CREATING LAW AT THE SECURITIES AND EXCHANGE COMMISSION: THE LAWYER AS PROSECUTOR

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I

INTRODUCTION

The Securities and Exchange Commission ("SEC" or "Commission") engages in a wide range of regulatory activities, and its mix of administrative functions has changed over the years. At one time it was busily engaged in dismantling public utility holding companies and participating in bankruptcy reorganizations,[1] and today it devotes considerable resources to oversight of securities self-regulatory organizations and implementation of the national market system.[2] Since its creation in 1934, an important function of the SEC has been processing registration statements and other disclosure documents by public issuers.[3]

Nevertheless, the SEC's public reputation rests largely on its work as a prosecutorial agency—the policeman of Wall Street. It has a vast and varied arsenal of prosecutorial weapons in proceedings before the agency,[4] and it can

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1. The Public Utility Holding Company Act, 49 Stat. 803 (codified at 15 U.S.C. §§ 79a-79z-6 (1994)), was passed in 1935. Although the SEC's work in dismantling public utility holding companies was completed years ago, it continues to administer this statute despite repeated suggestions that its administration be passed on to the former Federal Power Commission or that the statute be repealed, an example of the persistence of regulation long after the need for a particular regulatory scheme has passed. *See* I LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 241-42 n.38 (1989).

2. The task of facilitating the national market system was given to the SEC in 1975 through amendments to the Securities Exchange Act of 1934. *See* Pub. L. No. 94-29, 89 Stat. 97 (1975); *see also* Norman S. Poser, *A Critical Look at the SEC's National Market System*, 56 N.Y.U. L. REV. 883 (1981).

3. Initially, the SEC's authority was confined to processing disclosure documents by companies engaged in public offerings and to reviewing the annual and periodic disclosure documents of listed issuers. In 1964, the SEC was given authority with respect to the annual and periodic disclosures of all public companies. *See* Pub. L. No. 88-467, 78 Stat. 556 (1964).

4. For example, under the Securities Act of 1933, the SEC can stop order registration statements and issue cease-and-desist orders, 15 U.S.C. §§ 77h(d)(3), 77h-1 (1994), and under the Securities Exchange Act of 1934, it can suspend or revoke the registration of broker-dealers and their associates,

bring injunctive actions that can include ancillary relief in the federal courts.[5] Furthermore, violations of the securities laws are both civil and criminal. Accordingly, when judges interpret novel cases under the securities laws, the outcome may differ depending upon whether the judge invokes the doctrine that the securities laws are broad remedial statutes that should be liberally interpreted or are criminal statutes that should be strictly construed.[6]

Frequently, the SEC makes new law through enforcement cases rather than through rulemaking. Sometimes this effort at creating new law is blessed by the courts, as recently occurred with the SEC's misappropriation theory for the crime of insider trading.[7] Sometimes the SEC makes new law through enforcement cases and then this extension of its authority is incorporated by Congress in statutory amendments to the securities laws, as happened after the SEC's sensitive payments enforcement cases, which resulted in the enactment of the Foreign Corrupt Practices Act.[8] At other times, SEC creativity at extending the securities laws is rejected and disregarded.[9]

This essay will discuss the role of the SEC prosecutor in the context of the ethical obligations of a government lawyer when expanding the SEC's authority through the development of new legal theories. If the obligation of a government prosecutor is not simply zealous representation of a client, but also the obligation to seek justice, is it appropriate to use enforcement cases as policy instruments to achieve new legal standards? How does a government lawyer acting as a prosecutor in a novel case balance obligations to the public at large against fair treatment of an individual defendant? It is easier to pose these

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compel issuers and others to correct filings, issue cease-and-desist orders, issue fines, and suspend trading in securities, 15 U.S.C. §§ 78*l*(k), 78o(b)(4) - (6), 78o(c)(4), 78u-2, 78u-3 (1994).

5. *See* 15 U.S.C. §§ 77t(b), 78u(d) (1994). There are similar provisions in other statutes administered by the SEC. *See generally* George Dent, *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 MINN. L. REV. 865 (1983).

6. *See* United States v. O'Hagan, 117 S. Ct. 2199, 2220 (1997) (Scalia, J., dissenting). The courts have focused on the problems of dual civil and criminal violations in double jeopardy claim cases, and the Supreme Court has recently concluded that an administrative sanction imposed by federal banking regulators posed no double jeopardy bar to a later criminal prosecution. *See* Hudson v. United States, 118 S. Ct. 488 (1997). The Court considered the sanctions, and also the civil goal of deterrence and the criminal goal of punishment, and concluded that the civil sanctions were not criminal punishments. Courts have sometimes used the doctrine of lenity to interpret a statute narrowly in a civil case because the statute also has criminal sanctions. *See, e.g.*, United States v. Thompson/Center Arms Co., 504 U.S. 505, 518-19 (1992); Crandon v. United States, 494 U.S. 152, 168 (1990). But courts have not squarely confronted the problem that, if the securities laws are liberally interpreted in civil cases, criminal acts are thus defined.

7. *See O'Hagan*, 117 S. Ct. at 2199. In fact, insider trading is not defined in the securities laws and is itself an excellent example of law creation by the SEC, accomplished through an administrative broker-dealer disciplinary proceeding, *see* Cady Roberts & Co., 40 S.E.C. 907 (1961), and through an SEC injunctive action, *see* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

8. *See Report of the SEC on Questionable and Illegal Corporate Payments and Practices to the Senate Comm. on Corporate Disclosure to the SEC, House Comm. on Banking, Housing and Urban Affairs*, 95th Cong., (1976) (the backdrop to Pub. L. No. 95-213, 91 Stat. 1494 (1977), which added §§ 13(b)(2), 30A and 32 to the Securities Exchange Act of 1934, codified at 15 U.S.C. §§ 78m(b)(2), 78dd-1, 78dd-2, and 78ff (1994)); *see also* S. REP. NO. 95-114 (1977).

9. *See, e.g.*, International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979) (rebuffing SEC's attempt to extend the definition of "security" to include pension rights); *see also* SEC v. Sloan, 436 U.S. 103 (1978).

questions than to answer them, especially in a field like securities law where the public interest is defined in terms of investor confidence in the public securities markets—an amorphous goal—and defendants are frequently big businesses or individuals who are flamboyant confidence men. It is easy for populists to believe in the righteousness of their cause in chasing white collar criminals. It is more difficult to decline to prosecute those who have engaged in questionable conduct because such conduct does not breach any clear legal standard in a complex statutory scheme where many standards are unclear.

This essay will also discuss the tensions between the enforcement staff and the SEC Commissioners with respect to this process of law creation. Although the SEC enforcement attorney does not represent his own view of the public interest, but rather the agency as an entity, if there are conflicting viewpoints among agency commissioners, to whom does the enforcement attorney listen for guidance? Should the Commission take a different view of the law when it is acting in an executive role in instituting a case than when it is acting in a judicial role in deciding an administrative proceeding? Since most cases are settled, at what juncture should prosecutorial discretion be exercised, and by whom—the staff or the Commission?

The articulation of new standards is a difficult business, especially in a dynamic and fast paced area like securities regulation. The government is always in a reactive mode, lagging behind developments in the marketplace. The case-by-case development of the law of fraud, overreaching, or similar conduct is involved is not necessarily bad, but I have always been troubled by the utilization of novel theories in criminal prosecutions and many SEC civil enforcement cases where the consequences are serious to the individual defendants. An agency that operates this way needs very good judgment and prosecutorial restraint to maintain its credibility as a regulator. The government prosecutor must therefore be attentive not only to the agency's and the public's best long term interests, but also to current political and judicial trends. Government prosecutors are public servants. In my view, persons under investigation and defendants in government prosecution are among the members of the public served.

II

THE GOVERNMENT LAWYER'S CLIENT

"When a lawyer is employed by or retained to represent an organization, the lawyer represents the interests of the organization as defined by its responsible agents acting pursuant to the organization's decisionmaking procedures."[10] In day-to-day matters, this means a lawyer generally takes instructions from an organization's managers. In the corporate context, there has been considerable

10. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 155(1)(a) (Tentative Draft No. 8, 1997) [hereinafter "RESTATEMENT"]. The ABA Model Rules uses a slightly different phrasing: "A lawyer employed or retained by an organization represents the organization acting through its duly organized constituents." MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13(a) (1992).

debate about the role of the lawyer when a corporation is violating the law. Much of this debate was sparked by SEC cases that suggested the corporate lawyer should be a whistleblower, owing a duty either to shareholders or to the marketplace.[11] This debate was resolved by acceptance of the principle that when a lawyer represents a corporation that is acting illegally, the lawyer must bring the matter to the attention of the corporation's board of directors, and if the directors do not rectify the situation, the lawyer must resign.[12] Nevertheless, in some situations, courts have suggested that a corporate lawyer represents the shareholders, not the corporate officers.[13]

Similar debates have focused on the government lawyer. Does the government lawyer represent the agency or the public interest? According to the *Restatement of the Law Governing Lawyers*, the government lawyer represents the agency that employs him.[14] An agency lawyer also serves the interests of commissioners who have decisionmaking authority, and his responsibilities are determined through a chain of command that relieves him of the duty to assess the public interest personally.[15]

Representation of the government client differs from representation of a private sector client in three principle respects. First, the goals of a governmental client necessarily include pursuit of the public interest.[16] Second, both government lawyers and those who direct their activities are often subject to greater legal constraints.[17] Third, and conversely, a government lawyer may possess powers beyond those possessed by a corporate lawyer, such as the power to select those persons who will be charged with crimes or prosecuted in civil actions for illegal behavior.[18] As a practical matter, a government prosecutor has a certain amount of autonomy in investigating and prosecuting cases. The SEC prosecutor also has the tools to marshal public opinion in favor of its choice of prosecutions through dealings with the Congress and the press.

Good arguments have been made about why the government lawyer cannot determine the public interest without regard to an agency's hierarchical decisionmaking process. The agency client must believe that the lawyer will represent the legitimate interests the agency seeks to advance, and not be influenced

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11. *See* SEC v. National Student Mktg. Corp., [1971-72 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,360 (D.D.C. Feb. 3, 1972). Although the SEC prevailed in obtaining a judgment, the appeals court rejected its theory that attorneys should be whistleblowers for the government. *See* SEC v. National Student Mktg. Corp., 538 F.2d 404 (D.C. Cir. 1976).

12. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.16 (1992); Simon M. Lorne & W. Hardy Callcott, *Administrative Actions Against Lawyers Before the SEC*, 50 BUS. LAW. 1293 (1995).

13. *See, e.g.*, Garner v. Wolfinbarger, 430 F.2d 1093 (5th Cir. 1970).

14. *See* RESTATEMENT, *supra* note 10, at §§ 155, 156.

15. *See* Geoffrey P. Miller, *Government Lawyers' Ethics in a System of Checks and Balances*, 54 U. CHI. L. REV. 1293, 1298 (1987); Beth Nolan, *Removing Conflicts from the Administration of Justice: Conflicts of Interest and Independent Counsels Under the Ethics in Government Act*, 79 GEO. L.J. 1, 42 (1990).

16. *See* RESTATEMENT, *supra* note 10, at § 156 cmt. b.

17. *See id.*

18. *See id.*

by some unique and personal vision of the public interest.[19] The agency approach permits the agency to rely on the governmental lawyer.[20] Further, neither the Constitution nor the electorate has invested the government attorney with independence to determine what policies are enlightened or to advance the cause of justice or further his individual public policy agenda.[21]

Although a government lawyer must follow the instructions of his superiors with respect to scope and implementation of the representation, he is supposed to advance the public interest, not merely the partisan or personal interest of the agency.[22] Also, a prosecutor must protect the rights of the innocent and the guilty.[23] In criminal cases, this is interpreted as meaning prosecutors must bring charges only if based on probable cause.[24] While it would seem to follow that such a standard should apply to serious civil prosecutions such as SEC cases, there is no case authority on point.[25] The courts sometimes have rejected arguments that the severe consequences of SEC prosecutions should make them subject to principles utilized in criminal cases by invoking the doctrine that the securities laws are remedial statutes.[26] But since a violation of the securities laws is both civil and criminal, it would seem that prosecutorial discretion should be similarly restrained.

I experienced the conflicts between an enforcement attorney's own view of the public interest in the development of cases and an agency's more general and sometimes contrary view on two different tours of duty at the SEC. From 1962 until 1969, I served as an enforcement attorney, then branch chief, and then assistant regional administrator in the SEC's New York Regional Office. From 1977 until 1980, I was a Commissioner of the SEC. In analyzing the ethical obligations of an SEC prosecutor, it is important to understand that the SEC frequently articulates new policies and develops the law through cases. What kind of probable cause standard applies to such a situation? If a new legal standard is untested, must the prosecutor believe that the Supreme Court will accept this doctrine, or must the prosecutor only believe that a proposed defendant engaged in conduct that ought to be illegal? Or is it sufficient to believe that the defendant will settle the case?

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19. *See* Roger C. Cramton, *The Lawyer as Whistleblower: Confidentiality and the Government Lawyer*, 5 GEO. J. LEGAL ETHICS 291, 298 (1991).

20. *See Report by the District of Columbia Bar Special Committee of Government Lawyers and the Model Rules on Professional Conduct, reprinted in* WASH. LAW., Sept.-Oct. 1988, at 53.

21. *See* Bruce E. Fein, *Promoting the President's Policies Through Legal Advocacy: An Ethical Imperative of the Government Attorney*, 30 FED. BAR NEWS & J. 406, 408 (1983). *But see* Charles Fahy, *Special Ethical Problems of Counsel for the Government*, 33 FED. BAR J. 331, 332 (1974) (arguing that a government lawyer's client is "the people as a whole").

22. *See* RESTATEMENT, *supra* note 10, at § 156 cmt. f.

23. *See id.* at cmt. h.

24. *See id.*

25. *See id.*

26. *See* Steadman v. SEC, 450 U.S. 91 (1981) (ruling that burden of proof in disciplinary cases is preponderance of the evidence, not clear and convincing evidence). *But see* Johnson v. SEC, 87 F.3d 484 (D.C. Cir. 1996) (sanction in administrative proceeding a "penalty" for purposes of statute of limitations).

III

CASE PROCESSING AT THE SEC

The SEC is an independent federal agency organized as a commission. There are five commissioners, one of whom is designated as Chairman. The SEC has always valued its independence, and as a prosecutorial agency, independence is an important feature of the agency's culture. The SEC is feared, on both Wall and Main Streets and on Capitol Hill, because of its power to generate adverse publicity and its key role in the capital raising process.[27] Congress and the President have generally been wary of interfering with the SEC's prosecutorial functions, although occasional lapses in this hands-off attitude have occurred.[28] The SEC represents itself in the lower courts, although the authority for so doing is somewhat unclear, but Congress declined to give the SEC authority to represent itself before the Supreme Court.[29] Early chairmen of the SEC recognized that in order to maintain the SEC's independence and integrity, the agency would need to stay out of politics and prevail in its cases. Great care was taken not to institute cases the SEC was not certain it would win.[30]

While the securities bar or the securities industry sometimes may complain that the Enforcement Division is "out of control," and investigations may sometimes range beyond the Commission's supervision, cases cannot be instituted or settled without the Commission's approval. A formal order of investigation from the SEC is needed for the Enforcement Division to take testimony under oath and subpoena records. A Commission order is also necessary for any civil action to be commenced in a federal court or before the Commission itself. The Commission also passes on settlement offers.

Nevertheless, the enforcement staff generally shapes the Commission's policies and develops new law through the cases it selects to pursue and the theories it utilizes in prosecuting them. This dynamic seems out of joint since it is the Commissioners who are selected by the President and confirmed by the Senate and invested with policy making functions. An analogy to the functioning of large public corporations is perhaps apt. Directors no longer actively manage corporations on a day-to-day basis; they monitor management.[31] This analogy cannot be pushed too far, however. Unlike directors, SEC Commissioners work full time and are generally more proactive.

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27. A high ranking SEC enforcement official once told me he had no interest in leaving the Commission despite the financial rewards available in the private sector because "now, every CEO in America will take my phone call."

28. *See infra* text accompanying note 33; *see also* SEC v. Wheeling-Pittsburgh Steel Corp., 648 F.2d 118 (3d Cir. 1981).

29. *See* Neal Devins, *Unitariness and Independence: Solicitor General Control over Independent Agency Litigation*, 82 CAL. L. REV. 255, 290 (1994).

30. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 126 (1982).

31. *See* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.01 cmt. a (1994).

In any event, the Commission's obligation to approve various stages of a case creates a certain tension between the Commission and the Enforcement Division. When I was an enforcement attorney, I thought obtaining a Commission order before I could go to court was a nuisance, a waste of valuable time before I could get an injunction to stop a scam or close down a broker-dealer with inadequate capital. I was led to believe that promotion within the agency turned on the development and successful prosecution of attention-grabbing cases. When I encountered problems persuading the Commission to institute a factually complex case based on a novel legal theory, I thought the Commissioners did not have proper political will. It did not occur to me that perhaps they questioned the policy implications of the case. When I was a Commissioner, however, I felt the enforcement staff was insufficiently respectful of my views on law and policy and too inclined to substitute their view of the public interest for the Commission's best interests.

To some extent, such a tension is healthy. The Commission prides itself on the give and take between the Commissioners and the staff. The Commission meeting room evidences this approach. It is not furnished like a courtroom with judges sitting above everyone else. Rather, the Commissioners and staff meet and discuss cases at a round table. Although lawyers in the United States are accustomed to working things out in an adversarial way, a third party—the hapless target of an SEC investigation or prosecution—who is not present or represented might well complain of unfairness in becoming the object of a struggle over enforcement policy.

During the time I was a Commissioner, policy creation was not entirely within the agency's control because of political changes outside the SEC. From its formation in 1934 until the mid-1970s, the SEC had a stellar record in the Supreme Court and the circuit courts, especially the Second Circuit, not only in cases where the SEC or the United States was the plaintiff, but also in cases where the SEC participated as *amicus curiae*. This was also a period of continuous expansion of the securities laws, through court interpretations of the statutes and their amendment by Congress. Then, in 1975, the Court began to cut back on the jurisdictional reach of the federal securities laws through restrictive interpretations of substantive provisions, particularly the general anti-fraud provisions.[32] This change in the judiciary's attitude was a harbinger of a far reaching political shift toward deregulation and less government at the federal level.

This change was wrenching for the Commission and its staff. The questions about the role and loyalties of the government prosecutor that are addressed here arose frequently while I was a Commissioner during the late 1970s. The context of prosecutorial decisionmaking was markedly different from the 1960s

32. This trend began with *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). The Second Circuit, like the SEC, resisted the Court's efforts to cut back on the scope of the statutes, particularly in anti-fraud cases. *See* Roberta S. Karmel & John P. Ketels, *Securities Commentary*, 44 BROOK. L. REV. 1189 (1978).

when I was an SEC enforcement attorney in the Commission's regional office in New York. An intervening watershed event was Watergate, which led to suspicion of government and to statutory regulation of the regulators. Watergate had a perverse effect on the SEC, however, because of President Nixon's efforts to tamper with the SEC's investigation of Robert Vesco, which embroiled the agency in rare and agonizing scandal.[33] During the post-Watergate years the SEC restored its reputation for integrity by investigating and prosecuting corporate violations of campaign finance laws.[34]

Although the world was changing during the Carter years, the SEC staff was resistant to such change, believing that any efforts to dampen its prosecutorial zeal were somehow corrupt and, in any event, contrary to the public interest. The Commission itself was divided. Two Commissioners were long-time staff members: Philip A. Loomis, Jr., a former General Counsel, and Irving M. Pollack, a former enforcement director. A third Commissioner, John R. Evans, had been a staffer on Capitol Hill. All three had been with the SEC during the Watergate scandal involving G. Bradford Cook,[35] which made them protective of the Enforcement Division and suspicious of business interests. The Chairman, Harold M. Williams, came from the business and academic worlds. I was the fifth and youngest member, and the first woman, and after leaving the SEC staff, I had been engaged in private practice, primarily representing firms in the securities industry. Many enforcement attorneys on the staff had been my friends and my mentors when I was a staffer, and they assumed I would return to the Commission as the vigorous prosecutor I had been when I was younger. However, my views had been seasoned by representing the regulated. I also had been affected by Watergate, but this crisis left me with a deep suspicion of government rather than a suspicion of Wall Street and big business.

In addition to the Watergate scandals, the outlook and activities of the SEC as a prosecutor had also been shaped by the SEC's organization and the formation of the Enforcement Division under Chairman William J. Casey in 1972. Before 1972, the Enforcement Division had been combined with what is now the Division of Market Regulation as the Division of Trading and Markets. It therefore had both regulatory and enforcement functions and responsibilities, a combination of functions that, in my experience, tends to temper prosecutorial zeal. Casey's vision was that the SEC's enforcement capabilities would become

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33. *See* SELIGMAN, *supra* note 30, at 446-48. In November 1972, the SEC filed a complaint against Vesco, charging him with looting $224 million from four mutual funds managed by Investors Overseas Services, an offshore investment adviser that had been in regulatory difficulty for many years. In May 1973, a federal grand jury charged that Maurice Stans, a former Secretary of Commerce and chief campaign fund raiser for President Nixon, had pressured G. Bradford Cook, who became Chairman of the SEC when William J. Casey resigned, to delete from the SEC's complaint against Vesco mention of a $250,000 cash delivery. This effort succeeded. As events unfolded, it was revealed that $200,000 of this money was secretly given by Vesco to President Nixon's re-election campaign. *See* Jurek Martin & Pascal Fletcher, *Fugitive Financier in Cuban Detention*, FIN. TIMES (London), June 10, 1995, at 3.

34. *See* SELIGMAN, *supra*, note 30, at 539-44.

35. *See id.* at 441-42, 445-46. Chairman Cook was forced to resign because of discrepancies in his testimony about the *Vesco* case. *See* State ex rel. Nebraska State Bar Ass'n v. Cook, 232 N.W. 2d 120 (Neb. 1975).

more professional and more subordinate to its policymaking activities. A cynic might wonder whether Casey also intended to ameliorate the agency's vigorous pursuit of powerful business interests. In any event, matters did not work out as envisioned.

Because of Watergate scandals at the Commission, the elevation of a former enforcement chief, Irving M. Pollack, to the Commission, and the strong and creative leadership of the Division of Enforcement for many years by Stanley Sporkin, the Enforcement Division dominated the Commission and to a significant extent set its agenda. As Chairman, Harold M. Williams gave the office of General Counsel a role in analyzing recommendations of the Division of Enforcement, but this generally led only to combat at the staff level rather than the development of fresh policies at the Commission level. Sometimes, however, this more assertive role of the General Counsel did effect a significant change in the Commission's prosecutorial posture.[36]

As a Commissioner, I was very concerned about the development of securities law, and opposed to both substantive and procedural jurisdictional expansionism through enforcement prosecutions. The United States Supreme Court had become highly critical of the SEC because of its efforts to expand its jurisdictional reach and I believed that the Court's new view of the securities laws merited obeisance and not resistance. Frequently, however, I was a dissenting voice and vote on such issues.[37]

What duty did the SEC prosecutors owe to me, as one Commissioner out of five who often disagreed with other Commissioners? If their duty was to the agency, as represented by the Commissioners, how did that duty play out when the Commission was divided? Commissions, like boards of directors, generally act by consensus. But political and personal policy differences may make consensus difficult. When the Commission is philosophically divided, the staff has three choices: It can delay decisionmaking; it can look to the chairman for guidance; or it can make policy on its own, formulating its own view of the public interest. Because the staff has a permanence that the Commission lacks, the third choice occurs more frequently than may be acknowledged.

In the prosecutorial function at the SEC, enforcement attorneys are the activists. They investigate suspicious facts and present cases to the Commission. Although the Commission must authorize any formal investigation, prosecution, or settlement, the staff controls the factual record which is presented to the Commission.[38] It is psychologically and politically difficult to decline to institute a case involving bad facts or to accept a questionable settlement. A

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36. For example, in *Lasker v. Burks*, 441 U.S. 471 (1979), the SEC's *amicus curiae* brief did not simply argue for affirmance of the Second Circuit decision, but took a more conservative posture, which was then adopted by the Supreme Court.

37. For a list of my dissents, see ROBERTA S. KARMEL, REGULATION BY PROSECUTION—THE SECURITIES AND EXCHANGE COMMISSION VERSUS CORPORATE AMERICA app. C (1982).

38. This is why I insisted on reviewing a Wells Submission, setting forth a proposed defendant's view of the facts and law, before voting in favor of any prosecution when I was a Commissioner. *See id.* at 222-26.

prosecutor's view of justice or public policy may, indeed probably will, be different from that of a Commissioner. Commissioners tend to be more moderate, perhaps because they are appointed as part of a political process, and perhaps because they have responsibilities for a wide variety of regulatory policies, not only litigation policy. An abstract principle that states that an agency attorney owes an ethical duty to the agency is not much help in resolving serious and sincere differences of opinion about novel cases.

As a Commissioner, I was particularly troubled by the frequent use of settlements to announce Commission policy in borderline cases. Many of my dissents involved the use of Section 21(a) of the Exchange Act[39] to settle cases which, in my view, would not have succeeded in the courts.[40] It is in this context that I wonder whether a prosecutor's obligation to bring a case only if there is probable cause applies to the use of leverage by the SEC to settle novel cases. Although settlements often are motivated by uncertainty about legal outcome, in my view, an SEC prosecutor should have a good faith belief that the courts would uphold the legal theory utilized and the Commission should not accept a settlement based on a theory it does not reasonably believe the courts would uphold.

Sometimes the Commission is better able to appreciate the policy implications of a particular enforcement case after it has been authorized and tried. On rare occasions, the Commission, when acting in its judicial role, will reject theories that it put forth in its prosecutorial role.[41] Such a reversal after the facts and legal theories have been vetted may make for better development of the law, but is it fair to the respondents whose careers have been adversely affected during this process?

I am not faulting enforcement attorneys for pushing cases that are novel. To the extent this is troublesome, it is a problem that is endemic to the administrative agency that combines prosecutorial, lawmaking, and adjudicatory functions. Furthermore, the inherent problems of a combination of functions have been exacerbated by the numerous constraints put on the regulatory process in recent years by Congress and the courts. These constraints increase the incentives on agencies like the SEC to develop new standards through enforcement cases rather than through rulemaking proceedings. However, where an investigation is complete, it is very difficult for the Commission to decline to institute a case involving bad facts or bad actors solely on the ground that the Supreme

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39. *See* 15 U.S.C. § 78u(a) (1994).

40. When I was a Commissioner, I filed a dissent to the practice of using settlements to announce new law. *See* Securities Exchange Act Rel. No. 15664 (March 21, 1979). A case disposed of in this fashion on that same day, *In the Matter of Robert K. Lifton*, Securities Exchange Act Rel. No. 15665 (Mar. 21, 1979), involved insider trading conduct that the Supreme Court subsequently held not to be a violation of the anti-fraud provisions. *See* United States v. Chiarella, 445 U.S. 222 (1980). Yet, many years later, the Court retreated from *Chiarella* in *United States v. O'Hagan*, 117 S. Ct. 2199 (1997). Further, in 1990, Congress gave the SEC authority to bring cease-and-desist actions, which was what the SEC was really doing in its use of Section 21(a) publicity as a sanction. *See* 15 U.S.C. §§ 77h-1, 78u-3 (1994).

41. *See, e.g.*, In re George C. Kern, Jr., 50 S.E.C. 596 (1991).

Court might not agree with the legal theory upon which the case is based. Therefore the Enforcement Division is often in the position to create new law when it is the Commissioners who should be doing so.

In addition, three avenues of communication utilized by SEC prosecutors may sometimes enable them to by-pass the Commission and take the initiative in the law creation process: lines to members of the financial press, relationships with congressional staff members or key members of the Congress, and direct communications with U.S. Attorneys' offices. A story about a financial scandal can, as a practical matter, create a climate where prosecution against a particular person or practice is no longer a Commission decision. The pressures to bring a case become too strong. Whether the story is leaked by an SEC staffer, a Congressional staffer, or an Assistant U.S. Attorney, or discovered by an enterprising reporter, is irrelevant. The SEC Enforcement Division has almost always enjoyed very good press. While this may be deserved for the most part, it is not an accident. Press relations are carefully cultivated.

Dealing with congressional staffers is a different kind of problem. At least while I was a Commissioner, the SEC did not consider itself as independent of Congress as it did of the White House. Perhaps this was a Watergate legacy, but it seemed to be more fundamental. Members of Congress who head up oversight committees can cause an agency like the SEC a great deal of aggravation or can benefit the agency through budgetary largess or friendly statutory amendments. Furthermore, SEC Commissioners frequently have come from the oversight committees, especially the Senate Banking Committee. There generally are cordial relations between the SEC staff and the congressional staffs. While the Enforcement Division probably would not quash an investigation because of congressional pressure, the staff can and does begin and pursue investigations because of it.

Because the securities laws specifically authorize the Commission to transmit evidence acquired in its investigations to the Attorney General for prosecution, relations with U.S. Attorneys' offices are different from relations with Congress.[42] When I was a staff enforcement attorney in the 1960s, formal criminal reference documents were prepared and authorized by the Commission for transmittal to the Department of Justice. By the time I was a Commissioner, the Commission did not review the facts or the legal theories upon which a criminal reference was based. Rather, the Commission authorized access to investigatory files by the Department of Justice. Whatever conversations then ensued between representatives of the Enforcement Division and representatives of U.S. Attorney's offices were not supervised by or reported to the Commission.

Some of the adverse effects of this abdication by the Commission of its responsibility for shaping the securities laws later became apparent. Restrictive court interpretations of the securities laws, especially in criminal cases, threat-

42. *See, e.g.*, 15 U.S.C. §§ 77t(b), 78u(h)(9)(B) (1994).

ened important enforcement programs.[43] During the 1980s, when Rudolph Giuliani was U.S. Attorney for the Southern District of New York, many high-profile insider trading cases were prosecuted on unsettled theories of law.[44] Moreover, the highly publicized and notorious arrests of three Wall Street investment bankers who were handcuffed in their offices but then refused to plea bargain or plead guilty to insider trading charges resulted in the dismissal of these charges as to two of the defendants years later.[45]

The cozy relationships between enforcement attorneys and influential outside forces like the financial press, Capitol Hill, and the Department of Justice can give the prosecutors more power than Commissioners have, especially in deciding legal policy issues. The ethical and legal questions involved in such a situation have rarely been examined. One issue of legal ethics involved is that attorneys have a duty to keep client confidences. If the client is the agency as represented by the Commissioners, should any enforcement attorney be discussing enforcement cases with anyone outside the agency?[46] It is difficult and unrealistic for Commissioners to prohibit communications between enforcement attorneys and Congress or criminal prosecutors. Calls from the press are difficult for enforcement attorneys to ignore. Prosecutors who are ambitious and persuaded of the righteousness of their cause seek publicity and favorable public opinion, especially when up against business interests they regard as powerful.

IV

CONCLUSION

This essay has examined the role and ethics of the SEC enforcement attorney in developing and prosecuting novel cases and the tensions between the prosecutors and the Commission that arise in this process. The essay has drawn to a large extent on my own experiences in government and so its inquiries and conclusions may be more subjective than the typical scholarly article. If my government service had occurred during different periods of the Commission's history, perhaps my outlook would be different. But I believe that my concerns

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43. *See, e.g.*, Chiarella v. United States, 445 U.S. 222 (1980); United States v. Mulheren, 938 F.2d 364 (2d Cir. 1991).

44. The law remained unsettled on these points until about a decade later, when *United States v. O'Hagan*, 117 S. Ct. 2199 (1997), was decided. *See supra* notes 6-7.

45. *See* Steve Schwartz & James B. Stewart, *Justice Delayed—Kidder's Mr. Wigton, Charged as "Insider," Ends His Long Ordeal*, WALL ST. J., Aug. 21, 1989, at A1. The third defendant eventually pleaded guilty to one count of mail fraud and consented to an injunction against him. *See* SEC Lit. Rel. No. 13663 (June 7, 1993).

46. Although government lawyers have a duty of confidentiality, this duty is more limited than the duty of a private practitioner because a government lawyer's duty does not extend to materials the government is required to make public or has otherwise made public. *See* Cramton, *supra* note 19, at 294. Further, it is unclear whether the client in this context is only the agency but may include government officials above the agency level. *See id.* at 303-05. In the case of ongoing enforcement investigations at the SEC, confidentiality is protected by the Freedom of Information Act, 5 U.S.C. § 552 (1994), and the Sunshine Act, codified in scattered sections of 5 U.S.C. and 39 U.S.C., and therefore confidentiality would seem to be required.

about prosecutorial power and the need for that power to be constrained by the commissioners who are accountable politically for policy making are not merely the result of problems that I grappled with personally.

The combination of functions in administrative agencies has always been constitutionally suspect, and yet government could not function effectively without such agencies. The constraints put on the agencies since Watergate to make them more accountable and more conscious of the costs as well as the benefits of regulation have frequently led to regulatory ossification. The power of special interests and agency capture also have made creating policy in the public interest difficult. From the government's perspective, one way to cut through red tape is to create policy through enforcement actions. Thus far, the courts have not generally interfered with this method of action or an agency's choice of remedies or sanctions,[47] nor have the courts sufficiently focused on the issue of whether civil cases can fill in the contours of a vague statutory provision, allowing this enlarged view of a regulatory violation to serve as a predicate for a criminal prosecution.[48]

The case-by-case development of regulatory law and policy produces many problems, especially when the policy involves law enforcement actions against regulated persons and businesses that have serious adverse consequences. The SEC is an independent agency that represents itself in the lower courts and can bring a wide variety of enforcement actions, including cease-and-desist cases, without even going to court. Enforcement attorneys can assist and encourage U.S. Attorneys to bring criminal cases. The Commission has considerable latitude in choosing its enforcement targets and theories. The Commission therefore has a serious obligation to restrain the enforcement staff from overzealous prosecutions. Generally, the Commission takes this obligation seriously, but political and time constraints sometimes permit the prosecutors to create the law.

Failure by the SEC to supervise the enforcement staff adequately from time to time may be due to a more general failure to curb prosecutorial excesses in our political culture. The unhealthy relationship between the media and prosecutors in many government quarters leads to selective leaking of information about investigations and cases and to sensationalism. Exciting and novel cases satisfy prosecutorial ambitions and titillate the public. Prosecutors become celebrities and go on to be mayors, governors, and judges. Stanley Sporkin and other heads of the SEC's Enforcement Division seemed to receive more publicity and were better known than many of the Commissioners who served at the same time they did.

Development of the law should not be a public spectacle. It is a serious business that needs to be thoughtful and deliberative in order to command respect. Undisciplined prosecutions trivialize the law and encourage disregard

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47. *See, e.g.*, Heckler v. Chaney, 470 U.S. 821 (1985); FTC v. Universal-Rundle Corp., 387 U.S. 244 (1967); American Power Co. v. SEC, 329 U.S. 90, 112 (1946).

48. *But see* United States v. Chestman, 947 F.2d 551, 570 (2d Cir. 1991) (en banc).

for regulation by persons subject to a regulatory scheme and contempt for government by the general public.