

NEWS

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INVESTOR PROTECTION AND THE SECURITIES BAR

ADDRESS BY

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During the seven years I have served as a member of the Securities and Exchange Commission I have developed a deep appreciation of the role played by professionals in securing the protections to which investors are entitled under the Federal securities laws. Although government bodies such as state securities administrators, the courts, the Justice Department and the SEC also have important responsibilities, our system of investor protection depends in large part on the activities of broker-dealers, accountants, engineers, appraisers and attorneys for its success.

Most professionals perform a rather clearly identified function in our securities markets. For example, auditors are responsible for certified financial statements, appraisers for valuations, and engineers for activities within their expertise. The judgment of securities lawyers, on the other hand, permeates almost every aspect of securities transactions. Their opinion often determines whether securities are offered to the public. They counsel clients as to what must be done to comply with filing, disclosure and dissemination requirements. Their legal advice is the filter through which information that investors receive passes. Despite the central role of securities attorneys, neither its contours nor the responsibilities attendant thereto are clearly defined.

The views expressed herein are those of the speaker and do not necessarily reflect the views of the Commission.

As the Federal agency responsible for administering the Federal securities laws, the Commission is charged with the protection of investors. If that mandate is to be fulfilled, the Commission must see to it that the activities of professionals engaged in securities practice are guided by appropriate standards of professional conduct. Disciplinary actions by the Commission against securities lawyers and other professionals for failing to observe these standards appear to have evoked considerable negative feelings, particularly among certain segments of the securities bar. This is of concern to the Commission because we recognize that although some tension between the Commission and the securities bar is inevitable, antagonism can be detrimental to the interests of the public whom we both have a responsibility to serve.

With the hope that the antagonism which may exist is attributable to a lack of understanding of our respective points of view rather than to a spirit of protectionism among members of the bar, I would like to help open up the channels of communication by discussing the Commission's involvement in the activities of securities lawyers.

As the only non-attorney on the Commission, I have been somewhat hesitant to enter the public discussion of attorneys' responsibilities. Nevertheless, since I am a participant in decisions with respect to the activities of attorneys, my views on this subject may be helpful to you.

Not being a member of the legal profession may put me in a somewhat disadvantageous position. However, I have been dealing with attorneys and legal issues for the past seven years as a member of the Commission, during which time I have been associated with some very knowledgeable securities lawyers, and also during the preceding ten years as a senior staff member of the Senate Banking and Currency Committee and an assistant to a ranking Senator. Moreover, I have the freedom of being able to consider the subject without being encumbered by specific attorney-client relationships or a present or future personal stake in the level of responsibilities to which securities practitioners are subject.

There are a number of relatively recent developments which heighten the importance of and make more immediate the need to define appropriately the duties and responsibilities of securities lawyers. One of these is the continual erosion in the ability of private plaintiffs to pursue causes of action for violations of the Federal securities laws. It is now firmly established that a private plaintiff suing for money damages under Rule 10b-5 must demonstrate that he is a purchaser or seller of securities and that the defendant acted with scienter. The Supreme Court has told us, moreover, that a bidder in a tender offer does not have standing to maintain a cause of action against a competing bidder for money damages under Section 14(e) of the Exchange Act. The Court has also seen fit to deny standing to clients of an

investment adviser to pursue violations of the antifraud provisions of the Investment Advisers Act. In these and other instances the Supreme Court has excluded from the class authorized to enforce the Federal securities laws the persons who are often in the best position to detect and who have the greatest incentive to challenge conduct prohibited by those laws.

Whether one agrees or disagrees with the merits of these decisions, their net effect is either a reduction in investor protection or a heavier burden on the Commission and professionals engaged in securities practice. Given the Commission's small staff and limited resources, investor protection is clearly dependent on the probity and diligence of the professionals who practice before us. The security lawyer's "peculiarly strategic and especially central place . . . in the investment process," has led the Commission to conclude "that the task of enforcing the securities laws rests in overwhelming measure on the bar's shoulders." This conclusion has been reinforced by various court decisions.

A further development calling for increased reliance on securities lawyers is the use of soft information in filings with the Commission. As you know, the traditional disclosure policy of the Commission has been to permit only "hard" information (i.e., statements concerning objectively verifiable historical facts) in filings with us. The investor's task, however, is to assess the future earning power of the corporation, and forward looking and other

analytical information can be key ingredients in such an assessment. Therefore, the Commission has departed increasingly from its traditional disclosure policy and has sought to encourage disclosure of projections and other forms of soft information under conditions designed to enhance their reliability.

While opinions, predictions, analyses and other forms of soft information can be material to informed decision-making, they are, by definition, subjective in nature. The inability to verify such information objectively places an added strain on the process by which the Commission screens the reliability of information being furnished to investors.

The reliability of soft information is dependent to a great extent upon the reasonableness of the assumptions on which it is based and other factors which are peculiarly within the knowledge of those preparing it and those responsible for describing it to investors. Investors must therefore rely increasingly on securities lawyers, as well as engineers and accountants, to keep them from being misled by business enterprises seeking to sell their securities to the public.

It also appears that the public's expectations of securities lawyers are escalating. A recent indication of this is the rulemaking petition filed by the Institute for Public Representation, a public interest law firm affiliated with the Georgetown University Law Center. The petition sought an amendment to Rule 2(e) of the Commission's Rules

of Practice which would define the responsibilities of attorneys who, during the course of representation, receive information clearly establishing that clients or others have committed violations of the Federal securities laws. The Institute supplemented their original petition by requesting the adoption of rules by the Commission which would have: (1) required all registrants to include in their Form 10-K a certificate stating that the board of directors has received and taken appropriate action on reports from all employed or retained attorneys of violations or probable violations of law; (2) required all registrants to file copies with the Commission of written agreements delineating the relationships between the company and attorneys which it retains; and (3) required that in the event a registrant's general counsel or securities counsel resigns or is dismissed, the company must report that fact on Form 8-K, including if requested, the attorney's comments.

In July of last year, the Commission denied the original petition and published the supplemental petition for comment. Unlike a normal rulemaking proceeding, however, the Commission took no position, tentative or otherwise, with respect to the proposals. As you know the Commission recently published a release announcing that the supplemental petition had also been denied.

Our decision to deny the petition was influenced by a number of factors, including the timing and workability of the proposals as well as the costs that would be engendered

by their implementation. We also took into account the ongoing effort of the American Bar Association and its Commission on Evaluation of Professional Standards to address issues of professional responsibility related to the petition, such as when a lawyer in, or for, an organization should refer a matter to a higher authority in that organization.

In denying the petition, the Commission was careful to point out that although in our judgment it would not be appropriate to further consider the rulemaking proposals at this particular time, we would continue to monitor developments in this area and would bring enforcement actions or disciplinary proceedings in appropriate cases. Frankly, I am sympathetic to the overall purpose of the supplemental petition and believe that if timely and adequate progress is not made by the legal profession and the business community toward the goals sought to be achieved by the petition, the Commission should give renewed consideration to rulemaking which would achieve those goals.

This raises the fundamental question of the extent to which the Commission should be involved in matters affecting the conduct of professionals, a question as to which I am sure many of you have strong feelings.

There are several reasons why I believe that the Commission must require appropriate conduct from those who practice before us. One of these is based on the concept articulated so colorfully by Judge Friendly that "In our complex society the accountant's certificate and the lawyer's

opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar." A lawyer's legal opinion and drafting skills are one of the keys which provide access to the marketplace. This fact must be coupled with the recognition that it was not intended that the Commission have the enforcement resources to pursue effectively every fraudulent promoter and that the ability to supplement our enforcement efforts, which has been provided traditionally through private rights of action, is being continually eroded. Thus, part of a credible and effective enforcement strategy must be to deny unscrupulous, dishonest, and even well-intentioned promoters from obtaining improper access to the marketplace by insisting that professionals discharge their responsibilities with care and diligence.

Another factor which must be considered is the public's expectations and confidence that the Commission would oversee the entire securities offering process including the pivotal activities of securities lawyers. In order to maintain that confidence, the Commission has considered it to be a central part of its mandate in administering the Federal securities laws to hold the securities bar to appropriately rigorous standards of professional conduct.

As important as these factors are, the primary basis for involvement by the Commission in this area is the preservation and maintenance of its own processes. The devices by which the Commission's processes can be thwarted are numerous and are not confined to contexts in which the

Commission is acting in a quasi-judicial capacity. Administrative proceedings are only one manner in which the Commission establishes regulatory policy. Moreover, the nature of the activities included within the Commission's mandate under the Federal securities laws lends support to a broad construction of the scope of the Commission's processes. These processes are threatened whether misdeeds are committed in connection with an administrative proceeding, a regulatory proceeding, the filing of documents with, or submission of information to, the Commission, or the rendering to clients of advice that improperly condones activities that do not comply with the Federal securities laws.

It is thus apparent that conduct which can threaten the Commission's processes may involve attorneys in two distinct types of functions. Sometimes securities lawyers act as advocates to defend a client's past conduct which has been called into question. Far more often, however, securities lawyers function, as do most lawyers today, as advisers.

The important differences between these two roles often seem to have been overlooked by those who criticize the Commission's posture with respect to the responsibilities of attorneys. In my view, much of the controversy which has surrounded certain of our disciplinary actions against attorneys would be muted if greater attention were paid to these distinctions. More precision in the differentiation of the respective roles of advocate and adviser would also

serve to moot much of the debate which centers on the question of the client to whom the securities lawyer is responsible.

To a certain extent, the present Code of Professional Responsibility recognizes the differences between the two roles. Ethical Consideration 7-3 provides that:

Where the bounds of law are uncertain, the action of a lawyer may depend on whether he is serving as advocate or adviser In asserting a position on behalf of his client, an advocate for the most part deals with the past conduct and must take the facts as he finds them. By contrast, a lawyer serving as adviser primarily assists his client in determining the course of future conduct and relationships. While serving as advocate, a lawyer should resolve in favor of his client doubts as to the bounds of the law. In serving a client as adviser, a lawyer in appropriate circumstances should give his professional opinion as to what the ultimate decisions of the courts would likely be as to the applicable law.

Under Ethical Consideration 7-5 a lawyer, as adviser, is also expected to inform his client of the practical effect of that legal judgment. While a lawyer, as adviser, may continue to represent a client who has elected to pursue a course of conduct contrary to his advice, Ethical Consideration 7-5 indicates that he may do so only as long as he does not thereby knowingly assist the client to engage in illegal conduct or to take a frivolous legal position.

I believe that our disciplinary actions, as well as our expectations of securities lawyers in the disclosure process, are entirely consistent with these standards. Legal advice which knowingly or even negligently facilitates the

unlawful sale of unregistered securities, or the perpetration of a securities fraud, or assists in the non-disclosure of information which would be material to investors is at odds with these standards and cannot be countenanced by the Commission. If such conduct were left unchecked, the Commission's ability to function effectively would be substantially impaired.

The disclosure process operates effectively because much of the information which is filed with or submitted to the Commission can be taken on faith. We and the investing public have a right to expect that the securities lawyer acting as adviser, unlike the advocate, will not always accept the facts presented to him but must inquire sufficiently to determine a state of facts which can support his legal opinion. Thus, the system is able to function without a corps of government attorneys, or accountants or other professionals for that matter, performing an independent examination of the underlying facts prior to the consummation of securities transactions. The impracticality and enormous expense which would be entailed by such an approach makes it as unattractive in the face of today's increasing government austerity, as I am sure it must have been when the Federal securities laws were enacted. Instead, Congress opted, I believe wisely, for private sector involvement, but subject to liability provisions and flexible and far-reaching rulemaking authority in the Commission to make the system workable.

In discharging that mandate, the Commission has found it necessary to adopt Rules of Practice which establish a minimum level of acceptable professional conduct for those who practice before us and, where appropriate, to enforce those standards in disciplinary actions. While we generally prefer private sector solutions, we believe that it is necessary and appropriate for the Commission to be able to take action directly against professionals who disregard these minimum standards and thereby threaten the integrity of our processes.

By having that capability, we are assured that a threat to investor protection can be dealt with in a timely fashion with the necessary expertise and independence. There are cases, of course, which we feel can be handled more appropriately by state bar committees and have referred such cases to them. If we were convinced that state bar committees had the capability to handle a wider range of cases effectively, I for one, would be willing to refer more of our cases to them.

Distinguishing the responsibilities attendant to the respective roles of advocate and adviser also renders much less significant the debate over whether the securities lawyer's responsibilities run only to the corporate entity, which, under Ethical Consideration 5-18, is viewed as the client, or whether they should or do encompass the shareholders as the embodiment of the entity. When he is acting as adviser, the securities lawyer is responsible for assisting

his client in determining the course of future conduct which is in line with his best view of the applicable law and must refrain from assisting the client in engaging in illegal conduct.

The application of these principles in the disclosure context strongly suggests that the interests of the corporate entity and its shareholders are generally in harmony. If the corporate entity does not disclose the information which is required by the Federal securities laws, it will be open to actions by its shareholders and the Commission. Shareholders, on the other hand, do not have a right to expect more than that which is required to be disclosed. Thus, by competently advising the corporate entity as to what a court would likely rule should have been disclosed under the circumstances, the lawyer usually does not need to reach the question of whether his client is solely the entity. Because of the symmetry of the interests of the corporate entity and its shareholders, any responsibilities that the securities lawyer might owe to either should have been met, while the attorney meets his professional responsibility of not knowingly assisting the client to engage in illegal conduct.

I realize that my illustration runs the risk of oversimplification. Reasonable people can differ on the matters which must be disclosed to investors. But the type of conduct which has prompted Commission disciplinary proceedings is usually egregious by any reasonable standard.

If we are able to prevent such conduct in the future as well as to create a heightened degree of sensitivity within the securities bar generally to the Commission's view of what constitutes acceptable professional conduct, I believe we will have done our job--without asking the lawyer to sacrifice in any way his responsibilities to the corporate entity.

The practice of law is a noble profession and one in which I am sure you take great pride. It carries with it, however, enormous responsibilities to the society which it serves. For the most part, those responsibilities have been defined and articulated from within the profession. This is a precious privilege that may be lost by efforts to play it safe through narrow prescriptions of the scope of your obligations or by less than vigorous enforcement of the standards which are adopted. The less the legal profession is able or willing to do on its own, the more we and other government agencies must do to protect the integrity of our processes.

The current American Bar Association effort to reformulate the Code of Professional Conduct offers a unique opportunity to demonstrate the depth of your commitment to the evolution in ethical thought that has followed the adoption of the present Code. From a parochial point of view, I am heartened by the attempt in the Discussion Draft of the Model Rules of Professional Conduct to more clearly differentiate the roles of adviser and advocate. While the

Model Draft may not go as far as I would like, and does not tackle all of the hard issues facing the securities bar, it is an attempt to make a positive step forward. That effort and other initiatives which can be taken by the bar to conform its professional conduct more closely to public expectations are in its long-term best interests if it is to preserve the ability to self-regulate.