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REPORT OF THE ADVISORY COMMITTEE ON ENFORCEMENT POLICIES AND PRACTICES

JUNE 1, 1972

John A. Wells, Chairman Manuel F. Cohen Ralph H. Demmler

Summary of Recommendations

1. The Commission should establish a planning office whose primary purposes would be to identify emerging regulatory and enforcement problems and to develop a coordinated response by the Commission; the office should be headed by a director responsible directly to the Commission who would be assisted by a small staff of experienced professionals; the director would be charged with the responsibility for developing with the Division Directors and Regional Administrators and presenting to the Commission possible alternative courses of action and priorities (pp. 12-13).

2. The Commission should make greater use of compliance checklists which it would distribute to brokers and dealers, investment companies and investment advisers; use of checklists by all Divisions and Offices of the Commission should be expanded; checklists should be periodically reviewed and updated (pp. 14-15).

3. The Commission should attach a high priority to the adoption and implementation of rules which would improve accounting, internal auditing and financial reporting by broker-dealers; improvement of auditing practices by independent auditors should continue to receive the energetic attention of the Commission (p. 16).

4. The Commission should publish periodically a summary of significant interpretative positions taken by the staff (p. 17).

5. Interpretative exceptions to rules and policies should be promptly reflected in published revisions of such rules and policies (p. 17).

6. There should be prominently displayed on formal orders of investigation and on letters transmitting subpoenas a statement that the initiation of an investigation does not mean that the Commission has concluded that a violation of law has occurred (p. 19).

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7. The conduct of an investigation should remain within the control of the Commission; where circumstances permit, however, the Commission should as a general practice give a party against whom the staff proposes to recommend proceedings an opportunity to present his own version of the facts by affidavit or testimony under oath (pp. 19-20).

8. The Commission should adopt in the usual case the practice of notifying an investigatee against whom no further action is contemplated that the staff has concluded its investigation of the matters referred to in the investigative order and has determined that it will not recommend the commencement of an enforcement proceeding against him (p. 20).

9. The Commission should delegate to its Division Directors and Regional Administrators the authority to issue investigative orders (and therefore the power to issue subpoenas) in routine classes of cases; the recommended delegation would not include the power to authorize a public investigation, and oversight would be assured by a requirement that the Commission or designated members of the staff be notified of the issuance of an investigative order (pp. 22-23).

10. The Commission should give continuing attention to the conduct of investigations (p. 24).

11. A procedure should be established for auditing the investigative practices and techniques of enforcement personnel on a continuing basis; to that end the Commission should designate an official, who would perform a "staff" as distinguished from a "line" function and be responsible directly to the Commission, whose function would be, on a post-audit basis, to determine whether the Commission's policy of fairness, promptness and efficiency in investigative procedures is being observed (p. 24).

12. The Commission should substantially upgrade the training program for its enforcement personnel; enforcement training should be included as a separate item in the Commission's budget, and an allowance should be sought for the salaries of a program director, lecturers and other persons whose assistance may be required and for travel expenses and materials used in connection with the program (pp. 26-27).

13. The inspection and enforcement manuals now in preparation by the staff should be read and applied in practice by field personnel and should be periodically updated and redistributed; guidance should be provided in the use of these manuals (pp. 27-28).

14. The Commission should give due consideration in cases which appear to involve honest mistake or good faith efforts at compliance to exercising its discretion against bringing a formal enforcement proceeding notwithstanding the appearance of a violation (p. 30).

15. The Commission should adopt a procedure whereby it would issue a formal, but non-public, reprimand in those cases where public investors have not been injured and the Commission is satisfied that the conduct which may have constituted a violation will not recur (p. 30).

16. Except where the nature of the case precludes, a prospective defendant or respondent should be notified of the substance of the staff's charges and probable recommendations in advance of the submission of the staff memorandum to the Commission recommending the commencement of an enforcement action and be accorded an opportunity to submit a written statement to the staff which would be forwarded to the Commission together with the staff memorandum (p. 32).

17. The procedures whereby a prospective defendant or respondent is permitted to present to the Commission his side of the case prior to authorization of an enforcement action should be reflected in a rule or published release (p. 32).

18. The Commission's policy of requiring that a draft of an order for proceedings be completed prior to the submission of the staff recommendation should be continued (p. 33). . 19. In the ordinary case the staff should exhibit a draft of the proposed order for proceedings to the adverse party or his attorney at the time he is advised of the staff's intention to submit a recommendation to the Commission (p. 33).

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20. The Commission should adopt procedures permitting discussions of settlement between the staff and the prospective defendant or respondent prior to the authorization of a proceeding (p. 35).

21. Where a settlement is negotiated prior to Commission authorization of a proceeding, direct responsibility for supervising settlement negotiations should be placed on the Division Directors or Regional Administrators, and each offer of settlement should receive their approval or comment prior to submission to the Commission (pp. 35-36).

22. The Commission should authorize the Regional Administrators to refer offers of settlement in cases not involving novel or difficult issues directly to the Commission; a copy of the proposed settlement should be forwarded to the interested Division separately (p. 36).

23. The Commission should adopt a procedure under which evidence to be introduced at an administrative hearing, the identity of witnesses and the legal theories that the staff intends to rely on would normally be made available at the request of a respondent, unless good cause were shown to the hearing examiner for the refusal of such disclosure (pp. 38-39).

24. Consideration should be given to requiring the exchange of pre-trial memoranda between the parties in which the staff would outline its case and the respondent would respond with an outline of his defense (p. 39).

25. Rule 8(d) of the Commission's Pules of Practice should be rewritten to emphasize the opportunity for settlement or simplification of the issues at the pre-hearing stage of an administrative proceeding (pp. 39-40).

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26. Consideration should be given to the following modifications in the Commission's Rules of Practice:

a. adoption of a rule requiring that in a multi-respondent proceeding the Division, where practicable, indicate at least one day prior to the presentation of evidence the identity of the respondents against whom evidence is offered (p. 40);

b. adoption of a rule by which the Commission or the hearing examiner could grant a severance with respect to a particular respondent who is only peripherally involved in the case (p. 41);

c. amendment of Rule 8(a) to provide that, upon agreement of the parties, the hearing examiner may be consulted and requested to express his views regarding the appropriateness of any proposed offer of settlement (pp. 41-42); and

d. elimination of the restrictions on an examiner's authority to rule on motions to amend an order for proceedings or to dismiss the proceeding, in whole or in part, against one or more respondents (p. 42).

27. Limitations on the examiner's power to grant postponements, adjournments or extensions of time to file pleadings should be eliminated (pp. 42-43).

28. Where a petitioner has not shown circumstances warranting a review <u>de novo</u> or where there is no substantial policy question involved, the Commission should, pursuant to Rule 17(b), affirm summarily the initial decision of a hearing examiner (p. 43).

29. The Commission should give consideration to the desirability and practicability of employing money penalties or fines, as a sanction in broker-dealer proceedings (p. 46).

30. The Commission should seek legislation repealing Sections 9(a)(2) and 9(a)(3) of the Investment Company Act of 1940 (p. 48).

31. The Commission should reorganize its inspection and enforcement program for investment companies and their advisers and adopt a program specifically tailored to them; separate inspection units with specially trained personnel should be assigned to appropriate regional offices (pp. 48-49).

32. The inspection program for investment company advisers should be integrated into the overall program of investment company inspections currently being conducted by the Division of Corporate Regulation (p. 50).

33. The Commission should consider the feasibility of combining all investment company adviser responsibilities into a coordinated program of investment company-investment adviser regulation and of consolidating into that program the administration of statutory responsibilities with respect to brokerdealers whose business is primarily that of underwriting investment company securities (p. 51).

34. The Commission should reemphasize to its Regional Administrators the importance of maintaining a close and continuing liaison with the state securities administrators in their respective regions (p. 53).

35. In keeping with prior practice, state securities officers should be invited to participate in Commission training programs, and training materials should be made generally available to them (p. 53).

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36. The Regional Administrators should, in conjunction with the Office of Broker-Dealer and Investment Adviser Examinations,

to the extent practicable, continue to develop their brokerdealer inspection programs in cooperation with state authorities, the exchanges and the NASD (p. 53).

37. The Commission should confer with appropriate representatives of the Department of Justice with a view to shortening the period of time between the initial staff determination that a criminal reference is warranted and presentation of the matter to the Grand Jury (p. 55).

38. Procedures should be adopted in cooperation with the Securities Fraud Unit of the Justice Department to screen potential criminal cases at an early stage of an investigation (pp. 55-56).

39. The Commission should consider with the Justice Department the desirability of having staff attorneys appointed in appropriate criminal cases as Special Assistants to the U. S. Attorney who will be responsible for trying the case (p. 56).

40. The Commission should play an affirmative role in allocating inspection and enforcement responsibilities among the self-regulatory organizations; continuous effort should be made by the Commission and those organizations to coordinate both the timing and coverage of inspections and investigations (p. 59).

41. Meetings should be held on a periodic basis between the staffs of the Commission and of the self-regulatory organizations for a mutual discussion of current regulatory and enforcement problems (p. 60).

42. The Commission should request the self-regulatory organizations to reconsider their policies governing the publicity given to disciplinary proceedings so that their procedures and the standards on which their decisions are based would be opened to public scrutiny (p. 61).

43. The Commission should establish a goal of doubling the size of its total staff over the next five years (p. 66).

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REPORT OF THE ADVISORY COMMITTEE ON ENFORCEMENT POLICIES AND PRACTICES

Preliminary Statement

The members of the Committee were appointed by Chairman William J. Casey, with the concurrence of the members of the Securities and Exchange Commission ("Commission"), on January 27, 1972, to review and evaluate the Commission's enforcement policies and practices and to make such recommendations as they deemed appropriate. It was contemplated that the Committee would solicit and consider the comments and suggestions of persons outside the Commission who are affected by the Commission's enforcement activities. We were not expected to employ a professional study staff, analyze the Commission's case or other records or engage in extensive research into existing legal literature, nor have we done so. Our recommendations, therefore, are the product more of overview than of precise, detailed study and are offered as such.

The Commission has been repeatedly acclaimed as one of the best administrative agencies. Its enforcement program

has on the whole been fair and highly effective. The ability of the Commission to meet the demands placed on it within its limited budget is a tribute to the tireless efforts of a small but dedicated and highly competent staff. The Commission's enforcement program has been the result of a continuous building on and refinement of existing practices and procedures. Periodic reevaluation is required, however, if those practices and procedures are to be strengthened and improved. The purpose of the current study was to take a fresh overall look at the Commission's enforcement program and to recommend to the Commission possible changes or refinements that in our view would represent further improvement.

In the Committee's view, almost all the Commission's activities can fairly be characterized as "enforcement", or "regulation", whether the specific action taken involves the promulgation of a rule or guideline, the examination of a filed document, the inspection of a broker-dealer, review of the activities of a self-regulatory organization or a formal enforcement action. The objective is the same in every case -to assure compliance with the federal securities laws. While practical considerations dictated that the Committee focus on

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matters relating directly to investigations and formal enforcement proceedings, these have been considered within the broader context of the Commission's overall objectives and responsibilities.

The Committee approached the question of due process in a similar vein. The Commission's policy is to assure maximum fairness to private parties who are subject to its rules or become involved in Commission investigations or proceedings. The Committee inquired into the Commission's enforcement practices and procedures to determine whether fairness could be more certainly assured, consistent with the need for effective enforcement.

The Committee had discussions with members of the Commission and its staff and considered staff memoranda dealing with various aspects of the Commission's enforcement program. The Committee also met with representatives of the North American Securities Administrators Association, Inc., the Chairman of the Securities Investor Protection Corporation, and representatives of certain of the national securities exchanges and the National Association of Securities Dealers, Inc. ("NASD").

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No hearings were held, but on March 1, the Commission published at the Committee's request a memorandum soliciting the comments and suggestions of members of the Bar and other interested persons on matters within the scope of the Committee's inquiry. The Committee received in response thoughtful and informative communications from members of the legal and accounting professions, participants in the securities business and others. All these letters were read and considered. We are deeply grateful to all these persons for their assistance. We are particularly thankful to Howard G. Kristol, Special Counsel to Chairman Casey, who served as Executive Secretary of our Committee. He handled the Committee's agenda with dispatch and made a substantial contribution to this report.

The views expressed in this report are, of course, those of the members of the Committee. They reflect our considered judgment on the matters covered by this report. They do not represent, nor do they necessarily coincide with, the views of the Commission or of any members of its staff.

I. The Work of the Commission

Since the passage of the Securities Act in 1933, the Congress, by additional legislation, has expanded the legal

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responsibilities of the Securities and Exchange Commission. These responsibilities have also been expanded by the quantitative increase and growing diversity in offerings of securities, by the quantitative increase in trading, by the development of additional trading markets, by an increasing variety in trading practices and by the necessity of applying the statutes to a growing and increasingly complex economy.

The Commission is regarded by the Congress and the public not merely as an agency to administer a series of statutes but as the federal instrumentality for protecting the public interest and the interest of investors in its oversight of the processes of capital formation and trading in securities. This attribution of responsibility must be recognized as a fact of life. Hence, the efficacy of the Commission's work is an important element in maintaining the confidence of the public in the processes of capital formation and securities trading. The maintenance of that confidence is necessary to enable our free enterprise system to generate and allocate the capital resources needed to sustain our country's economic strength and vitality.

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Under the federal securities laws, principally the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company and Investment Advisers Acts of 1940, the Commission regulates the disclosure practices of thousands of corporate issuers and exercises broad, general authority over a diverse, highly complex industry whose central function is the creation, marketing and trading of securities. The . components of that industry are not only brokers and dealers -the traditional intermediaries between issuer and investor -but also attorneys, accountants, analysts, and public relations firms -- professionals whose activities are an integral part of the process by which securities are marketed and traded. Another increasingly important component of the securities industry is the financial intermediaries -- investment companies, pension funds and other institutions -- through which the savings of millions of individuals are channeled into the capital markets and ultimately into business enterprise.

The methods by which the Commission carries out its statutory responsibilities are varied. A major part of its energies is devoted to the examination and processing of

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registration statements and other documents and reports required to be filed by companies, corporate insiders, broker-dealers, investment companies and investment advisers. The preparation of these documents, the resulting interchanges between the registrant or reporting person and the Commission's staff and the publication of interpretative letters and releases are part of an ongoing process of public education concerning the requirements of the securities laws. Examination of filed documents, market surveillance and investor complaints lead on occasion to the discovery of manipulative or deceptive practices. Inquiries, which may lead to formal investigations, are then conducted, largely through the efforts of personnel assigned to the Commission's 16 regional and branch offices. If a formal investigation is authorized by the Commission, the subpoena power is available. Some, but not all, of these investigations result in formal enforcement proceedings. Civil injunctive actions and administrative proceedings require authorization by the Commission. Once authorized, they are prosecuted by members of the Commission's staff. Matters of a criminal nature are referred to the Department of Justice

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for prosecution. Other matters may be referred to one of the self-regulatory organizations for appropriate action.

The Commission does not exercise exclusive regulatory authority over the conduct of brokers and dealers. The Securities Exchange Act created a unique scheme of cooperative regulation under which the stock exchanges and the NASD as self-regulatory organizations were delegated authority to adopt rules regulating the conduct of their own members, subject to Commission oversight and the exercise, where necessary, of direct rule making and other powers. Self-regulation is premised on recognition by the Congress that the participants in the securities business can bring to bear on certain problems a greater degree of expertness and expedition than the Commission and can act in the realm of ethical standards and practices, some of which may not be within the reach of the antifraud provisions of the securities laws. Self-regulation also broadens the base of education and enforcement of the securities laws, and, being financed by the private sector, substantially reduces the costs to the taxpayers of securities regulation and enforcement. To be workable, cooperative regulation requires that the self-regulators exercise their powers in ways that

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will serve the public interest and protect investors and that the Commission perform diligently its oversight responsibilities. Cooperative regulation has worked reasonably well over the years. However, the 1968-1970 back office problems and financial problems in the securities business brought to light numerous unsound and unsafe practices, the existence and persistence of which have raised questions as to the efficacy of the oversight exercised by the Commission and the self-regulatory instrumentalities.

A major development in the past several years has been the expansion of the Commission's oversight over the activities of lawyers, accountants and other professionals. In a number of court actions and administrative proceedings the Commission has taken the position that these professionals in certain circumstances are accountable under the securities laws for actions undertaken in their professional capacities. The position adopted by the Commission in these cases has been controversial and is compelling a rethinking of traditional professional-client relationships and obligations. The process of articulating appropriate standards of conduct and reconciling fiduciary and public responsibilities, however, has only begun.

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A period of consultation and cooperative effort between the Commission and representative professional associations may assist in developing practicable guidelines.

The wide variety of activities in which the Commission is currently engaged and the new problems that are emerging as the result of the continuing evolution of the securities markets have imposed a severe strain on the resources of the Commission. Its staff presently numbers 1,500 persons. Burdened with the exacting tasks of examination, inspection, investigation and enforcement, the Commission has been handicapped in long range planning and in anticipating, and developing a response to. emerging problems. Limitations on its resources have had the effect of exaggerating the need to resort to a case-by-case approach in meeting new problems. In evaluating the effectiveness of the Commission's enforcement policies and practices, we took cognizance of those limitations. In the specific recommendations that follow, however, particularly in those areas where additional staff positions are suggested, we have assumed that, if the need is acknowledged, appropriate funding will be available.

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Forward Planning

The Commission's desire and duty to protect investors are obvious, but the most effective or desirable method of discharging that duty is frequently unclear. When new problems emerge, due to increased complexities of modern business compounded by the ingenuity (and sometimes the cupidity) of man, two steps are necessary: (1) to identify the problems and (2) to deal with them effectively.

We believe that the Commission has at times been tardy in identifying new problems and reacting to them effectively. For example, during the development of the back office glut of 1968-70, each broker-dealer tended to ignore its own shortcomings. The stock exchanges and other self-regulators were slow in identifying the condition as widespread. The Commission's identification and preventive or curative actions were not timely or sufficiently comprehensive.

In our judgment, the Commission and its staff are so preoccupied in discharging their vitally necessary day-to-day functions that insufficient time is allocated to future planning.

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Realistic planning for tomorrow's problems or programs requires the orderly collection of information and data; its classification, analysis and evaluation; and projection into the reasonably foreseeable future of indicated trends or developments. Performance of these functions should be effectively coordinated rather than dispersed throughout the offices of the Commissioners, the Divisions and the regional offices.

The Committee recommends that the Commission establish an instrumentality the primary purposes of which would be to identify emerging regulatory and enforcement problems and to develop a coordinated response. Such an instrumentality, properly structured, would hopefully provide an early warning system which would reduce the number of unheralded crises and permit an orderly approach to emerging problems.

The Committee suggests a planning office headed by a director responsible directly to the Commission. The director would be assisted by a small staff and would be free from any responsibility for day-to-day operations. His staff might usefully include a small number of experienced professionals

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in such fields as accounting, finance and law as well as one or more persons having a broad background in the securities industry.

The planning office would not work in an ivory tower. Responsibility would be shared with Division Directors and Regional Administrators, each of whom would be a participant in the planning process. There should be meeting's with agenda prepared and circulated in advance, and conclusions reached should be recorded in minutes. The planning office would provide a formal structure for the interchange of information on developing matters and for the consideration of alternative Though that office would be proposals for dealing with them. discharging a "staff" as distinguished from a "line" responsibility, it would have continuously available as input not only its own studies of developing trends but also the considered observations of the line officers. The director would be charged with the responsibility for developing with the Division Directors and Regional Administrators and presenting to the Commission possible alternative courses of action and priorities,

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111. Voluntary Compliance

Voluntary compliance with the securities laws is a major objective of the Commission. Voluntary compliance is aided by knowledge of applicable laws and principles on the part of corporate officers, broker-dealers, accountants, lawyers and others involved in the process of compliance. To promote greater awareness and understanding of legal requirements the Commission promulgates guides to compliance through rules, registration and reporting forms, statements of policy, interpretive releases, guidelines and speeches. In addition, there are available published services on securities regulation. Seminars are held in various parts of the country in which members of the Commission and its staff frequently participate. The mutual exchange of views is beneficial both to the Commission and to those subject to its regulation. On the whole, a reasonably accurate answer to the question of what the Commission requires in a given situation can be found in publicly available material.

In view of the growing complexity of the securities laws, the Committee recommends that the Commission should make greater use of compliance checklists which it would distribute

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to brokers and dealers, investment companies and investment advisers. The official transmittal of such a list might strengthen the hand of compliance officers in such organizations. Since compliance officers generally lack the prestige associated with direct contribution to net profit, anything which the Commission does to enhance the status of such officers and to emphasize the importance of each of their many tasks should aid compliance. The Committee has examined a compliance checklist prepared by the Division of Trading and Markets and found it to be a useful tool for compliance officers. We recommend expansion of the use of similar techniques by all Divisions and Offices of the Commission, together with periodic review and updating.

Requirements for adequate internal accounting and financial reporting guide brokers, dealers and investment advisers into sound business practices which, in turn, protect investors. The Commission has broad authority to prescribe accounting and reporting requirements. The recent crisis in the securities industry has revealed, however, that inadequate accounting is far too prevalent among brokers and

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dealers. Moreover, meaningful financial reporting to customers by brokers and dealers is not prevalent enough. The Commission has recently taken steps to improve accounting and internal auditing by broker-dealers and to require the reporting of certain information to their customers on quarterly and annual bases. The Commission should attach a high priority to the adoption and implementation of rules in these areas. Comprehensive and uniform reporting by broker-dealers would represent a major step forward in the realization of the objectives of the Securities Exchange Act of 1934.

The exchanges, the NASD and the American Institute of Certified Public Accountants ("AICPA") bear a heavy responsibility to further the development of accounting practices and auditing standards for brokers and dealers. An exposure draft on the auditing of brokers and dealers has been prepared by the AICPA and is being circulated to appropriate parties for their comments. Improvement of auditing practices by independent auditors should continue to receive the energetic attention of the Commission.

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The process of securing compliance through a broad public information program is not without pitfalls. The Committee believes, for example, that the public availability of virtually all no-action letters has resulted in a deluge of paper with no practicable means of making the contents useful as a medium of information. Moreover, no-action letters are so frequently based on narrow and peculiar factual situations that they have little precedential value. As a more useful and effective aid to securing compliance, the Committee recommends the publication of a periodic -- perhaps quarterly -- summary of significant positions taken by the staff. Such summaries are used within the Commission, and there is no sufficient reason for not making them available to the public.

While this report does not deal with the substance of interpretative pronouncements, the Committee suggests that the Commission and the staff would contribute to better understanding of the securities laws and more general voluntary compliance if interpretative exceptions to rules and policies were promptly reflected in published revisions of such rules and policies.

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Investigations

IV.

Investigations by the Commission, both formal and informal, are the primary source of the Commission's disciplinary proceedings and of court actions seeking an injunction or criminal conviction. Generally speaking, an informal inquiry by the staff without the use of compulsory process precedes a formal investigation. The issuence of a subpoena requires formal authorization by the Commission pursuant to an order of investigation. The Commission issues such orders on the basis of a staff memorandum, prepared initially in a Regional Office or in a particular Division.

Investigations are normally not publicly announced. Nevertheless, the fact that an investigation is in process becomes known, and, therefore, the initiation of an investigation may itself operate as a sanction. The multiple steps involved in issuing an investigative order have developed because of the impact of an investigation on the party being investigated. The fact that an investigation has been ordered by the Commission itself is frequently interpreted by the public as a predetermination by the Commission that the party named in the order has violated the law. Almost 40 years of

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