DIVISION OF TRADING AND EXCHANGES
AND
OFFICE OF OPINION WRITING

TRAINING PROGRAM LECTURES

Thirtieth Session -- May 29, 1957

Subject: Commission's Enforcement Program, and
Functions of the Office of Opinion Writing

Speakers: Mr. Walter G. Holden, Assistant Director
Division of Trading and Exchanges

Mr. W. Victor Rodin, Associate Director
Office of Opinion Writing

MR. HOLDEN. The Division of Trading and Exchanges consists of two branches. Mr. Phillip Loomis is the Director. Mr. John Loomis is the Associate Director. Mr. Ray McCutcheon is Assistant Director in charge of the Branch of Exchange Regulation and Economic Research. I am Assistant Director in charge of the Branch of Enforcement, and that is the phase of the work that I shall discuss with you this morning.

In the Branch, the Section of Enforcement, headed by Mr. Blair, has administrative supervision over the investigatory and enforcement functions of the Commission. Each of the Acts administered by the Commission contains provisions for investigation and provides sanctions for violations of the Act. All investigations are confidential.

There are rules adopted by the Commission under the Acts which prohibit members of the staff from divulging any information obtained in the course of an investigation without specific Commission authorization. These include Rule 122 under the Securities Act and Rule X-4 under the Securities Exchange Act.

These rules are strictly adhered to. If an employee of the Commission is subpoenaed, for instance, to testify concerning any matter coming to his knowledge as the result of an investigation, he is required to decline to answer any questions relating to the investigation or any information obtained in connection with it without specific Commission authorization. In appropriate cases the Commission will, of course, grant authorization. If it is to assist some other law enforcement officer and will not be detrimental to our own enforcement work, or situations of that kind, the Commission ordinarily will permit an employee to respond; but otherwise they usually do not permit disclosure of such information.

These investigations may arise in one of several ways and as a result of a number of things, probably the most common being complaints from members of the public. These complaints are examined to determine whether there is any indication of violation of law -- something which would merit investigation or inquiry. If it appears that an investigation may be warranted, the matter is referred to the appropriate regional office and the necessary facts obtained through the course of an investigation.

I might say that a great many of the complaints received by the Commission do not result in that type of action. However, from those that do, some of our most important cases have arisen, perhaps from a letter seeking information about a particular security or a particular transaction. It may relate to a situation that otherwise may not have come to our attention.

Other sources from which investigations develop are examinations of filings required to be made with the Commission. It is not infrequent that as a result of such examination some indication of a violation appears that is pursued to determine whether or not there has in fact been an actionable violation. Another very common means of finding these matters is through the newspapers. It might appear in the form of an advertisement, or it might appear in a news item. Many members of the staff, not only in this office, but in the various regional offices, direct our attention to some item or advertisement appearing in a newspaper which indicates a possible violation and results in an investigation.

Investigations, themselves, are classified as preliminary or docketed. A preliminary investigation is one in which, based upon a very limited amount of inquiry, it is determined that no actionable violation has occurred. The purpose of the preliminary investigation is to determine whether a full-scale investigation is warranted. The preliminary investigation may reveal, upon talking to two or three people or the exchange of a few letters, that no violation of law has occurred, or that the Statute of Limitations would preclude any action. But based upon that preliminary inquiry, a determination is made as to whether or not full-scale investigation is warranted. If it appears that further inquiry is not warranted, the matter is closed out as a "PI" -- a preliminary investigation.

If it appears that further investigation is warranted, the matter than becomes a docketed case and is assigned a number to designate the particular region to which the investigation is assigned. For example, New York files are designated NY with a number assigned to them, Chicago files are C, Denver D. Each regional office has its own series of numbers starting with No. 1, following the Regional Office designation.

The docketed cases are again divided into formal and informal investigations. An informal investigation is one which is carried on without the use of the subpoena power, where all the necessary information can be obtained through interviews with investors and the subject of the investigation is fully cooperative and willing to make available all the information that we may need. If that information is not forthcoming on a voluntary basis, or if witnesses are reluctant to furnish information, then the Commission, pursuant to the power in each of the Acts, may issue a formal order for investigation. Such an order delegates to staff members the power to issue subpoena and administer oaths. The subpoena power is not delegated lightly. The

Commission restricts use of this power to those cases in which it appears that an investigation cannot be otherwise successfully completed. In order to get a formal order, it is necessary to satisfy the Commission that the case cannot be otherwise developed, that there is an indicated violation, which doesn't have to be established by evidence, but there has to be a substantial indication of the elements which would make an actionable violation of the Statute. There must be some indication of the use of the mails, for example, and if the order is based upon fraud, we must be able to explain to the Commission what the indications of fraud are and why we believe that it constitutes fraud; or if it is based on a violation of the registration provisions, we must be able to explain to the Commission why it appears that there has been a violation.

When the Commission does issue that order delegating the subpoena power, it is limited to the particular case and to the particular officers named, who are generally staff employees of the regional offices. They cannot use that subpoena power except in connection with that particular case. If witnesses are reluctant to furnish information, even under the subpoena, or fail to respond to the subpoena, as sometimes they will do, (corporations, for instance, will sometimes refuse to make available their books and records for examination), we have to apply to the District Court for an order enforcing the subpoena. So far as I know we have never applied to the Court for an order requesting subpoena enforcement without that having been granted. Courts have, I think in every instance that we have ever applied, enforced our subpoena. And we have had people held in contempt where they still failed to comply after being directed by the Court to make the information available.

It is generally necessary also to use the subpoena in order to obtain certain types of information from persons who are not the subject of the investigation. Banks, particularly, are reluctant to disclose any information about a customer's account without the protection of the subpoena. Similarly the telephone company and Western Union also want the subpoena for their protection before revealing any information about calls or telegrams.

The subpoena power is also used under the formal order in cases where the regional office for some reason may not want to rely upon the statements of witnesses unless they are under oath. Witnesses then become subject to the possibility of perjury if they don't answer truthfully.

The Acts also provide that no witness may refuse to respond on the ground that their testimony might tend to incriminate them. That power to grant immunity where a person is required to respond is never exercised by an employee, without specific Commission authorization, and the Commission is also very reluctant to grant immunity to a person in order to get a story from him. After very careful consideration, it will be done; but the factors that have to be considered in granting immunity are whether or not the immunity would be granted from prosecution for violations of other Federal Statutes. So the Commission is very reluctant to grant immunity unless it is absolutely certain that first, the individual is not a principal in our action; and second, the case cannot be developed without granting immunity; and third, that there be no injury done to other law enforcement agencies as a result of granting immunity in our cases.

The actual investigations, for the most part, are carried on by the Regional Offices. They have accountants, attorneys, investigators, who are experienced and work under the direction of the Regional Administrator to develop the necessary evidence to determine whether or not a violation has occurred. Based upon that, they recommend what action, if any, should be taken. Our relations with the Regional Offices in that respect are that we have general administrative supervision over enforcement activities. We have the power of making suggestions as to certain avenues of investigation, and of terminating investigations that don't appear to be fruitful. These the Regional Administrator usually accept, although we do not have the power of direction. We cannot tell them what to do, we can only suggest. They keep us apprised of the developments of an investigation by means of a quarterly progress report. That report covers information that has been developed during the preceding period of time -- three months -- what is expected to be done during the next three months, and how much time they expect to take in completing the investigation.

In addition to those quarterly progress reports, we have an arrangement with the Regional Offices that carbon copies of everything of an evidentiary nature going into their regional office file is submitted to us, and is placed in the file here. In that way when we have the time, we can follow the development of the case as it goes along. However, we cannot always keep up with the approximately one thousand open investigation files which we have, and for that reason the material is generally just placed in the file without review. When a question arises in connection with a particular case, the information is probably in our file and we don't have to refer so frequently to the Regional Offices for current information.

In our enforcement program we have close cooperation with the various States. The amount of enforcement done by the States varies in about the same proportion as there are States. Some States have good enforcement programs, others have not. But it is our policy in order to conserve manpower to turn over to the States any clear indication of a violation of State law where we think that the State would take the case and develop it under their own law. If they don't, we may have to pursue the matter further. The purpose of that is that we can then use our investigative power for those cases which are too big for any particular State, or where it is wide-spread and reaches across State lines.

We have similar arrangements with other Government agencies. We have an exchange of information with the F.B.I., Internal Revenue Service and others. Information can be made available only with Commission authorization, and requests for information from them are generally made by the Chairman.

The investigation files themselves are maintained in this office. There is a duplicate file in the Regional Office for each investigation. The Regional Offices do not open their own investigation files. The purpose of the opening and closing of files here is that we can maintain a control over them and know what is going on in the Regions. When they want an investigation file opened, they make the request to us and it is opened here. When the investigation has been completed, they submit it with the report and appropriate recommendation to us. That is considered here and we either agree or disagree with the recommendation of the Regional Office. That recommendation may take one of several different forms. It may, for instance, recommend

an injunctive action. In that event, we give the file an independent review here, we consider the report submitted by the Regional Office, and a draft of the proposed complaint for injunction prepared in the Regional Office. We consider that as to form and legal sufficiency; we consider the evidence submitted upon which they expect to rely to support the complaint for injunction, and if we are in agreement that injunctive action is appropriate, we then submit to the Commission a recommendation in which we concur with the recommendation of the Regional Office. If we are in disagreement with the Regional Administrator, we try to work out our differences with him. If we still cannot agree, then we submit the matter to the Commission with both recommendations and the Commission determines whether or not the action should be instituted. There is no action instituted by the staff without Commission authorization. That includes injunctive action, criminal prosecution, or administrative proceedings.

If the Commission authorizes the filing of the complaint for injunction, we so advise the Regional Administrator. If a contest develops in the case, it is then referred to the General Counsel's Office and the General Counsel has charge of contested litigation. Most of our cases result in consent decrees, but there have been a good many, particularly in recent months, where contests have developed. If the recommendation is for criminal action, that report is reviewed by the General Counsel's Office, and if he is in agreement that criminal action is warranted, he clears the matter through the Commission for reference to the Department of Justice. But again it does require Commission authorization to refer that report to the Department of Justice.

If administrative proceedings are recommended against a broker-dealer, we review the case and the evidence to make certain that the proposed charges of violation can be established. If we agree that revocation proceedings are appropriate we get Commission authorization to institute the proceedings, prepare the order for hearing, and arrange for a hearing date. We supervise the Regional Office in the trial of the administrative proceeding.

After the investigation has been fully completed and all action has been instituted which appears to be appropriate in the case, a closing is in order. That also comes into the Division, and we review the recommendation of the Regional Office. If we are in agreement, the informal cases can be closed in the Division. If it is a case that has once been before the Commission for any purpose, such as the issuance of a formal order of investigation, injunctive action, administrative proceedings or criminal action, then the case must be closed by the Commission and we submit our recommendation to the Commission.

Our files in connection with investigations, as well as litigation files, are maintained by Miss Curtis. Those files are confidential and employees are prohibited by rule from making any information from them available to anyone other than another employee without specific Commission authorization.

Also in the Branch of Enforcement there is a Broker-Dealer and Investment Adviser Registration Section. Applications for registration as such are filed and processed in that section. Our method of processing an application is immediately to advise the Regional Office in which the applicant is located of the receipt of the application so that we can get any information that he may have concerning the individual. We also have a search made of our files for all pertinent information which may affect the availability of registration to the individual. Many of the

applications arrive in deficient form, and if these appear to be inadvertent -- don't appear to be willful or deliberate -- a letter of deficiency is sent and the person is asked to file an amendment making any necessary correction. However, if it appears that he is trying to conceal something from us, we may not send a letter of deficiency. We may institute denial proceedings.

Registrations become effective ordinarily 30 days after they are filed, so that the complete examination and inquiry concerning the background of the individual concerned has to be completed within that time. If any action is instituted denying registration, the Commission can postpone effectiveness for a broker-dealer only for a period of 15 days from that 30 days. So if an application is filed today, it ordinarily will become effective 30 days from today. Before that time the Commission can summarily suspend it for an additional 15 day period. During that 15 day period it is necessary for us to have a hearing, produce the evidence to establish any statutory bar to registration, prepare and file proposed findings and briefs with the Commission. The Commission's opinion has to be issued within the 15 day period or the registration will become effective by passage of time. Frequently we will get an applicant for registration to consent to postponement of effectiveness pending final determination on the question of whether denial should be entered. That, of course, relieves the pressure. But absent such an agreement, we and the Regional Offices have to work very fast.

The basis for instituting denial proceedings or broker-dealer registrations is either the entry of an injunction based upon a violation, conviction for violation of the Acts, a violation of one of the Acts or misstatement of a material fact in the application itself.

For an investment-adviser registration, we are much more limited. We can go to denial proceedings or revocation only after obtaining an injunction or a conviction for violation of one of the Acts, other than a misstatement in the application itself. As a result, often it is extremely difficult to revoke an adviser once he becomes registered.

Withdrawals of registration become effective 30 days after they are filed. Frequently, a withdrawal will be filed by a person who is the subject of an investigation. The case may not be fully developed. Unless we institute proceedings during that thirty-day period, the withdrawal becomes effective. Frequently if we suspect that an individual is a violator, we attempt to institute revocation proceedings during that thirty-day period so that the withdrawal will not become effective and we will have a record establishing a violation for use in the event the individual attempts to register again.

In 1938 the Securities Exchange Act was amended by adoption of Section 15A, commonly called the Maloney Act. Under that Act the Congress authorized associations of brokers and dealers for the purpose of self regulation to be registered with and operate under the supervision of the Commission. The primary function is to establish a code of just and equitable principles of trade. There has been only one association organized under the Act. That is the National Association of Securities Dealers, commonly known as the NASD. Its headquarters are here in Washington. It has district offices throughout the Country. They work with their own members, trying to keep them in compliance not only with the Acts administered by the Commission but with the rules adopted by the NASD which have been approved by the Commission as not being inconsistent with the Statutes administered by the Commission. The

NASD carries on a program of examination of its members, and imposes sanctions on members who violate the rules which may consist of a censure or fine, or perhaps expulsion from membership. From the NASD there is an appeal to the Commission by a person who has been the subject of a sanction. The Commission then reviews the record of the case and determines whether or not the sanction imposed is appropriate in view of all of the circumstances.

We work closely with the NASD, particularly in the area of inspection. Our inspection program relates to all registered brokers and dealers, and we attempt to inspect as many broker-dealers each year as available manpower will permit. There has been quite an increase in the number of such inspections in the last couple of years, and I think it is going to increase still more in the future. At the present time we are on a basis of being able to examine every registered broker-dealer about every 2-1/2 years. We hope to get that down to 1-1/2 years. In making an inspection of a broker-dealer we check their financial condition to see that they are in compliance with our net capital rule. In addition we check for spreads, mark-ups on their transactions with customers, see if they are over-trading their customers' accounts, see that the customers' securities that they have for safe-keeping are actually being preserved, that they maintain the required books and records, and that they do not violate Regulation T adopted by the Federal Reserve Board for the regulation of credit on securities transactions.

In scheduling these inspections of brokers and dealers we keep in mind the schedule of the NASD. They apprise us of the inspections they have made during the previous month. Similarly, the exchanges examine their own members and keep us informed in the same manner. This enables us to make better coverage and provides more protection to the public with the available manpower, not only of the Commission but of the other inspecting agencies.

OFFICE OF OPINION WRITING

MR. RODIN. The name of our office is not a glamorous one, but it is descriptive. It indicates the principal function of the Office of Opinion Writing, namely, to prepare drafts of Commission findings, opinions and orders in contested and other proceedings under all the Acts administered by the Commission.

Besides that, however, we do a number of other things. We assist the Commission in determining appeals from rulings by hearing examiners on procedural and evidentiary matters in hearings held before them. We have overall charge of preparing the annual report of the Commission to the Congress. We draft minutes and orders in a number of matters on which we are consulted by the Commission. We occasionally draft press releases in cooperation with the Secretary of the Commission in cases in which we have drafted opinions. We have joint responsibility with the General Counsel's office in dealing with problems arising under the Administrative Procedure Act. We assist the General Counsel in connection with litigation arising in cases where we have drafted the opinion, and we prepare legal memoranda at the request of the Commission in a number of miscellaneous matters which are related to our functions.

I should like to say a few words about the operations of this Office in a fairly typical case prior to the actual drafting of an opinion. After the hearing examiner has submitted a

recommended decision, and exceptions and supporting briefs have been filed by the parties, including the operating Division, and oral argument before the Commission has been requested, we receive copies of all those documents together with the proposed findings and supporting briefs, and in many cases a copy of the transcript of testimony. We then prepare and submit to the Commission a pre-argument memorandum which summarizes the salient facts, contentions, and issues in the case. This enables the Commissioners to familiarize themselves with the issues so that they are in a better position to follow the oral argument.

In addition to the pre-argument memorandum, we prepare an opening statement for the Chairman which he reads into the record at the beginning of the oral argument. The purpose of that statement is to indicate what the proceedings are about and under what statutory provision the proceedings were instituted.

We attend the oral argument. After it is over and the room has been cleared, we usually have an instruction session with the Commission. The Commissioners discuss the various issues that have been raised and argued, and normally express their views concerning the resolution of such issues. Where all the Commissioners are unanimous on how they feel the case ought to be decided, we are instructed to prepare a tentative draft of an opinion reflecting their decision. But it occasionally happens that the Commissioners will be divided. In such case we may be asked to prepare alternative opinions. In one recent case we were asked to prepare four alternative opinions, treating the various issues in different manners.

If in drafting an opinion we discover that the record does not support the tentative views of the Commission, we call that to the Commissioner's attention.

In a number of cases the Commissioners may not be in a position, because of conflicting contentions with respect to the facts in the record, to issue specific instructions and will ask us to prepare a tentative draft on the basis of the facts which are established by the record. In such cases we often accompany the draft of opinion with an objective abstract of the record. The Commissioners upon reading our draft and abstract are then in a better position to determine how they would like to decide the case. Our draft might be scrapped at that point or modified.

There are also a number of cases where there is no contest, no oral argument, and no instructions. The file is sent to us with the notation that the case is ready for decision. In such cases we prepare a tentative draft which we submit to the Commission.

After the draft of an opinion has been thoroughly considered by the Commissioners and changes made therein to reflect their suggestions, it is voted on by the Commissioners. If the vote is not unanimous, a discussion may follow resulting in further changes in the opinion sufficient to bring about unanimity. If one or two Commissioners still cannot agree with the majority, or agree for reasons other than or in addition to those stated in the opinion, we frequently assist them in the preparation of a draft of a dissenting or concurring opinion.

In preparing a draft of an opinion the drafting attorney analyses the record and reviews all pertinent Commission precedents, judicial precedents, and Commission policy. If he is confronted with a highly technical problem, he may with the approval of his superiors consult

with experts on the staff who have not participated in the investigation or in the hearing of the case. For example, he may contact an accountant in the office of the Chief Accountant, an analyst, or the oil and gas engineer, in order to obtain a clearer understanding of the problem. If the evidence indicates that a reference to the Attorney General for prosecution may be warranted, that matter is called to the Commission's attention when the draft is submitted. If it is felt that a Commission rule is not adequate and should be amended, or that a new rule should be adopted, such matters also are called to the Commission's attention.

As I have just indicated, the Office of Opinion Writing is independent in the sense that it cannot consult with any of the persons who participated in the particular case or in a factually related matter. That includes the outside parties and the interested staff members unless the outside parties have consented to the staff participating in the rendering of the decision.

We are careful to confine ourselves to the record. While under the Administrative Procedure Act the Commission may in its opinion take official notice of facts which are not in the record, the parties who feel aggrieved may request re-opening of the record in order to contest the facts officially noticed. We are also careful not to make findings with respect to issues which are not raised in the Order for Proceedings, unless pursuant to Rule IV(c) of our Rules of Practice we find that such issues were tried with the express or implied consent of the parties.

You may have heard that technical rules of evidence are not applied in hearings before the hearing examiner, but that hearsay evidence is admissible if relevant and material. However, under the Administrative Procedure Act, the Commission's findings must be based on reliable, probative and substantial evidence. That means that we cannot base a finding on uncorroborated evidence that is pure hearsay not admissible under the exceptions to the hearsay rule.

Another point I should like to make is that the hearing examiner's decision is advisory only. However, there is an exception with respect to the credibility of witnesses. In a situation where one witness contradicts another, and the examiner, on the basis of the demeanor of the witnesses, believes one witness is telling the truth and the other is lying, we are bound to accept the testimony of the witness whom the examiner considers credible unless there is countervailing evidence in the record.

Sometimes we are asked by attorney applicants why Commission opinions are not in the form of a "yes" or "no"? Why do we go to the trouble of writing a detailed opinion? There are several reasons for writing an opinion which describes the underlying facts. It is required by the Administrative Procedure Act, although we followed the practice of writing full opinions before that Act was adopted. It is a guide to the industry and to the Bar. It is a valuable aid to the aggrieved party and to the Court in the event of an appeal. It is a safeguard against ill-considered or arbitrary action which might be unfair to the private party or not serve the public interest. And it acts as a sanction. For example, in a broker-dealer revocation proceeding, the Commission may be of the opinion that it is not in the public interest to revoke the broker-

dealer's registration although he has committed willful violations. Issuance of an opinion describing the misconduct will act as a sanction on the registrant.

Adjourned.