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A CIVIL LIBERTARIAN LOOKS AT SECURITIES REGULATION

BY MONROE H. FREEDMAN*

Since I am a stranger to this group and, indeed, to this area of the law, it seems appropriate that I begin by introducing myself and indicating the perspective from which I view securities regulation. I suppose I would be characterized as an old-fashioned New Deal Democrat. I therefore approach the area of securities regulation with a great deal of sympathy with the rights of the little guy and a good deal less sympathy with those whom the Securities and Exchange Commission [SEC] Chairman Ray Garrett, Jr., recently referred to as "robber barons, princes of privilege, [and] malefactors of great wealth."¹ Moreover, as a civil libertarian, I have been primarily concerned with free speech, equal protection, and the due process rights of criminal defendants, with particular regard to indigents. I think it is fair to say, therefore, that I began my inquiry into securities regulation with a minimum of compassion for those who are regulated. Nevertheless, I was genuinely shocked with the implications of securities regulation practices and policies as they affect two inseparable concepts that must be of concern to all of us—the rights of individuals in a free society, and the independence of the Bar.

Let me begin with three propositions. The first is that the promoters of securities are entitled to the same constitutional rights as are the pushers of narcotics. The second is drawn from a quotation that I have used on a number of occasions in a rather different context. It comes from the *Harvard Civil Liberties/Civil Rights Law Review*, which stated: "It has become both professionally and legally dangerous to be a lawyer representing the poor, minorities, and the politically unpopular."² To that group that stands in professional and legal jeopardy, I would now add another category: attorneys representing members of the securities industry. My third proposition (and this one I would expect to

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¹ "New Directions in Professional Responsibility," Address by SEC Chairman Ray Garrett, Jr., before American Bar Association, Washington, D.C., Oct. 11, 1973 [hereinafter Garrett].

² Comment, *Controlling Lawyers by Bar Associations and Courts*, 5 HARV. CIV. LIB.-CIV. RIGHTS L. REV. 301 (1970).

be the least popular with this audience) is that the fault lies with the securities Bar itself. As one highly experienced and highly regarded securities lawyer commented to me, "The professional training of the New York securities Bar is to cave in." Another equally prominent authority said, "The securities Bar has abdicated its responsibilities to its clients in deference to the Commission."³

The Commission starts with the best of motives. It has an important job to do in the public interest, and it has been provided with a grossly inadequate staff with which to achieve its goals. That, of course, is a familiar problem. I have heard the same justification given in virtually every case of police abuse and every prosecutorial circumvention of constitutional rights with which I have been involved. The Commission has sought to resolve its difficulty in four ways. The first is by dragooning members of the private Bar, without benefit of Civil Service status, as federal police and prosecutors of their own purported clients. The Commission itself has observed that "this Commission with its small staff, limited resources, and onerous tasks is peculiarly dependent on the probity and the diligence of the professionals who practice before it."⁴ Accordingly, "Members of this Commission have pointed out time and time again that the task of enforcing the securities law rests in overwhelming measure on the Bar's shoulders."⁵ The SEC attorney has indeed become, in the phrase of Commissioner A. A. Sommer, Jr., "another cop on the beat."⁶

A second method used by the Commission is a system of investigation through the use of private spies and informers, euphemistically called "in-house compliance," which includes telephonic eavesdropping without any warrant or, indeed, without any basis that approaches a constitutional justification. To a great extent, that aspect of securities investigation is carried on under the auspices of the National Association of Securities Dealers and the New York and American Stock Exchanges. Although the activities of those organizations are commonly referred to as "self-regulation," they are in fact closely controlled by the SEC as an integral part of its enforcement process. Third, the Commission em-

³ Almost none of the many lawyers with whom I have spoken was willing to be identified by name. That, in itself, is some indication of the unhealthy relationship between the Securities and Exchange Commission and the lawyers who practice before it. However, in each instance in which I refer to information obtained in an interview with a lawyer, I subsequently received confirmation from at least one reputable and experienced attorney that the information I had received was consistent with his or her experience.

⁴ In the Matter of Emanuel Fields, 2 S.E.C. Docket 1, 4-5, n.20 (July 3, 1973).

⁵ *Id.*

⁶ Sommer, *Emerging Responsibilities of the Securities Lawyer*, N.Y.L.J., Jan. 30, 1974 at 4, col. 5.

plays other investigatory and adjudicatory practices (discussed below) that are probably unparalleled in our jurisprudence for their open violation of basic rights. Fourth, the Commission depends upon intimidation of individuals, business firms, and attorneys through aggressive abuse of its power over the economic life and death of those subject to its jurisdiction.

For example, an investigation may be initiated and conducted without any notice to the person involved until he or she (and the rest of the world) reads about the commencement of formal proceedings in the *Wall Street Journal* or the *New York Times*.⁷ The proceedings are conducted by staff members who combine the roles of investigator, prosecutor, and judge. Moreover, staff members have been known to harbor the attitude that respondents are "unworthy" of the respect due to any citizens by government officials and that they are therefore not entitled to basic rights.⁸ It is also entirely possible that the administrative law judge will have received *ex parte* information and will be committed, prior to any formal hearing, to a conclusion of guilt. Illustrative of the attitude of SEC staff members toward the citizens subject to their regulation is the comment of Mr. Stanley Sporkin, Associate Director of the Enforcement Division of the SEC. When challenged at a public meeting with charges of violations of fundamental rights, Mr. Sporkin replied that such practices were justified because "these are the fat cats we are dealing with."⁹

I have received numerous illustrations of violations of due process in the course of SEC investigations. For example, if a prosecutor were to discourage a witness from talking to a defense attorney, it would be grounds for disciplinary action. As stated in the American Bar Association publication, *Standards Relating to the Prosecution Function*, "A prosecutor should not obstruct communication between prospective witnesses and defense counsel. It is unprofessional conduct to advise any person to decline to give information to the defense."¹⁰ The *Standards* explain

Prospective witnesses are not partisans; they should be regarded as impartial spokesmen for the facts as they see them. Because witnesses do not "belong" to either party, it is improper for a prosecutor, defense counsel, or anyone acting for either to suggest to a witness that he not

⁷ Freeman, *Administrative Procedures*, 23 BUS. LAW. 891, 896 (1967).

⁸ *Id.* at 893.

⁹ Letter from Professor Henry G. Manne in *The Wall Street Journal*, Aug. 10, 1973, at 6, col. 4.

¹⁰ AMER. BAR ASSN., *STANDARDS RELATING TO THE PROSECUTION FUNCTION*, § 3.1 (1971).

submit to an interview by opposing counsel. It is not only proper but it may be the duty of the prosecutor and defense counsel to interview any person who may be called as a witness in the case (except that the prosecutor is not entitled to interview a defendant represented by counsel).¹¹

Despite that clear rule, it is common for SEC staff members to instruct witnesses not to discuss their testimony with counsel for respondents, and, in at least one case, an attorney was threatened with being prosecuted for obstruction of justice simply for making efforts to interview a government witness.

A respondent may be subpoenaed without being given notice that he or she is a target of the investigation and may even be purposely misled into the erroneous belief that he or she is not the target. Respondents are also interrogated without being given advance knowledge of the contents of the order instituting the investigation against them. Such practices necessarily have the effect of depriving the individual of an adequate opportunity to prepare a defense and they increase the likelihood that the respondent will be trapped into making damaging errors in the course of the investigation. An attorney who requests necessary time to prepare a defense or who invokes the attorney-client privilege may be asked rhetorically, "Are you saying your client won't cooperate?" In one case, when the attorney indicated that the client intended to invoke his constitutional privilege against self-incrimination, he was advised by the SEC staff member, "That's the best way to guarantee an indictment."

Despite the Commission's general insensitivity to the rights of those subject to its jurisdiction, it has been strangely solicitous to ensure that respondents use separate counsel. In fact, during an investigative hearing the Commission imposes a rule of sequestration upon counsel as well as witnesses, thereby making it impossible for a lawyer to represent effectively more than one party before the Commission. Those tactics have been defended on the ground of protecting the rights of respondents by preventing possible conflicts of interest on the part of the attorneys. The objective observer might well conclude, however, that the true motive is to divide and conquer or, at least, to subject the parties to enormous and unnecessary expense and place them at a severe tactical disadvantage. In a somewhat analogous case, a prosecutor in the District of Columbia was recently admonished by Bar Counsel for the Disciplinary Board for prejudicing the fair administration of justice by telling a prospective defense witness that the witness was exposing him-

¹¹ *Id.* at § 3.1, Comment c.

self to potential prosecution and that he should seek his own counsel before testifying.¹²

Another serious problem in securities regulation is prejudicial publicity. Indeed, it has been noted that "the relief sought by the Commission, even if granted, may not be as significant or as onerous a sanction as the publicity attendant upon the commencement of the proceeding."¹³ Although one would expect, therefore, that staff members of the Commission would be particularly sensitive to the problem of ruining reputations by inconsiderate investigative tactics, the fact is precisely to the contrary. Potential witnesses have been told by SEC staff investigators, "We have reason to believe that Mr. Y is a crook, and that you are one of his victims." Not long ago, a staff member was quoted in *Business Week* magazine accusing a respondent in a pending proceeding as carrying on "the biggest rip-off" he had ever seen.¹⁴

The investigative hearing is frequently the most critical stage, for practical purposes, in the adjudication of guilt or innocence. Or, more accurately, if a decision is made to proceed to a formal hearing, that decision itself may well destroy personal reputations, corporate good will, and entire business ventures. I was interested to note, therefore, that without any prompting on my part, the phrase most frequently used by attorneys with experience in investigative hearings was "Star Chamber." Rights of examination and cross-examination of witnesses are severely restricted. Critical documents, including a copy of the order authorizing the investigation and defining its scope, are not provided to respondents in advance. They may be examined, but not copied, at the hearing itself. One attorney recounted how he had been "laughed at" when he asked for a copy of the charges against his client. Opportunity for rebuttal is rarely provided. In addition, the Commission has rejected recommendations by the Wells Committee¹⁵ and by Milton Freeman¹⁶ that it provide a right to be heard by the Commission before the Commission rubber-stamps a staff decision adverse to a respondent. Perhaps most importantly, the Commission has also rejected recommenda-

¹² Letter from Fred Grabowsky, Esq., to Herbert B. Hoffman, Esq., Oct. 17, 1973. The letter cited ABA CODE OF PROFESSIONAL RESPONSIBILITY DISCIPLINARY RULE 1-102(A) (5); AMER. BAR ASSN., STANDARDS RELATING TO THE PROSECUTION FUNCTION, § 3.2 (1971); and Informal Decision No. 575 (1965) AMER. BAR ASSN., OPINIONS ON PROFESSIONAL ETHICS (1967).

¹³ SEC, REPORT OF THE ADVISORY COMMITTEE ON ENFORCEMENT POLICIES AND PRACTICES (1972). The Report was prepared by John A. Wells, Manuel F. Cohen, and Ralph H. Demmler, and is commonly referred to as the Wells Report.

¹⁴ *Business Week*, Nov. 17, 1973, at 36.

¹⁵ Wells Report, *supra* note 13 at 19-20, 31-33.

¹⁶ Freeman, *supra* note 7 at 894-95.

tions that it issue notice when proceedings have been terminated.¹⁷ Thus, respondents are left in the untenable position of never knowing whether proceedings against them have ended or whether an indictment might issue many months or even years later. Such tactics impose tremendous and unconscionable pressure to resolve the matter conclusively by entering into a consent decree with the Commission on its terms.

Where, in all of this, are the lawyers? What has turned the securities Bar from the attorneys' traditional role of champions of their clients into wholly owned subsidiaries in the enforcement conglomerate? Why, indeed, to quote the words of an SEC Commissioner, are "all the verities and truisms about attorneys and their roles in question and in jeopardy"?¹⁸

In order to intimidate the lawyers, the Commission uses what Chairman Garrett has confessed are "overly crude weapons."¹⁹ He has explained that the Commission "keep[s] the pressure on the professionals" to do the government's job through "suitable incentives."²⁰ Those incentives include "rewards" as well as "punishments."²¹

The rewards consist of favored treatment to some lawyers in their appearances before the Commission. For example, some few attorneys do receive the opportunity, denied to others, to appear before the Commission before a staff recommendation is approved.²² That, of course, represents a conscious effort to encourage lawyers to trade off the rights of some clients in order to curry favor with the Commission and thereby advance the rights of other clients. It also amounts to a denial of equal protection of the laws to the clients of those lawyers who are not so favored.

The punishments are directed toward intimidating attorneys into foregoing zealous advocacy on behalf of their clients. One attorney, engaged in vigorous defense of his client's rights, was advised by a staff member that he should "take a look at the National Student Marketing complaint," in which attorneys were named as respondents. Indeed, an attorney may appear before the Commission on behalf of a client, and receive no warning that the attorney is also a target of the investigation. Attorneys have been threatened with subpoenas in the course of hearings, and one attorney arrived at the Commission offices to represent a client, only to be served with a subpoena upon arrival.

¹⁷ Wells Report, *supra* note 13, at 20; Freeman, *supra* note 7, at 895.

¹⁸ Sommer, *supra* note 6 at 4, col. 6.

¹⁹ Garrett, *supra* note 1, at 15.

²⁰ *Id.* at 10.

²¹ *Id.*

²² Freeman, *supra* note 7, at 895.

The Bar at large has also been reminded that an entire law firm might be disbarred or suspended for a lapse on the part of a single firm member²³—a sanction that is particularly vicious in view of the fact that disbarment or suspension may result from simple negligence without any showing of improper intent.²⁴ In one case it was necessary for an attorney to go to the United States Court of Appeals to obtain reversal of a two-year suspension on a charge of improper conduct five years previously.²⁵ Although the court ultimately found the Commission's evidence to be insufficient to support a finding of impropriety, and directed the Commission to vacate its order against the attorney, the intimidating effect of such abuses of power is plain. The problem is further compounded by the vagueness of the standards applied by the Commission.²⁶

The damaging impact of that kind of tactic upon the attorney-client relationship is illustrated by the comment of one client to an attorney after the attorney had given some overly cautious advice. The client asked, "Are you saying that for my protection or for your own?"

One of the most revealing comments that I have heard illustrating the unhealthy relationship between the Securities and Exchange Commission and the attorneys who practice before it was made by William J. Casey, a former Chairman of the SEC, in a speech at the Securities Regulation Institute Conference in San Diego. Mr. Casey had heard that, earlier the same day, I had criticized the Commission and the lawyers who practice before it, but he did not know that I had addressed myself to Chairman Garrett's system of "rewards and punishments." Unaware, therefore, that he was confirming my criticism, Mr. Casey related the story of an irate attorney who appeared at the Commission to protest that a staff attorney had been engaging in arbitrary conduct toward the attorney's client. With obvious approval, as well as relish, Mr. Casey quoted the staff attorney as saying, "Listen, if we weren't as arbitrary as we are, you wouldn't be as fat as you are." The high-minded moral that former Chairman Casey drew from that episode was, "So keep in mind that your practice depends upon what the Commission does." Having established that securities regulation attorneys reap financial rewards from the privilege of practicing before the Commission, Mr. Casey then went on to admonish the attorneys that they have a

²³ Sonde, *The Responsibility of Professionals Under the Federal Securities Laws—Some Observations*, 68 NW. U.L. REV. 1 (1973).

²⁴ *S.E.C. v. Spectrum, Ltd.*, 54 F.R.D. 70 (S.D.N.Y. 1971).

²⁵ *Kivitz v. S.E.C.*, 475 F.2d 956 (D.C. Cir. 1973).

²⁶ See Shipman, *The Need for SEC Rules to Govern the Duties and Liabilities of Attorneys Under the Federal Securities Statutes*, 34 OHIO ST. L.J. 231 (1973).

professional responsibility to "force" their clients toward "a process of disclosure."

There are two justifications that are frequently suggested in support of the revolutionary²⁷ notion that attorneys in the field of securities regulation should play the role of government enforcers and informers against their clients rather than the traditional lawyers' role of counselors and advocates. The first justification is that securities regulation frequently involves civil or administrative sanctions only, and not criminal penalties. It is contended, therefore, that due process rights are inapplicable. The SEC has taken the position, however, that it has the power simultaneously to pursue civil, administrative, and criminal litigation against identical defendants in common fact situations.²⁸ Moreover, it is well established that governmental action that has the effect of impairing important property rights must comply with due process standards even in a purely civil context. Thus, before the government can terminate welfare rights,²⁹ permit garnishment of wages by a creditor,³⁰ permit replevin of a television set,³¹ or suspend a driver's license,³² the affected party must be afforded both notice and an opportunity to be heard "at a meaningful time and in a meaningful manner,"³³ and "the fact that there is a later constitutionally fair proceeding does not alter the result."³⁴ Moreover, the court has specifically recognized that such rights must be respected where "any significant property interest" is affected, even though the deprivation "may only be temporary."³⁵ In the light of those principles, it seems clear that a business person should not be deprived of the property right represented by business good will, as a result of fundamentally unfair tactics employed by the Securities and Exchange Commission in an investigative proceeding.

A second justification that is often asserted for compelling the SEC lawyer to work for the government rather than for his or her client is the notion that there is an essential distinction between the litigating attorney and the office attorney. What that argument ignores is that our legal system is basically an adversarial one, and every lawyer—whether

²⁷ The characterization is that of Commissioner Sommer. Sommer, *supra* note 6, at 4, col. 6.

²⁸ S.E.C. v. Stewart, 476 F.2d 755 (2d Cir. 1973). See especially the dissent by Judge Timbers, who is former general counsel of the SEC.

²⁹ Goldberg v. Kelly, 397 U.S. 254 (1970).

³⁰ Sniadach v. Family Finance Corp., 395 U.S. 337 (1969).

³¹ Fuentes v. Shevin, 407 U.S. 67 (1972).

³² Bell v. Burson, 402 U.S. 535 (1971).

³³ Fuentes, 407 U.S. at 80.

³⁴ Goldberg, 397 U.S. at 261.

³⁵ Fuentes, 407 U.S. at 82, 84, 86.

drafting a contract, counseling in a business venture, writing a will, or performing any other service on behalf of a client—acts in such a way as to protect the client from being at a disadvantage in potential future litigation. Particularly should that be so, in a free society, when the potential adversary is the government itself. In that sense, and it is a crucial one, every lawyer is an advocate, irrespective of whether he or she ever enters a courtroom.

In elaborating the fallacious distinction between the litigating attorney and the office attorney, Professor Morgan Shipman, in his remarks at the San Diego Conference, adverted to Disciplinary Rules 4-101 and 7-102 of the *Code of Professional Responsibility*. His reliance, however, was misplaced. Under DR 4-101 the lawyer is required to preserve the confidences of the client. Even the lawyer who knows that the client intends to commit a crime is not required to reveal that fact, but is merely permitted to do so. It is true that DR 7-102(B)(1) says that a lawyer who receives information clearly establishing that the client has perpetrated a fraud must call upon the client to rectify the fraud. Further, the original ABA draft goes on to say that if the client refuses to rectify the fraud, the lawyer "shall reveal the fraud to the affected person or tribunal." Significantly, however, that quoted provision was put to a vote of the Bar in the District of Columbia (the jurisdiction in which the SEC is located), and by an overwhelming vote of the Bar, the clause was eliminated. Thus, although the lawyer does have an obligation to urge the client to correct any false statement to the SEC, the lawyer has no obligation to report the client to the authorities if the client declines to take the lawyer's advice.

In sum, therefore, securities regulation is characterized by denial of the right to counsel, corruption of the independence of the Bar and of the traditional professional standards of attorneys' obligations to their clients, a police-state system of investigation, and denial of a variety of other basic due process rights. Even if a balancing test were appropriate in such a context, what is there to place on the other side of the scale?

According to one commentator, the field of securities regulation has recently seen some "spectacular . . . failures" that rival any securities frauds prior to the passage of the federal securities regulation laws. According to the same commentator, in the last few years we have seen some "truly monstrous financial debacles," in which "hundreds of thousands of persons have lost hundreds of millions of dollars" through investments in securities that had received "the full treatment" under the securities laws. That is, indeed, a harsh judgment of gross failure of the

securities regulation system. It is significant, therefore, that those observations were made not by some chronic critic of federal regulation, but by SEC Chairman Ray Garrett, Jr., in an address to the American Bar Association.³⁶

Unquestionably, the government's purposes are beneficent and those responsible for securities regulation are well meaning. As Justice Brandeis once observed, however, "Experience should teach us to be most on our guard to protect liberty when the Government's purposes are beneficent The greatest dangers to liberty lurk in the insidious encroachment by men of zeal, well meaning, but without understanding."³⁷ I do not feel competent to pass judgment upon the wisdom of regulating sales of securities. It is clear to me, however, that if securities regulation is worth doing, it is worth providing sufficient governmental resources to do the job in a way that comports with due process of law, and in a way that does not corrupt the attorney-client relationship and gravely threaten the independence of the Bar, which is essential to the maintenance of a free society.

³⁶ Garrett, *supra* note 1.

³⁷ *Olmstead v. United States*, 277 U.S. 438, 479 (1928).