OUTLINE OF
RULES OF ETHICS FOR EMPLOYEES AND OFFICIALS
OF A SECURITIES REGULATORY AGENCY

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INTRODUCTION

Ethics questions are common in any Government agency. Some of the questions to be answered include: What gifts may be accepted by Government officials, and under what circumstances? What restrictions, if any, should be placed upon the financial holdings of public employees? Are there limits as to the matters upon which Government employees may work? While there are long-term Government employees, some persons come and go between the public and private sector, in some cases serving two or more tours of public service. How should problems posed by this revolving door between public and private employment be resolved? Do public employees sacrifice any of their privacy? If so, how much? What limitations are appropriate on activities of Government employees that would be entirely legitimate and completely unregulated if done by private citizens? Should there be restrictions on the activities of former Government employees after they have left office, and for how long a period?

In this outline we describe the system of ethical conduct regulation in place at the Securities and Exchange Commission. We believe it to be an effective system in the sense that persons outside and inside the Commission regard the agency as observing the highest ideals of ethics and integrity. That system is multi-layered and somewhat complex.

The outline is in five parts:

In Part I we discuss general principles of an ethics regulatory system.

In Part II we describe the Government-wide statutes relating to ethical conduct. In general, these apply to the three branches of the United States Government -- the executive, legislative, and judicial branches.

In Part III we describe the rules that apply to the executive branch of the Government, of which the SEC is a part.

In Part IV we describe the rules pertaining only to employees and Commissioners of the SEC.

Finally, in Part V we describe how the ethics program is administered at the SEC.

PART I. GENERAL PRINCIPLES

Despite the myriad permutations that ethics rules may involve, most commentators have agreed upon several core principles that influence the final form of any system of ethics regulation. These include:

1. Public office is a public trust. The concept of "trust" is based on the fiduciary principle, very important in the U.S. legal system, but not known in some countries. The principle is that one owes a greater duty to someone else than to himself. This concept, applied to Government employees, recognizes that favoring private interests, either those of the public employee himself or those of any other person or organization, over the public good, that is, of all the citizens, violates the purpose and spirit of public office. Thus, in the United States, bribery is condemned, as is using Government resources for one's own benefit. In some other countries, Government employees expect small amounts of money or favors for doing their job. This is not tolerated in the U.S. This public trust concept also underlies those rules that prohibit U.S. Government employees from holding certain interests (like stock in a company on whose matters they are working) and that prevent them from working on certain matters if those interests are held.

2. Equal Treatment. Every person with dealings with the Government should be treated not only fairly, but also equally. Public service cannot condone partiality or favoritism.

3. Appearances do matter. Vital to public confidence in Government is a general consensus that the previous principles regarding fairness are being followed. Government employees not only must act in an ethical manner, they must also appear to be acting ethically. Or, put more precisely, they must not appear to be acting unethically. Thus, ethics regulation also concerns itself with "the appearance of impropriety" -- with any appearance that private interests are being favored or that Government is not being impartial. This principle also supports some form of a public disclosure or reporting system by Government employees.

4. Elements of a Successful Ethics Regulatory System. As noted, this outline deals primarily with the system of ethics regulation under which the SEC operates. Any other securities regulatory agency establishing an ethics system could legitimately and understandably make choices different from the ones made by the SEC, in light of the traditions and culture of the society and legal system in which it operates. Nevertheless, whatever the details may be, we believe the

following elements will most likely be part of a successful system:

a. Written Code. To be effective, ethics rules should be known both to the employees covered by them and to the public on whose behalf they are instituted. Therefore, regulations should be put in writing and widely disseminated. A necessary corollary is effective initial training and periodic reinforcement.

b. Leadership by Example. The actual level of ethical behavior in an institution is in large part a function of the culture of that particular institution. Where the top officials set an example of doing the right thing, the agency as a whole will be more ethical from top to bottom. By contrast, where the leadership cuts ethical corners, no code or other set of rules will really be effective. ("If it's OK for the boss to do it, it's OK for me to do it, too.")

c. Fair and Vigorous Enforcement. Nothing will destroy a system of ethics more quickly than the perception that it is administered unfairly. By contrast, fair and vigorous enforcement will deter violations. Of course, to be fair, a system of ethics regulation must distinguish between rules that go to the core of the principles of ethics and those that are merely adjuncts to such principles. A properly functioning system should, therefore, be proportional, nontrivial, and practical.

PART II. GOVERNMENT-WIDE STATUTES RELATING TO ETHICAL CONDUCT

1. History -- Statutory ethics restrictions were originally enacted (and later amended) in piecemeal fashion in response to particular problems that arose throughout American history. For example, the First Congress in 1789 imposed restrictions on the Secretary of the Treasury. In 1853, Congress prohibited federal employees from prosecuting claims before the Government. During the Civil War, taking money while engaged in procurement activities and participation in matters in which an employee held a financial interest were outlawed. In 1917, at a time when private foundations were paying for governmental salaries, Congress made illegal the supplementation of federal salary from outside sources.

These scattered laws were harmonized and brought together in 1962 into Chapter 11 of Title 18 of the United States Code. These are generally referred to as "the federal conflicts of interest laws." Violators can be punished both criminally -- by jail and fines -- and civilly -- by injunction and requiring the repayment of monies or property received. Subsequent major amendments to the ethics laws occurred in 1978 and 1989. In the Ethics in Government Act of 1978, passed in response to the Watergate scandals, Congress created the separate agency called the Office of Government Ethics ("OGE") and established by law a system of public financial reporting by senior employees. In the Ethics Reform Act of 1989, Congress made certain of the laws that were applicable to the executive branch also apply to the legislature, amended the post-employment statutes, and provided specifically for civil enforcement of the conflict of interest statutes, which had been implied earlier by the courts.

2. The Federal Conflicts of Interest Laws. As noted, these fundamental statutory ethics restrictions are found in Chapter 11 of Title 18 of the United States Code and apply generally to persons in all three branches of the U.S. Government.

   a. 18 U.S.C. 201 -- prohibits both bribery, the giving or receiving something of value in return for being influenced in the performance of an official duty, and illegal gratuities, the giving or receiving something of value for or because of an official act. An illegal gratuity does not require a quid pro quo between the public official and the person making the gratuity and is punished less severely than bribery.

   b. 18 U.S.C. 203 -- prohibits nongovernmental compensation to Government officials in matters affecting the interests of the Government.

   c. 18 U.S.C. 205 -- prohibits acting as agent or attorney, with or without compensation, by Government officials on behalf of a private person or entity in a matter in which the Government has an interest.

   d. 18 U.S.C. 207 -- this section applies to activities by a former Government employee after leaving the Government. It prohibits former Government employees from switching sides in particular matters upon which an employee actually worked. The statute also contains additional restrictions, beyond matters in which the employee participated as a Government official, applicable to higher-level employees who, because of their former senior position, have a greater ability to influence their former colleagues. The statute imposes a two-year ban on contacting the

former agency with regard to matters within a person's official responsibility, even where the employee was not personally aware of the matter. It also contains a one-year cooling off ban for certain former employees who were highly paid. These persons may not make any communications or appearances before their former agency for one year after leaving office, even on wholly new matters that arise after they leave office.

e. 18 U.S.C. 208 -- the core conflict-of-interest law prohibits a Government employee from working on a matter that would have a direct and predictable effect on his or her financial interest or the financial interests of a spouse, minor child, general partner, organization for which he or she is officer, director, or trustee, or entity with whom the employee is negotiating for employment.

f. 18 U.S.C. 209 -- prohibits the supplementation of salary for Government service by nongovernmental sources.

g. 18 U.S.C. 216 -- provides for criminal misdemeanor and felony penalties for violations of sections 203, 205, 207, 208, and 209. The Ethics Reform Act of 1989 also added civil penalty provisions for violations of these statutes.

3. Public Financial Reporting. The system of public financial reporting for senior executive branch employees was enacted into law by the Ethics in Government Act, and was subsequently amended by the Ethics Reform Act of 1989. The law was passed after the Watergate scandals of the early 1970's in order to promote public confidence in Government. This goal is met both by avoiding conflicts of interest through the review of the financial statements and through the cleansing power of public disclosure itself. Senior Government officials must disclose their assets, debts, gifts, financial transactions and affiliations with organizations. The document is public. The statutory requirements are codified in an appendix to Title 5 of the United States Code.

4. Other Statutes. In addition to the statutes listed above, there are a number of other statutory provisions dealing with ethics. These laws include the following:

a. Procurement Integrity, 41 U.S.C. 423 (these laws not only apply to Government officials engaged in Government contracting, but also to some of the private persons involved in the procurement process);

b. Gifts, to superiors, 5 U.S.C. 7351, from particular prohibited sources, 5 U.S.C 7353, from foreign Governments, 5 U.S.C. 7342;

c. Hatch Act Restrictions on Certain Political Activity by Government Employees, 5 U.S.C. 7321 et seq. and 18 U.S.C. 602, 603, 606, 607 (generally, most employees may not engage in political activity while on official duty and may not raise funds for political purposes);

d. Use and Misuse of Government Property and Records, such as misuse of a Government vehicle, 31 U.S.C. 1344, or misuse of the frank (the Government mailing privilege), 18 U.S.C. 1719; and

e. Conflicts Related to Employment, such as anti-nepotism, 5 U.S.C. 3110, restrictions on recommendations from members of Congress, 5 U.S.C. 3303, and restrictions on dual pay, 5 U.S.C. 5533.

PART III. RULES THAT APPLY TO THE EXECUTIVE BRANCH OF GOVERNMENT

1. Executive Orders. Presidents of the United States have authority over the entire executive branch of Government, including independent regulatory agencies such as the SEC. Presidents have used this power to ensure ethical standards on the part of executive branch personnel.

    a. Executive Order 11222. This was the first executive order dealing with ethics. In 1965, President Johnson issued an executive order setting forth the ethical obligations of executive branch personnel, including prohibitions against direct or indirect financial interests that conflicted with Governmental duties and engaging in financial transactions based on information obtained through Government employment. The then Civil Service Commission was directed to implement this order through regulations codified at 5 C.F.R. 735, and each agency was directed to adopt regulations consistent with the executive order and its implementing regulations.

    b. Executive Orders 12674 and 12731. In 1989, President Bush replaced Executive Order 11222 by issuing Executive Order 12674, which was subsequently modified by his Executive Order 12731. These orders established government-wide standards of ethical behavior that were to be

promulgated into regulations by the Office of Government Ethics. These orders were part of a process also found in the Ethics Reform Act of 1989 that sought to ensure uniformity of ethics regulation throughout the Government.

2. Regulation by the Office of Government Ethics.

   a. Standards of Ethical Conduct for Employees of the Executive Branch. In response to President Bush's Executive Orders and the Ethics Reform Act of 1989, the Office of Government Ethics promulgated regulations setting forth standards of conduct applicable to executive branch officials and employees, superseding most prior agency regulations. These OGE regulations, known as the "Standards," codified at 5 C.F.R. Part 2635, currently apply to SEC Commissioners and employees. The Standards address in some detail a number of areas of ethics concern including the following:

      i. Gifts. Gifts from outside sources with interests before the Government, and gifts given because of an employee's Government position are prohibited generally. Also prohibited are gifts from lower-level to higher-level officials. There are some exceptions to the gift rules, including those based on the de minimis amount of the gift and pre-existing relationships between the donor and donee.

      ii. Financial Conflicts. The Standards implement 18 U.S.C. 208. Executive branch employees may not participate in particular matters that affect their own financial interests or those that are imputed to them (such as the financial interests of a spouse, dependent child, or organization of which the employee is an officer).

      When faced with a financial conflict of interest, the employee must disqualify himself from participation, divest the interest, or obtain a waiver of the restrictions from his supervisor. Waivers may be granted where the conflicting interest is not so substantial as to be deemed likely to affect the integrity of Government services. The Standards leave it up to each executive branch agency to determine whether a particular category of financial holding is to be

prohibited entirely.

iii. Personal Conflicts. The Standards reach situations that do not involve a direct financial conflict of interest but that may create reasonable doubt regarding a Government employee's impartiality. Thus, employees may not participate in particular matters affecting the financial interests of other members of their household, close relatives, recent employers, partners, or organizations in which they actively participate. Also, employees may not participate in matters affecting the interests of a spouse's employer. A supervisor may grant an employee an authorization to proceed where the importance of the employee's participation outweighs the perceived lack of impartiality.

iv. Seeking and Negotiating Employment. Special rules restrict the circumstances under which a Government employee may participate in matters affecting the interests of prospective employers.

v. Misuse of Position. Executive branch employees are prohibited from using their public office for their own or another's private gain, and from misusing nonpublic information, Government property, or Government time.

vi. Outside Activities. In addition to the statutory restrictions of 18 U.S.C. 203, 205, and 209, and any particular agency rules regarding prior approval, Government employees are prohibited from engaging in any outside employment or activity that conflicts with their federal duties. Special rules control service as an expert witness, and payment for speaking, writing, and teaching. High-level employees are also subject to absolute limits on the amount of earned income they may receive each year.

b. Other OGE Regulations. In addition to the Standards, the Office of Government Ethics has also promulgated regulations governing:

i. Financial Reporting. OGE rules in 5 C.F.R. Part 2634 govern executive branch financial disclosure, qualified trusts, and certificates of divestiture. Upon taking office (or upon nomination for positions subject to Senate confirmation), and annually

thereafter, senior officials file Form 278, in which they disclose their financial holdings and those of their spouses and children; certain financial transactions; certain contractual agreements and arrangements; gifts and reimbursements; and outside positions.

As earlier noted, these forms are publicly available. At the SEC, approximately 120 out of 3,900 employees must file public financial reports. Lower level policy-making employees file Form 450, which is less detailed than Form 278 and designed to catch potential conflicts of interest. These reports are not publicly available but are reviewed internally by senior agency officials. Because the SEC is so heavily professional, about 2,100 employees of the 3,900 are in positions that require annual confidential reporting.

In some cases, employees may establish qualified trusts to shield themselves from conflicts of interest, and persons required to divest certain interests may obtain a certificate of divestiture from OGE to defer tax consequences.

ii. Post-employment. Regulations issued by OGE in 5 C.F.R. Part 2637 implement 18 U.S.C. 207 as it was prior to the amendments found in the Ethics Reform Act of 1989. These regulations continue to apply to former Government employees who left Government service prior to January 1, 1991. Regulations in 5 C.F.R. Part 2641 govern the procedure to seek waivers from OGE of the one-year cooling off ban found in the current statute.

iii. Training. Pursuant to 5 C.F.R. Part 2638, Subpart G, all Government employees must receive ethics training upon entry into Government service. Employees required to file either public or confidential financial statements -- policymakers, contracting officers and other procurement officials -- must also receive ethics training each year.

iv. Financial Conflicts. Regulations issued by OGE in 5 C.F.R. Part 2640 set forth regulatory exemptions from the statutory conflict of interest provisions for particular interests that do not pose significant conflicts.

c. Host-Paid Travel. There are times when Government employees are asked to deliver a speech or appear at a convention, and the sponsor, or "host", offers to pay the travel and lodging expenses. As part of the Ethics Reform Act of 1989 drive to standardize ethics regulations throughout the Government, the General Services Administration issued regulations, codified at 41 C.F.R. Part 304-1, defining the circumstances upon which executive branch agencies may accept payment for the travel expenses of their employees. These regulations superseded prior agency rules regarding acceptance of host-paid travel. Under the regulations, an agency official must conduct a conflict-of-interest analysis before such payments may be accepted, and all payments over $250 are made public.

PART IV. SEC REGULATIONS AND POLICIES

In addition to the rules and laws described above, the SEC has a number of restrictions that apply solely to SEC employees and Commissioners. Some are imposed by the Securities laws. For example, Section 4a of the Securities Exchange Act of 1934 forbids Commissioners from having any other profession. Commissioners may not, therefore, earn any outside income.

1. History. At its inaugural business meeting in 1934, the Commission, as one of its first acts, passed an ethics resolution that prohibited employees from (a) trading except for the purpose of making bona fide investments in certain types of securities; and (b) buying securities on margin. The new Commission also established a system of reporting employees' securities transactions. Violation of the trading and reporting rules was grounds for immediate dismissal.

   Over the next two decades these rules were refined until, in 1953, the SEC became the first agency in the U.S. Government to adopt a written Conduct Regulation. The Conduct Regulation governed limitations on outside employment, securities transactions, personal conflicts, negotiation for private employment, and practice before the Commission by former Commissioners and employees.

   In 1966, the Conduct Regulation was amended and reissued to comply with Executive Order 11222. Since that time it has been amended again in 1980, 1988, and 1995. These latter amendments have generally changed the length of the holding period imposed on securities purchased by Commission employees and gradually relaxed the 1953 total prohibition on the purchase of mutual funds.

Originally, employees were required to hold all securities for at least one year after the purchase date. Later, the holding period was reduced to eleven months and then to six months, which is the requirement currently in effect. Mutual fund purchases, once totally banned, may now be made with certain limited restrictions. The Conduct Regulation is currently being revised again to reflect the supersession of many of its provisions by the OGE Standards.

2. Canon of Ethics. In 1958, the Commission adopted a Canon of Ethics for Commissioners, found at 17 C.F.R. Part 200, Subpart C. The Canons constitute an additional obligation beyond the Conduct Regulation regarding Commissioners' responsibilities as law enforcers, judges, and legislators. The Canons are presently being amended to reflect changes made by the OGE Standards.

3. Securities Ownership. Rule Five of the Commission's Conduct Regulation, 17 C.F.R. 200.735-5, contains a number of provisions applicable to all Commissioners and employees. The key provisions are summarized below.

   a. Carrying securities on margin, purchasing securities with borrowed funds, and selling short are prohibited;

   b. Holding an interest in a broker-dealer or investment advisor directly regulated by the Commission is prohibited;

   c. Purchasing or selling securities that are subject to current registration statements is prohibited, but waivers are available for sales if the employee has no nonpublic information and is not working on the registration;

   d. Purchasing securities of a company that to the employee's knowledge is involved in current Commission investigations or proceedings, or that is in a bankruptcy proceeding in which the Commission has made an appearance is prohibited;

   e. Purchasing or selling options, futures, or options on futures involving a security or group of securities is prohibited;

   f. Selling a security that has been held for fewer than six months after purchase is not permitted unless an exception (such as transfers within a family of mutual funds after being held for 30 days, or if a stop-loss order

has been entered at the time of purchase) is available;

g. All securities transactions (other than subsequent transactions in a money-market fund or some other exceptions) must be reported within five days of the transaction and all securities holdings must be reported annually.

4. Post-employment. Rule Eight of the Commission's Conduct Regulation, 17 C.F.R. 200.735-8, regulates the Commission's implementation of 18 U.S.C. 207. Former members and employees are prohibited from appearing before the Commission in matters in which they once participated. They are also required to file notices of all appearances for a period of two years after leaving the Commission.

PART V. OPERATION OF THE COMMISSION'S ETHICS PROGRAM

1. Structure. The ethical conduct program at the SEC is administered on a day-to-day basis by senior lawyers in the Office of the Ethics Counsel, part of the General Counsel's Office. Employees are encouraged first to bring ethical questions to the ethics officials, called the Ethics Liaison Officers, in the part of the agency where they work.

a. Designated Agency Ethics Official. The Ethics in Government Act established the position of DAEO who is appointed by the head of the agency. The DAEO's responsibilities are to act as liaison with OGE, oversee the system of reviewing financial disclosure reports, administer training and education programs, and monitor compliance. At the SEC the DAEO is the Ethics Counsel and the alternate DAEO is the General Counsel.

b. Ethics Counsel. Within the Office of the General Counsel is the position of Ethics Counsel, established pursuant to 17 C.F.R. 200.21a. The Ethics Counsel oversees compliance with the Conduct Regulation, reviews and refers allegations of employee misconduct to the Office of the Inspector General and acts as liaison with that Office, refers allegations of professional misconduct to the proper state authorities, reviews speeches and articles, drafts rules and regulations as needed, and provides ethics counseling to current and former SEC employees and Commissioners.

c. Inspector General. Established pursuant to the Inspector General Act, the

Inspector General reports to the Chairman of the Commission but is otherwise independent of Commission management. The Inspector General conducts investigations into alleged misconduct and, in consultation with the Ethics Counsel where appropriate, refers matters to the Department of Justice for possible criminal prosecution.

2. Counseling. Under the OGE Standards and its own Conduct Regulation, the SEC has instituted an extensive ethics counseling program. Employees are encouraged to seek counseling before engaging in any potentially unethical conduct. The counseling program is administered in the Office of the Ethics Counsel with assistance from Ethics Liaison Officers in each of the Commission's Offices and Divisions. Any employee who relies in good faith upon the advice of a duly authorized ethics official after making a full disclosure of all relevant facts is protected from punishment or discipline.

CONCLUSION

The SEC's ethical conduct system is well-regarded in the U.S. Government as a successful system. Differences in culture and the legal system in other countries will require some changes in the system, if it is looked to as a model for a securities regulatory agency.