4/ suggesting revisions in material used in the Federal Reserve Board's briefs to the District Court and then to the Court of Appeals for the District of Columbia in the Bankers Trust Co. commercial paper litigation.

The context of this new dispensation was in part the interpretation of "underwriting" as that term is used in the Glass-Steagall Act (whose congressional consideration and passage were virtually contemporaneous with consideration and passage of the Securities Act) and in part the effort to extend the SEC's authority to cover banks' securities activities despite contrary indications in the 1933 Act itself and despite fifty years of history. (The possibility of extension of authority seems to have miraculous power to justify new theology in Washington.) The District Court accepted the revised credo, but the Court of Appeals recognized heresy as soon as it appeared in the courtroom and rejected it sharply -- or at least sent the heresy underground. Now, since October 25, 1988, the heresy has been renounced by the heretic itself: at the end of a 50-line footnote to Release No. 6806, the SEC formally admitted error ("Footnote 58 of the Rule 3b-9 Release should not be read as a Commission statement that a 'non-public offering' can be a 'distribution'"). 5/

In retrospect the whole process of fall from faith and return to orthodoxy seems peculiar at best. The initial effort was wrongheaded and ill-considered, and even the renunciation tried hard to disguise itself. The only good things to be said are that no petition for certiorari was filed in the Rule 3b-9 case and that a subsequent rule proposal virtually required, and the rapid pace of change allowed, a public abjuration.

The Bar's role in all this was curiously accepting: the commentators of course commented on Rule 3b-9, and the litigators of course filed briefs for the Board of Governors and for the amicus banking associations in the commercial paper litigation, but none of the rest of us (I say "us" because, as a practicing lawyer and then as a sitting Commissioner, I too sat silently) stood up and demanded, "SEC, what are you doing, and why?" I applaud the Business Roundtable's challenge to the SEC's

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3/ Exchange Act Release No. 22,205 (July 1, 1985), 33 SEC Docket (CCH) 807, at 817 n. 58.

4/ See Letter from Daniel L. Goelzer, General Counsel of the SEC, to Michael Bradfield, General Counsel of the Board of Governors, at 2 (Apr. 16, 1985).

5/ Securities Act Release No. 6806 (Oct. 25, 1988), 42 SEC Docket (CCH) 76, at 91 n. 145.

authority to promulgate Rule 19c-4 (I believe the Roundtable will lose in court, but that's not what's important), because nothing short of that kind of challenge keeps a regulatory agency -- even one as devoted as the SEC -- honest.

After all, if members of the Bar -- that is, you -- don't assert that challenge, who will?

A different matter that demonstrates the possibilities of action, perhaps particularly for this Committee, was engendered last spring at a public meeting of the SEC. As part of the response to the October 1987 market break, the SEC staff included in a package of legislative proposals a request for a legislative grant of authority to the SEC to rewrite a good deal of Article 8 and perhaps part of Article 9 of the Uniform Commercial Code. The Commission narrowed the proposal somewhat, 6/ but still sought to arrogate to itself a swath of authority in an area in which the SEC and its staff have no traditional expertise and, in my view, only slightly more understanding of the implications of change potentially affecting a host of everyday secured transactions. This time the proposal did not just slip into the pond to emerge as a full-grown alligator.

The problem to which the legislative proposal was addressed is a very important one, namely, that, when the different legs of a hedged options-and-futures position move in opposite directions, the futures position requires (or produces) cash while the options position results in (or demands) credit, so that the economic result of a long futures position in a decline like the one experienced on October 19, 1987 may be offset by the increase in value of a long put position but, even so, no cash can be derived from the puts (to discharge the obligation owing to the futures clearing corporation as a result of the futures price decline) unless a bank can be found that is willing to advance funds against what is at best an inchoate and unperfected lien. As important as this problem is, the SEC doesn't seem to me to be the appropriate locus for its resolution.

Happily, a group of alert and knowledgeable lawyers from the Uniform Commercial Code Committee of this Section of Business Law learned of that proposal, realized the unsuitability of the SEC for the job it was undertaking, and got cracking to tell the Congress that they were ready, willing and in fact already engaged in attacking the problem -- and that the SEC should not

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6/ See Letter from David S. Ruder, Chairman of the SEC, to George W. Bush, President of the Senate (June 23, 1988) (enclosing, *inter alia*, proposed new ¶ (f) to amend Exchange Act § 17A).

be directed to do so. Then, at the Economic Club dinner in Chicago last month, I was delighted to hear SEC Chairman Ruder say that in his opinion the Bar group was on the right track, 7/ and I believe Chairman Ruder has since written to the Chairman of the Section of Business law along the same lines. 8/ That kind of aggressiveness, and the initiative to select and propel an appropriate group well capable of getting the job done properly, ought to be demonstrated more often.

After all, if members of the Bar -- that is, you -- don't take that initiative, who will?

Turn with me to a forecast of certain effects of one of the statutes passed in the final hours of the 100th Congress: the Insider Trading and Securities Fraud Enforcement Act of 1988. 9/ Section 3(b)(1) of that Act adds a new provision to the broker-dealer regulatory section of the Exchange Act requiring broker-dealers to establish, maintain and enforce procedures directed against misuse of inside information by the broker-dealer or by any of its controlling persons or employees. 10/ The SEC is authorized to adopt rules requiring specific policies and procedures, with its discretion in this regard limited only by the standards of "public interest" and "protection of investors". 11/

Now, insider trading may be heinous (it's certainly not a practice I would want to defend), but I would want to know what it means to "misuse" "material, nonpublic information" "in violation of this title" 12/ before I required every broker and dealer to establish, maintain and enforce procedures to prevent

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7/ Ruder, October Recollections: The Future of the U.S. Securities Markets, Speech to the Economic Club of Chicago, at 21 (Oct. 20, 1988).

8/ See Letter from David S. Ruder, Chairman of the SEC, to David E. Nelson, Chairman of the ABA Section of Business Law (Oct. 25, 1988), reported in 20 Sec. Reg. & L. Rep. (BNA) No. 46, at 1789 (Nov. 25, 1988).

9/ Pub. L. No. 100-704 (1988) (to be codified in scattered sections of 15 U.S.C.).

10/ See id. § 3(b)(1) (to be codified as 15 U.S.C. § 78o(f)). See also id. § 3(b)(2) (to be codified as 15 U.S.C. § 80b-4A).

11/ See id. § 3(b)(1) (second sentence).

12/ See id. (both sentences).

that misuse. You will remember that the SEC tried to agree on a definition (achieving only a 3-to-2 concurrence), that a Task Force from this Committee had previously presented two suggested alternative definitions, and that an ad hoc group organized in response to a request from Senator Riegle (and led by members of this Committee) presented a draft quite close to the majority SEC view. You will also remember that Congressman Dingell rejected all those efforts, reaching what appears to me to be the right result for the wrong reason.

Chairman Dingell rejected the proposed definitions reportedly because he was afraid that evil-intentioned traders with shrewd legal advisors would find loopholes in, or end-runs around, any definition. In fact, the various proposals seemed to me rather to have transferred the uncertainties (and the prosecutorial discretion) concerning this type of violative conduct from the periphery of analysis to its core -- and I believe that it's with just such an expansible core that the SEC views this conduct today, encompassing within the notion of "insider trading" all trading in securities while in possession of material nonpublic information obtained or used or communicated "in breach of a duty". 13/ I can assure you here and now that, when people are discovered to be trading with information to which the markets generally don't have access, the SEC will find duties, and breaches of duties, where you never realized that duties existed! I have no doubt that, when the SEC disclaims a parity-of-information approach to insider trading, it is sincere; but the SEC does frequently follow the information rather than the insiders, despite the Supreme Court's admonition to the contrary.

I bring up this subject because whatever the SEC does under the new Act by way of rulemaking or enforcement directed at broker-dealers' new rules will inevitably affect the activities of large classes of other participants in the securities markets: institutions, issuers, major individual investors, and, of course, securities professionals. If nothing else, the provisions of the new Act directed at liability of "corporate

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13/ See Letter from David S. Ruder, Chairman of the SEC, to Senators Donald W. Riegle and Alfonse M. D'Amato, at 2 (Nov. 18, 1987) (transmitting proposed "Insider Trading Proscriptions Act of 1987"). See also Committee on Federal Regulation of Securities, ABA Section of Corporation, Banking and Business Law, Report of the Task Force on Regulation of Insider Trading, Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934, 41 Bus. Law. 223, 260 (1985) (Proposed Section 16A -- Alternative A); id. at 264 (Proposed Section 16A -- Alternative B).

entities, employees [and] other control persons" 14/ assure that will be the case. For that reason, it seems to me, this is no time to forfeit the quest for the grail of an effective, scalpel-sharp definition of "misuse of material nonpublic information". To the contrary, this is a time for the Bar to strive harder, to think more innovatively -- and to press on the SEC and its staff, even without legislation, a working definition (in the sense of a prescription of substantive elements and an allocation of burdens of proof) for application in the non-criminal enforcement process.

Perhaps the members of last year's ad hoc committee were right about the rubbery core of what constitutes insider trading; certainly a majority of the SEC commissioners seemed to think so. With respect, I disagree. But this Committee should not shirk from asserting standing of its own to advise the affected public, <u>and</u> the administrative agency, what <u>it</u> thinks the law is, and ought to be.

After all, if members of the Bar -- that is, <u>you</u> -- don't assert that standing, who will?

There are times, of course, when the effort to draw attention to, and to correct, SEC positions or practices is made in good faith and nevertheless seems to fail (failure being reflected not in rejection but rather in complete lack of response). I am thinking of the 1986 Report of this Committee's Task Force on Rules Relating to Investigations. That was an effort that went to the jugular -- not to the rulemaking activities of the SEC but to its enforcement procedures. Perhaps it did seek to inhibit the prosecutor to the point that he would have been hamstrung in the performance of his assigned functions, or perhaps it did address, with formal and detailed proscriptions, a series of problems whose solutions are best accomplished informally in fair understandings between prosecutor and defense counsel. At any rate, it failed of its intended goal in that it had no influence at all on reform of the pre-existing procedures.

But was it a worthwhile effort to have undertaken? Definitely, yes! And would it be useless to try again if time and resources allow? Definitely, no! The goal itself motivates the effort: the potential for Government to do unwarranted harm is nowhere more clearly evident than in the enforcement process, and that process requires constant monitoring by <u>all</u> concerned as it shifts toward achievement, or betrayal, of a proper equilibrium between citizens' rights as society and citizen's rights as defendant. One cannot trust Government alone to

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14/ H.R. Rep. No. 910, 100th Cong., 2d Sess. 17 (1988).

provide procedures protecting that equilibrium, even when Government is personified in an agency as careful and professional as is the SEC; it is the organized Bar that traditionally grapples to readjust that equilibrium -- and knows that it's a balance never fixed for very long.

At bottom, I don't share the belief that the adoption, even in full without a single tinkering, of those 1986 proposals would so have impacted the SEC's Enforcement Division as to result in paralysis of the enforcement effort. Nor am I a partisan of those proposals, do-or-die. But what's important is to come back, to persevere in the effort, to elicit and analyze the responses (or the lack of responses) of the SEC and its staff, to dispute them where they're wrong, and, where they're right, to undertake a zero-based revision of the proposals in acknowledgment.

After all, if members of the Bar -- that is, <u>you</u> -- don't persevere in that effort, who will?

Approaching my next topic, let me explain that, after three years in a regulatory position, I feel myself obsolescent if not obsolete as a substantive securities lawyer. As a result, I've tried to become a procedures lawyer, focussing my attention increasingly on questions arising under the Administrative Procedure Act, the Freedom of Information Act, the Sunshine Act, the Regulatory Flexibility Act, and even the Equal Access to Justice Act.

The good intentions that underlie these several statutes don't always translate into the public informational benefits that were contemplated by the legislative draftsmen. For example, at SEC meetings that are required under the Sunshine Act to be open to the public (and therefore to the media), I frequently watch in dismay as stringers who can't be expected to understand much of what they are hearing struggle to report on SEC public meetings -- and therefore fail to report, and sometimes misreport, the true nuggets that they hear. But the media do report, correctly, on high-visibility legislative proposals submitted by the SEC after discussion at non-public meetings -- non-public because of enforcement implications <u>15/</u> -- and no one at the Bar complains. Similarly, the media report, correctly, on amicus briefs submitted by the SEC after discussion in non-public meetings -- non-public because of implications for litigation <u>16/</u> -- and no one at the Bar complains. And, at the meetings it does hold in public, the SEC limits, to staff

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<u>15/</u> <u>See</u> 17 C.F.R. § 200.402(a)(7)(i) (1988).

<u>16/</u> <u>See</u> <u>id</u>. § 200.402(a)(10)(v).

personnel and Commissioners, the distribution of materials relating to matters under discussion (so that dialogue ensues, for example, about the implications of a particular footnote on an inside page, although no one among the attending public can follow or, except by divination, understand) -- and no one at the Bar complains.

I don't need to point out that the discussion process determines the regulatory result in very many instances. That is why, despite all the statutes' failings, the Congress passed and the President signed the Administrative Procedure Act and the Sunshine Act. FOIA requests for material in the SEC's files, where applicable, are but pale substitutes for the contemporaneous open audience to which the public and the Bar are statutorily entitled.

After all, if members of the Bar -- that is, you -- don't insist on that audience, who will?

Now changing focus: Nothing has had so substantial an impact on the securities markets in the 25 years since the Special Study as the market break of October 1987. The SEC, as well as the CFTC, the New York Stock Exchange, the Chicago Mercantile Exchange, the Chicago Board of Trade, the Brady Commission and ultimately the Presidential Working Group, have studied, and sought to respond to, the problems that the market break made evident. On some responses the SEC has been divided, on some it's been unanimous, but overall its policy has been to make haste very slowly. I strongly believe that policy has been correct, if only because (to use my colleague Charles Cox's terminology) all we seem to be able to do hastily is to throw sand in the market's gears; we haven't yet figured out the key answer: how to encourage liquidity, how to elicit the contra side.

Former Commissioner Karmel is one member of this Committee who has publicly voiced a contrary view: that the policy followed thus far by the SEC sets aside the SEC's 55-year tradition of forceful leadership for the protection of investors and reflects a "paralysis of . . . leadership on public policy issues" relating to regulatory reform of the financial markets. 17/ We argue -- former Commissioner Karmel and I -- in notes, in corridor conversation, in harrumphing rebuttal when we read each other's opinions at a distance of two hundred miles. I know that other members of this Committee, not only former Commissioner Karmel, are critical of the present SEC policy. That many of you may disagree with me on this crucial subject is

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17/ Karmel, Looking Back on the Crash: Mayer's "Markets" Reviewed, N.Y.L.J., Oct. 20, 1988, at 3, 4.

not discouraging; that the organized securities Bar has not reached and spoken its opinion is, however, truly disheartening.

And even if the Bar has deliberately stood back from a position on issues specific to SEC policy regarding the market break, I would still expect it to speak loudly on the issue of the new Special Study recently authorized. 18/ It was at this very meeting two years ago that Judge Sporkin called for a new Special Study. 19/ At that time I disagreed, and continued to do so for more than a year. Some time this spring I came to the conclusion that I had been wrong. But where has the Bar been during these two years? The Bar -- this Committee -- should take the lead among those who say that, after 25 years, what with

- internationalization,
- deregulation,
- computerization,
- the telecommunications revolution,
- the florescence of derivative products and derivative markets, and
- innovation in securities and the securities markets at an almost unimaginable pace,

it's time to analyze, to amalgamate, to re-think how the quality and role of American capital markets, of which this nation is in fact a product, can be maintained in the next quarter-century.

After all, if members of the Bar -- that is, you -- don't take the lead in that re-thinking, who will?

I phrase my repeated question in the way I do because, in the last analysis, I think the organized Bar has a high responsibility to this nation. The SEC has rejected what it calls the "good soldier defense" in several of its enforcement

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18/ See Pub. L. No. 200-704, § 7 (1988).

19/ Sporkin, A Call for a New Special Study of the Securities and Financial Markets, Speech to the Committee on Federal Regulation of Securities, ABA Section of Corporation, Banking and Business Law (Nov. 21, 1986).

actions: 20/ if a company officer has a responsible hand in the preparation of materials filed with the SEC for public reliance, that officer cannot be allowed to avoid duties of accuracy and completeness just because a senior official has told him how the disclosure is to be mis-made. The Bar's function is obviously different from that of officers of public companies, akin in my mind to the difference between line officers and staff officers in the military.

In-house and outside lawyers, when acting in their lawyer's role, perform what is analogous to a staff function in laying out alternative strategies for the accomplishment of the client-commandant's goals within the limits prescribed by law and accepted by society. While I am well aware both that the value judgments inherent here are different for each one of us and that no individual can be expected to be private counsellor and public tribune on an everyday basis in his or her professional life, still it seems to me that the best and highest use of the securities lawyer's function is in reconciling the legitimate accomplishment of the client's individual goals with the broader social good to which we all subscribe. In the context of the administration and practice of securities law, that broader social good of course includes the values expressed in the mandates of Sections 5 and 17 of the Securities Act, Sections 7, 17 and 36 of the Investment Company Act, and Sections 10, 13, 14 and 15 of the Exchange Act, as administered by the SEC, but always in admixture to political and constitutional values addressing the institutionalized protection of individual rights against untoward Government direction.

Last weekend, in its edition published on the eve of November 11, the seventieth anniversary of the Armistice Day, the French newspaper Le Monde published an article entitled "Les 'Der des Der'" ("The Last of the Last" or "The Last of the Survivors") 21/ looking backward to the First World War. It is hard to render the values embodied in the federal securities laws apposite to the values for which the Poilus and the Yanks came out of the trenches into the machine gun fire during the spring and summer and fall 70 years ago -- and I do not mean to demean the latter by suggesting a comparison. I do mean, however, to assert that the organized Bar is so important a rampart in the defense of the values addressing individual rights against Government that it should be the first of the first to engage in the battle and the last of the last to surrender.

20/ See, e.g., Exchange Act Release No. 23,066 (Mar. 26, 1986), 35 SEC Docket (CCH) 432, at 434; Exchange Act Release No. 23,067 (Mar. 26, 1986), 35 SEC Docket (CCH) 435, at 441.

21/ Le Monde, Nov. 10, 1988, at 1.

For both the Bar <u>and</u> the SEC, the Bar's engagement and continuance in that battle is urgent. While properly demanding the Bar's respect for the legislative mandates of the statutes it administers, the SEC, for its own sake, requires not the Bar's subservience but its spur. It is when reacting to the spur of the Bar that the SEC is at its best, its most constructive, its most effective in fulfilling its assigned responsibilities. By contrast, no government agency -- not even the SEC -- not subject to challenge will long remain unsullied by the tempting belief in its own correctness and propriety. That challenge comes from few autonomous sources within our American society. One of those sources is, and I think must always be, the organized and independent Bar.