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# A LOOK AT THE SEC'S ADMINISTRATIVE PRACTICE

An Address by

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Securities and Exchange Commission

April 25, 1974

SOUTHWESTERN LEGAL FOUNDATION

Hilton Inn
Dallas, Texas

This annual symposium of the Continuing Legal Education Center of the Southwestern Legal Foundation has long been held high in my esteem. Each year, the assortment of topics has been remarkably timely, especially considering the fact that the planning is necessarily done many months in advance, and the speakers have been of uniformly high caliber. I have looked forward to being part of the occasion.

Certainly the general area of individual and professional responsibility in the disclosure process and beyond, in our corporate life generally, is timely and will continue to be timely. But so, too, are your other topics. Their selection reflects to a degree the sad state of our public capital markets, both six months ago, when the program was being arranged, and today. The registration of an underwritten public offering of new equity securities to be offered for cash was a rare species last October, and it still is.

Businessmen are still not willing or, sometimes even if willing, not able, to sell new shares for cash in these markets. How long this circumstance can endure without doing major damage to our economy is a matter of increasing concern. The drying up of the market for new equities has already done serious harm to the securities industry, and is causing the curtailment of expansion or the perversion of capital structures for many companies.

Meanwhile, as we all know, offerings of tax shelters are thriving, along with other modes of investment that are largely outside of our jurisdiction, or at least are thought to be by their promoters. We have nothing against tax shelters, given the present state of our tax laws, but I, at least, would be happier - - and our economy would be healthier - - if they did not contribute so large a segment of our new money offerings. But it does not add much to this symposium to dwell on our current economic miseries, important

though they are. I would rather use these few minutes to explore another area, namely our activities through formal administrative proceedings.

Mention of taxes reminds us that April 15 wasn't very long ago. So the analogy with which I begin the remainder of my talk may not be altogether pleasant. But it is apt.

The securities laws have much in common with the Internal Revenue Code. Both depend, in overwhelming measure, on voluntary compliance. In neither area, however, can we afford to depend solely on that. In both, enforcement programs are an effective spur, and hence an essential supplement, to voluntary compliance. So the securities statutes provide for a battery of enforcement techniques.

The SEC can bring injunctive actions in the federal courts. It can also refer matters to the Attorney General for criminal prosecution. And it is itself a tribunal. Each statute administered by the Commission authorizes it to institute and decide cases that affect private rights.

Adjudication by administrators, rather than by judges, has long been with us. The first federal regulatory agency, the Interstate Commerce Commission, dates back to 1887. The SEC is not quite so venerable. But even it is about to celebrate its fortieth birthday. Yet age has not brought total acceptance. Even after all these years, the idea of combining prosecutorial, legislative, and decisional functions in a single body seems peculiar at first blush. Those trained in the common law tradition tend to think it unseemly. (Some use even stronger words.) Men in business suits around a table aren't quite the same as men in robes on a judicial bench. And most lawyers still have a marked preference for robed tribunals.

Good manners and the normal desire of advocates to ingratiate themselves with the tribunal to which they speak may inhibit you from voicing that preference in your briefs and arguments before us. But we know it is there. We may have voiced it ourselves in our own days at the bar. The voluminous literature in which lawyers, law professors, political scientists - - and former regulators - - have spilled oceans of ink on administrative adjudication and its shortcomings reminds us of the profession's aversion to administrative power.

The litigants who appear before us pro se are often less restrained than lawyers when it comes to telling us what they really think. They aren't at all shy about saying that it is unfair, unconstitutional, and, perhaps, even "Unamerican" to have to stand trial for an alleged violation of a rule before a body of men who:

(a) wrote the rule in the first place;

(b) have repeatedly announced that they think the rule important and beneficent and that they intend to enforce it vigorously;

(c) are in intimate daily contact with, and are also the superiors of, the very people who gathered the evidence against the respondents;

(d) have, by authorizing the initiation of the proceeding, already decided that the charges are true and that the respondents ought to be punished;

(e) while purporting to pass on the respondent's case objectively and disinterestedly, are sometimes doing their level best (wearing another set of hats) to send him to jail; and

(f) to top it all off, needn't be lawyers, and occasionally aren't.

My colleagues and I find these aspersions a bit unfair. For we review the contentions of unrepresented litigants with especially painful care. So the unflattering sentiments some of them voice about us can, on a bad day, stir us to gloomy reflections. But we understand their feelings.

The judge-jury-prosecutor combined at the SEC and in other administrative agencies does look strange. Some say that it cannot be squared with the ancient maxim that no man should be a judge in his own case. For that reason, and for others, it has been suggested that the agencies be stripped of their decisional functions and that the cases that now come before them go to "administrative courts." That is a big subject on which reasonable men can reasonably differ. I won't talk about it here, except to note two points:

(1) Were this change made, my job would be less interesting but much easier. Adjudication is fascinating. But it is also taxing. The records are massive, the briefs voluminous, and the issues are often subtle.

(2) The critics' quarrel is not with the agencies, but with Congress.

Having said that, I propose to focus on things as they are, rather than on proposals for radical restructuring.

Administrative tribunals are imperfect. But so are courts and other human institutions. Those who maintain that administrative justice is necessarily inferior to the judicial variety and that administrative adjudication is inherently unfair are, I think, mistake. They underestimate what agencies can do, and have done, to attain the ends of justice in the litigated controversies that come before them.

Let us begin at the beginning. How does an SEC administrative proceeding start? That depends on the kind of a case it is. This unilluminating answer is a rhetorical device designed to draw your attention to an often overlooked point.

Many of the cases that come to us are initiated by private persons. Neither the Commission nor its staff has anything to do with starting these cases. Thus, for example, most cases under the Public Utility Holding Company and Investment Company Acts come to us on applications by regulated interests for leave to do something that cannot be done under those statutes without our approval. The Securities Exchange Act also produces adjudicatory work of that type. We get delisting applications by exchanges, applications by issuers for exemptions from the Act's continuous disclosure requirements, and applications for review of disciplinary action taken by the National Association of Securities Dealers. Those among you who follow our decisions know that the last type of case, appeals from the NASD, accounts for much of the SEC's docket. And, if you read the cases, you also know that neither our devotion to the principle of cooperative regulation nor our staff's close liaison with the NASD in many areas has had much influence on our NASD review decisions. When we think the NASD is wrong, we reverse or modify. And when we do so, we sometimes speak to the Association as sharply as appellate courts speak to us when they discuss our errors.

Some of you may think I am sliding away from the critical point. I can hear skeptics thinking: Granted that there are esoteric situation (actually, they aren't all that esoteric) under the Holding Company and Investment Company Acts in which the SEC looks something like a court, and granted further that the Commission can approach its

NASD cases disinterestedly; but what about the far more numerous class of cases in which the Commission's own staff is the charging party?

To begin with, SEC administrative proceedings are seldom begun on mere hunch. True, situations arise that call - - or seem to call - - for fast, drastic action on concededly imperfect knowledge. But such matters are not generally pursued administratively. In such cases, the Commission normally will go to the courts for temporary restraining orders and preliminary injunctions. An SEC administrative proceeding is almost invariably based on an investigation - - often a protracted one.

Seldom does the investigation consist entirely of the informal kind of inquiry that a lawyer in private practice makes before he starts important litigation. For the Commission's staff, that is usually just the beginning. It is generally followed by a formal investigation, in which subpoenas are issued and oaths are administered. Usually, no such formal investigation can be launched unless expressly authorized by order of the Commission.

So doesn't the Commission really decide the case right then and there when it issues a formal order of investigation? Absolutely not. Anyone who thinks that could conclude, with equal logic, that a judge who finds probable cause for the issuance of a warrant is rendering an advance decision in the prosecution's favor on the criminal case that may ensue - - rendering indictment and trial mere rituals.

The issuance of investigative orders is an administrative, not a judicial function. Of course, even at that juncture, we are interested in the nature of the staff's suspicions and in the legal theories it may have formulated. But, at this early stage, factual and legal theories tend to be sketchy. Often, all the staff can tell us is that here is a set of

circumstances that may well be wholly innocent but which look irregular and which call, in its judgment, for an inquiry more searching than the one the staff has been able to make informally. It is usually hard to disagree. But, once in a while, we do.

At the investigatory stage, counsel will sometimes think primarily about the Fifth Amendment. Much more often, however, the lawyer who knows what he is doing will concentrate on making as good an investigative record for his client as he possibly can. He'll be alert for ambiguities and diligent in clearing them up. And, even at this early point, there are many situations in which counsel should explore settlement possibilities with the staff. One needn't wait until a formal proceeding has been begun, even though, at that stage, the staff may not be authorized to negotiate. Of late, we have had a number of cases that were settled before they began. This happens pursuant to offers of settlement that include consents to the initiation of proceedings and to their simultaneous disposition. Respondents and their counsel frequently find this procedure advantageous. An important consideration in its favor from their point of view relates to the desire for a prompt disposition of the matter. In addition, if the proceeding is disposed of at the very time that it is begun, there normally will be only one round of adverse publicity. Otherwise, there may be two - - or more. Lawyers should think about such things.

Settlements are of the utmost significance in SEC work. And I'll have occasion to refer to them again. For the present, however, let us assume that there have been no settlement talks or that they have fallen through and that you and our staff are fighting it out all the way. Well, that can't happen, unless the Commission, not just its staff, has decided that the matter is worth a fight. The staff cannot initiate administrative or judicial litigation unless the Commission authorizes that step.

Some think that we should leave the investigation of cases and the initiation of proceedings to the staff's discretion and confine ourselves to the purely decisional function. Up to now, the Commission has not been able to see its way clear to that. Though the decision to initiate proceedings is made ex parte, we nevertheless perform what we consider a useful winnowing function when we pass on the staff's requests for authority to start cases. For one thing, those determinations are not made on a wholly one-sided basis. The staff's presentations to us, where appropriate, attempt to summarize the other side's contentions. And prospective defendants or respondents need not depend on the staff to state their cases. You can give us a written statement of your views. We'll always study it. And sometimes we'll even find it persuasive. If we do, the nature of the proposed proceeding may be modified , or, perhaps, there won't be any proceeding.

But, in assessing your chances of success at this pre-proceeding point, you have to remember that we, at this point, are still administrators, guessing about possibilities and probabilities not adjudicators making findings and drawing conclusions. The issue is simply this: Does the staff deserve, and is it in the public interest to give it, a chance to prove its case? It may be a little misleading to speak of the staff deserving a chance to make its case. Whether it deserves the chance does not depend upon the quantity of its investigative effort, but rather, upon the quality of its alleged case and the soundness of the legal theory involved.

Once an administrative proceeding is begun, it is assigned to one of the Commission's hearing officers. These adjudicators, the administrative counterparts of trial judges in the judicial hierarchy, who were once called trial examiners and later styled hearing examiners, are now known as administrative law judges. The title gives

them the recognition they deserve - - a recognition withheld from them for too long. The administrative law judge's duties are purely decisional. He has never had any prior connection with any matter that comes before him. And he is as insulated as he could possibly be from prosecutional influence.

I just compared administrative law judges to trial judges. Like most analogies, that one isn't altogether perfect. In the courts, the parties cannot normally waive a decision by the trial judge. At the SEC, they can. When they do, the case goes directly to the Commission on the record made before the administrative law judge. Generally, however, at least one party wants an initial decision. If the parties are satisfied with the administrative law judge's initial decision, it almost always becomes the Commission's final decision. We have the power to review initial decisions on our own motion. But we exercise it sparingly.

Most staff-initiated administrative proceedings that come to the Commission for decision get there on petitions for review by parties dissatisfied with the initial decision. We grant such petitions freely. We do that because we are reluctant to deprive either our staff or a respondent of an opportunity for review by the full Commission. Indeed, our rules provide for an absolute right to review in broker-dealer cases where the initial decision is adverse to the respondent. That is because of the seriously detrimental effect such decisions can have on respondents. We don't put a man out of business merely because his lawyer hasn't bothered to draft an artistic petition for review. In cases other than broker-dealer cases, our rules require that the petition for review make a "reasonable showing" of error in the initial decision, or of the presence of an important question of law or policy that the Commission should review. But our Office of Opinions and

Review, which has delegated authority to pass on petitions for review, interprets this "reasonable showing" requirement in a rather relaxed way. Save in a case wholly without a semblance of merit, no lawyer worth his salt should have any difficulty in preparing a petition for review that will pass muster. If you don't have any legal or factual points of substance, you can always argue that the recommended sanction is unduly severe. Often, that is the only issue. The respondent argues that the administrative law judge was too harsh. And our staff says that he was too lenient. These petitions needn't be elaborate. Normally it is enough to sketch the contentions to be developed in a subsequent brief.

Advocacy before the SEC is no different from advocacy anywhere else. So I won't lecture on it, except to say that most cases at the SEC and elsewhere turn on the facts. So it is usually well for the advocate to bear down on them. With respect to the law, I am tempted to say that you can safely assume that we know the rudiments. However, I remember the lawyer who was told that by an appellate judge who replied: "I made that mistake in the court below. I don't intent to make it here."

When a case comes to us for decision on the record and briefs - - and I should say at this point that, except with respect to interlocutory matters, we almost invariably grant requests for oral argument - - we put what we learned or were told about the matter in our prior extra-judicial contacts with it to one side. We do all that we can to see to it that our quasi-judicial decisions are based solely on the records before us. That may sound as though it calls for humanly impossible feats of mental gymnastics. And it is, of course, true, that human psychology is complex, and that no one can speak with total assurance about his own mental processes.

But a conscious self-disciplined drive for objectivity, a healthy awareness of one's own fallibility, and a keen sense of the importance of the decisional function are potent checks on prejudgment. We have some other checks as well.

One stems from the fact that our Office of Opinions and Review, which works with us in the decisional area, has nothing whatever to do with prosecutions or investigations. Its primary function is that of assisting us in our decisional work. Since that Office also has certain responsibilities with regard to settlements, this is a good place to touch on that important topic.

Settlements are important almost everywhere in the law. They are especially important in securities regulation. If our staff had to fight each case all the way through, the Commission's enforcement program would grind to a halt. It does not have, and probably never will have, the resources for so stupendous a litigation effort. So our general policy is that of encouraging settlements.

But, since our proceedings are not comparable to ordinary civil actions about money, they are not settled in quite the same way as one settles a routine action by John Doe against Richard Roe. Because of the significant public interest considerations involved in proceedings before it, the Commission keeps close control over the settlement process. Our practice in this regard has some resemblance to that of the courts in shareholders' derivative actions, class actions, bankruptcy and reorganization proceedings, and other areas deemed to call for special vigilance.

For the lawyer, this means that there is more to settling an SEC case than just striking an acceptable bargain with the staff. Every offer of settlement must be submitted

to the Commission. And, until the Commission issues its order accepting the offer, it is just an offer.

In passing on offers of settlement, we consult with our staff and are guided to a great extent by its recommendations. But that does not mean that we rubber stamp those recommendations. Proposals our staff considered acceptable have been found unacceptable by us. And, once in a great while, the Commission will accept an offer that the staff deems inadequate. Remember, that you do not necessarily need a green light from the staff in order to get your offer before us. Of course, settlement is not adjudication. And your chances of success are much better if the staff is on your side.

In closing, I borrow a phrase from the conveyancer's lexicon: I return to the "point of beginning." In this area that means that I go back in time to the very first SEC case to come before the Supreme Court, Jones v. Securities and Exchange Commission,* That case was decided exactly thirty-eight years ago, in April, 1936. It involved a stop-order proceeding under the Securities Act. Something about the S.E.C. reminded Mr. Justice Sutherland, who wrote the majority opinion, of "those intolerable abuses of the Star Chamber, which brought that institution to an end at the hands of the Long Parliament in 1660." Mr. Justice Cardozo dissented. In an opinion that was joined in by Justices Brandeis and Stone, he said:

> "The opinion of the court reminds us of the dangers that wait upon the abuse of power by officialdom unchained. The warning is so fraught with truth that it can never be untimely. But timely too is the reminder, as a host of impoverished investors will be ready to attest, that there are dangers in untruths and half truths when certificates masquerading as securities pass current in the market. There are dangers in spreading a belief that untruths and half truths, designed to be passed on for the guidance of confiding buyers, are to be ranked as peccadillos, or even perhaps as part of the amenities of business. When wrongs

* 298 U.S. 1 (1936).

> such as these have been committed or attempted, they must be dragged to light and pilloried."

Justice Cardozo went on to speak of the majority's comparison of the SEC "with denunciatory fervor to the Star Chamber of the Stuarts." Then he added: "Historians may find hyperbole in the sanguinary simile."

I think they have.