An SEC Chairman's Recollection

By
David S. Ruder
United States Securities and Exchange Commission
1987 - 1989

2004 Securities and Exchange Commission
Historical Society
Roundtable of SEC Chairmen
June 2, 2004

An SEC Chairman's Recollections – 1987-1989

By David S. Ruder[1]

Service as Chairman of the United States Securities and Exchange Commission (SEC) is exciting, rewarding, engrossing, and difficult. This paper sets forth my recollections of the events that in retrospect seem to be the most important or the most striking of those that occurred during the time that I served as SEC Chairman from 1987 to 1989.

Appointment

I was appointed as SEC Chairman by President Ronald Regan in the summer of 1987 and was confirmed by the Senate of the United States on August 7 of that year. Prior to my appointment I had been a professor at Northwestern University School of Law, teaching and writing in the corporate and securities law field. I served as Dean of Northwestern's Law School from 1977 to 1985, and was active in the American Bar Association Section of Business Law and in various securities law continuing education programs. I was not politically active or connected. When SEC Chairman John Shad announced his decision to resign as Chairman, I took no stops aimed at becoming Chairman.

To my surprise, the Regan administration contacted me during one of my trips to Washington, D.C. in May of 1987 and invited me to the White House to interview for the SEC job with Arthur B. Culvahouse, Jr., Counsel to the President, and with Howard Baker, the White House Chief of Staff. They told me that the search for an SEC Chairman had finally centered on lawyers and that my name had been suggested by many of their friends. I heard nothing more until mid-June, when I received a telephone call from John Shad telling me that I had been selected as Chairman.

I was an uncontroversial nominee, since I had no commercial or political ties and had not been outspoken on controversial issues. I was quite surprised during my Senate hearings when Democratic Senator William Proxmire of Wisconsin, Chairman of the Senate Banking Committee, announced that he was opposing my appointment because he did not believe that a Republican could be a strong regulator. I was shocked when Democratic Senator Terry Sanford of North Carolina not only voted against my nomination in the Senate Banking Committee, but also placed a hold on my nomination on the Senate floor because I had refused to oppose unfriendly corporate takeovers. The hold was removed during one of the last days of the Congressional summer session only after the intervention of a Northwestern Law School alumnus, Senator Dale Bumpers, and my appointment was confirmed by the Senate on August 7, 1987.

The confirmation process led me to believe that I would be facing political pressures unrelated to my abilities or views. As a result, I spent considerable time as

---

[1] William W. Gurley Memorial Professor of Law, Northwestern University School of Law; Chairman, United States Securities and Exchange Commission (1987-1989)

Chairman attempting to convince the Democratic chairs of the committees charged with supervising the Commission that I was indeed a strong regulator.

International Securities Regulation

Shortly after taking office I learned that the International Organization of Securities Commissions (IOSCO) was holding a September meeting in Rio De Janeiro, Brazil and that I had not been invited to attend. I learned that Commissioner Charles Cox had been serving as a liaison to IOSCO and that Chairman Shad had not been very interested in international securities regulation. However, at the urging of the SEC staff, Chairman Shad had delivered an important speech in Versailles in 1986 suggesting that IOSCO, an informal group of national securities regulators, should play a more important role in fashioning international securities policy. I invited myself to the Rio conference in order to learn about IOSCO and to demonstrate the Commission's increased interest in international securities regulation.

During the next two years, my office and the Commission staff became increasingly active in international matters. Linda Quinn, Director of the Division of Corporation Finance, led efforts to promote common disclosure standards, and Michael Mann, then a member of the staff of the Division of Enforcement, was instrumental in securing bi-lateral enforcement co-operation agreements between the SEC and securities regulators from other countries. Each Memorandum of Understanding (MOU) pledged cooperation between securities regulators in investigating violations of the securities laws of one country as a result of activities originating in the other's country. During his time at the Commission Mike was successful in negotiating such agreements between the SEC and the securities regulators of more than 25 countries.

By the fall of 1988, the Commission had become increasingly active in international matters. At the November 1988 IOSCO meeting in Melbourne, Australia, I released an "SEC Policy Statement on the Regulation of the International Securities Markets" urging international securities regulatory cooperation, including efficient market structures, sound disclosure systems, and fair and honest markets. I was particularly proud of the statement that: "In seeking solutions to common problems, securities regulators should be sensitive to cultural differences and national sovereignty concerns."[2] The Policy Statement was well received and I believe paved the way for substantial growth in IOSCO activities in later years.

The 1987 Market Crash

On October 19, 1987, just over two months after I became Chairman, the nation's securities markets suffered their worst daily decline in history. The Dow Jones Industrial Average (DJIA) sustained a 22.6% loss, falling 508.32 points to close at 1,738.40. Daily volume of 608 million shares on the New York Stock Exchange (NYSE) almost doubled the previous record reached on October 16, 1987, the prior Friday.

---

[2] SEC Policy Statement on the Regulation of International Securities Markets (October 1988), p. 2.

Needless to say, the atmosphere at the Commission was chaotic. During the day on October 19, I had no way of observing market conditions directly. The only computer terminals showing the market quotations were located in the fifth floor office of the Division of Market Regulation, a floor below my office. During the afternoon of October 19, I went to the fifth floor and observed the Bridge system showing all of the Dow Jones stocks in the red, well below their opening prices. There was little to do that day in response to the market drop. I received a call at about 6:30 p.m. from Democratic Senator Donald W. Reigle, Jr., Chairman of the Securities Subcommittee of the Senate Banking Committee, asking me if I would call the President to tell him to make a statement that would calm the markets. I called one of President's staff members to relay that message, and was delighted when the President made such a statement the next day.

Tuesday, October 20, 1987 was much more a day of crisis than was Monday, October 19. On that Tuesday, the DJIA rose approximately 200 points in early trading to approximately 1,940 and then in late morning declined more than 200 points to approximately 1,730, about eight points below its October 19 close. The market finally rose, and closed at 1,841.01, a recovery for the day of 102.27 points or 5.88%. As the market began its precipitous drop from its early day opening another major decline seemed to be under way. By 12:30 p.m., Eastern Time, trading had been halted in 145 New York Stock Exchange stocks, including 77 stocks in the S&P 500. At about noon I received a call from John Phelan, Chairman of the New York Stock Exchange telling me that he planned to close the New York market. He asked for my support. After talking with my staff and several Commissioners who had gathered outside my office, I told him that he was the best judge of the need to close the markets, and that I would support his decision to close. He told me he would call the White House to warn about the closing and would then close the New York Stock Exchange. About 15 minutes later he called to say that while he was on the telephone with the White House, buying support had emerged and the New York Stock Exchange would not close.

The noon time period on October 20, 1987 stands out as the most memorable moment in my time as Chairman. The nation's securities markets came close to collapse, with potential catastrophic consequences.

During the week of October 19, the Commission undertook many actions designed to sustain the stock markets. We approved early market closures in order to facilitate clearance and settlement procedures. We indicated that we would not enforce Rule 10b-18, which restricted corporations from repurchasing their own stock. We worked with many brokerage firms to assist them in their net capital computations. We allowed an amendment to the British Petroleum securities registration statement so that the Bank of England could as guarantor of the second and third waves of an initial public offering. We consulted with Allan Greenspan at the Federal Reserve Board and with Gerald Corrigan, President of the New York Federal Reserve Bank.

Market related matters took most of my time for next year. Our staff produced a Report on the October 1987 Market Break.[3] The role of the futures markets in the crash became controversial, and the Commission entered into active consultations with the Commodity Futures Trading Commission (CFTC). CFTC Commissioner Kalo A. Hineman and I met with John Phelan of the NYSE and Leo Melamed of the Chicago Mercantile Exchange and told them that the exchanges needed to increase their information flow, increase their contacts with each other, and deal with problems caused by the interconnected securities and financial futures markets. We warned them that failure to do so would have in serious consequences, including regulatory action.

Congress insisted on hearings regarding the market crash, and I found myself trying to resolve requests from each of our oversight committees that they be given the opportunity for the first hearings. In my February 3, 1988 testimony before the Senate Banking Committee, I stated the Commission's conclusion that a unified market for stocks exists between the securities and futures exchanges and that new computer trading mechanisms could cause overwhelming market volatility. I called for changers to increase market capacities, to improve coordination between the markets, and to retard the velocity and volume of intermarket and intramarket trading.

Two of my recommendations proved to be exceedingly controversial. One was the suggestion that stock index futures margins for non-floor traders be increased. The second suggestion was made in response to a proposal made in the January 1988 Brady Report[4] that because stocks, options and futures constitute one market, a single administrative agency should have the authority to regulate intermarket trading activities. The Brady report made the astonishing statement that the logical choice for this task was the Federal Reserve Board. The Fed had no experience regulating stock or derivative products, while the Commission had extensive experience regulating not only equities, but also stock options which have many characteristics of equity derivatives products. The Commission agreed with the Brady Report premise, but argued that the Securities and Exchange Commission was the logical choice for the intermarket regulatory task. Both of these suggestions were vigorously opposed by the futures industry, and during the succeeding year the futures exchanges entered into active lobbying efforts to prevent those results from occurring.

In March of 1988 I was called to the White House and asked to cooperate in a newly formed President's Working Group on Financial Markets consisting of Deputy Secretary of the Treasury George Gould, Federal Reserve Chairman Allan Greenspan, CFTC Chairman Wendy Gramm and me, as Chairman of the Securities and Exchange Commission. The Task Force met almost every week that spring, and in May issued an Interim Report concluding that changes in margin requirements were not required, and that circuit breakers should be established for the purpose of closing the securities markets in a coordinated fashion in the event of large declines.

---

3 The October 1987 Market Break, a report by the Division of Market Regulation, U.S. Securities and Exchange Commission (February 1988).

4 The Report of the Presidential Task Force on Market Mechanisms, (January 1988).

Although I agreed with the circuit breaker suggestion, I dissented from the view that margins should not be increased, stating that at least on an interim basis margins on futures market derivative equity products should be increased in order to reduce market volatility. That dissent caused increased consternation in the futures industry and resulted in my spending time in two long testimony sessions before the Senate and House Agriculture Committees.

During the discussions at the President's Working Group, I asked that consideration be given to supporting legislative initiatives that I thought important. When the Group failed to address these initiatives, I undertook to have the Commission seek introduction of the legislation. In the summer of 1988, the Commission submitted six legislative proposals to Congress. Four relatively uncontroversial proposed legislative initiatives were: large trader reporting authority; monitoring of broker-dealer risk positions; SEC emergency powers; and a cross margining provision. The staff called them the "four easy pieces." Two other proposals raised a fire storm of opposition, both within and outside of the Commission. These proposals sought to restructure margin regulation and to unify jurisdiction over equity related products (including futures market derivative index products) in the Securities and Exchange Commission.

Two SEC Commissioners vigorously dissented from the proposed margin and jurisdiction proposals. These commissioners had disagreed with me on other matters, and would continue to disagree on additional matters in the future. Not only did they dissent, but they did so in a very public manner. Eventually my attitude was that "three votes are enough" to authorize Commission action. I have related this view to the current Commission Chairman William Donaldson.

Serious opposition also came from the futures industry, which initiated a furious series of lobbying activities in Congress. Eventually I concluded that the jurisdictional fight was taking too much of the Commission's energy. I met with CFTC officials and Chicago Mercantile Exchange officials in an effort to substitute regulatory cooperation for conflict, and I believe I was successful.

Enforcement: The Drexal Burnham – Michael Milken Enforcement Actions

Enforcement of the securities laws is crucial to the mission of the Securities and Exchange Commission, and every Chairman devotes substantial time and energy to the enforcement area. During my tenure as Chairman, the Commission dealt with broker-dealer, insider trading, and other enforcement matters, including the controversial Kern disciplinary proceeding dealing with the role of a lawyer in preparing Section 13(g) tender offer reports.[5] Coming from an academic background I took particular interest in the theories underlying enforcement action and I enjoyed the give and take at closed Commission meetings between staff members and Commissioners.

---

[5] In re George C. Kern, Jr., SEC Admin. Proc. File No. 3-6869 (November 14, 1988); In re George C. Kern, Jr., SEC Exch. Act Rel 34-29365 (June 21, 1991).

When I arrived at the Commission in the late summer of 1987, the staff of the Division of Enforcement immediately briefed me regarding their investigation of Drexel Burnham Lambert and Michael Milken. They told me they were involved in contentious discovery and were facing several high priced Wall Street law firms. I told the staff they could have whatever resources were needed to complete the investigation.

A year later, on September 7, 1988, Gary Lynch, John Sturc, and Tom Newkirk, acting on behalf of the Commission, filed a 184 page injunctive action against Drexel Burnham, Michael Milken and other defendants alleging 21 instances involving insider trading, stock manipulation, fraud on clients, failure to disclose beneficial ownership of securities, and other securities law violations.[6] The complaint alleged that Drexel and Milken had a secret agreement with Ivan Boesky involving at least sixteen series of illegal transactions. Drexel and Milken mounted a strenuous public relations campaign, as well as pressuring Congress and the Regan Administration. They were remarkably successful with their publicity campaign, but were unsuccessful with the government.

In April of 1989, the Commission entered into a settlement agreement with Drexel Burnham, in which Drexel agreed to pay $350 million into a fund for the benefit of persons injured in the various transactions, agreed to pay $300 million in civil and criminal penalties, and agreed to sweeping compliance undertakings, including appointment of a compliance consultant, initiation of an internal investigation, and appointment of an independent Chairman at Drexel.[7] During the settlement negotiations the most difficult discussion centered on the theory that since most of the alleged wrongdoing took place in the Los Angeles office of Drexel, where Michael Milken was located, that office should be closed. Concluding that closing that office would have the effect of closing Drexel, the Commission decided instead to require the compliance undertakings.

The Drexel-Michael Milken investigation also had a criminal component, and involved extensive cooperation with United States Attorney's Office for the Southern Disctrict of New York. The Commission "loaned" several staff members to the Southern District on a full time basis. I believe the Drexel Burnham investigation provided important precedent for cooperation between the Commission and the Justice Department. We certainly learned that the U.S. Attorney's broad subpoena powers and ability to threaten jail time were effective investigatory tools.

Penny Stock Fraud

In the fall of 1988 I spoke to securities lawyers in Denver, Colorado. After that talk Bob Davenport, Director of the Commission's Denver Regional Office and his staff explained to me the pervasive nature of penny stock fraud in the Rocky Mountain region and in the rest of country. "Penny stock" fraud refers to fraudulent schemes using low-priced securities in the over-the-counter market. After hearing about boiler room sales

---

[6] SEC Litigation Rel. 11859 (September 7, 1988).

[7] SEC v. Drexel Burnham Lambert Incorporated, et. al, Litigation Release 12061 (April 13, 1989). See also In the Matter of Drexel Burnham Lambert, Inc. SEC Exch. Act Rel 27236 (September 11, 1989).

practices, controlled markets, misleading public statements, grossly inflated price spreads and sales prices, and the dumping of securities at inflated securities on unsophisticated investors, I decided that strong steps were necessary.

I caused the formation of a "Penny Stock Task Force" at the Commission under the leadership of Joe Goldstein. The task force entered into an active regulatory program including increased enforcement, increased co-ordination among securities, criminal and tax regulators, investor education, and rule making. In August of 1989, the Commission adopted Rule 15c2-6, requiring brokers selling penny stock to obtain written information from investors about their financial circumstances and a written record that suitability procedures had been applied.

The problems of dealing with the other Commissioners reappeared in connection with this process when by way of putting brakes on my regulatory enthusiasm, one of our Commissioners insisted that the definition of "Penny Stock" be crafted in a way that would not unduly interfere with capital raising by small companies. Even taking the Commissioner's concern into account, we were able to create effective regulation of penny stock fraud. While we were dealing with the problems of penny stock fraud, I testified before Congress on another matter, and described our reform efforts. Partly as a result of my testimony, Congress passed the "Penny Stock Reform Act" after I left the Commission.

Accounting Matters

Although I had followed the securities regulation field for many years, I had not been involved in filing registration statements or dealing actively with technical accounting matters. Before too many months passed at the Commission I learned that the Commission's Chief Accountant was one of the agency's most powerful staff members. The Chief Accountant regularly met with accounting firms and registrants to settle accounting interpretive problems with great consequence to issuers, and did so with little direct supervision from the Commission.

Accounting matters became increasingly important during my Chairmanship when I received a letter from Congressman John D. Dingell, Chairman of the House Energy and Commerce Committee, demanding to know what steps the Commission was taking in response to the report of the National Commission on Fraudulent Financial Reporting, called the "Treadway Report" after its Chairman, former SEC Commissioner James Treadway. In responding to the report, the Commission dealt with problems of opinion shopping, management reports, peer review, timely review of interim information, exchange rules regarding audit committee practices, and other matters. I can't say that I anticipated the accounting problems of the late1990's and 2000's, perhaps because of my distraction with market structure and enforcement matters, and perhaps because massive corporate frauds were not surfacing.

The Commission has responsibility to oversee the activities of the Financial Accounting Standards Board (FASB), a private sector body to which it has delegated the task of promulgating generally accepted accounting standards. I satisfied myself that the Chief Accountant was regularly reviewing the FASB's process for establishing standards, as well as it work product. I knew that the business community was not happy with the FASB because it frequently issued accounting standards that required financial disclosures and standards that sometimes had the effect of decreasing reported profits. On one occasion I rejected a plan put forward by the Business Roundtable to allow business to seize control of the FASB's standard setting agenda.

The Commission Chairman

The Chairman of the Securities and Exchange Commission is the chief administrator of an agency that regulates a highly complex industry. The Chairman must enlist the support of the other SEC Commissioners, supervise the SEC Staff, respond to Congressional inquiries, negotiate the agency's budget with Congress and the President (through the Office of Management and Budget), coordinate with other agencies, deal with the media and the press, support the legitimate capital raising activities of corporations and securities firms, and at all times protect investors from fraud and over reaching. Although the task of meeting all of these demands is exceedingly difficult, the Chairman of the Securities and Exchange Commission has a fascinating, compelling and satisfying job.