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THE TRI-FUNCTIONAL MODEL AND FAIRNESS AT THE SEC: RESPONDING TO MR. FLEISCHMAN*

John M. Fedders **

Former Securities and Exchange Commissioner Edward H. Fleischman has expressed concerns about the fair administration of justice by reason of the combination of the three functions—quasi-judicial, quasi-legislative, and quasi-executive—performed by the United States Securities and Exchange Commission (SEC).¹ I do not share his concerns.

Fleischman has written that the SEC's exercise of " 'combin[ing] its judicial work with work of policy-determination' "² does not satisfy the appearance of justice test articulated by the United States Supreme Court.³ Fleischman has even concluded that the SEC's prime aim in administering justice is not justice at all, but rather the execution of the legislative policy derived from its enabling statutes.⁴ I believe that both his conclusions and his analysis are flawed.⁵ There are no examples of failure by the SEC to carry out any of its responsibilities with integrity and fairness. Conse-

* This Essay is based on Mr. Fedders' remarks at the first in an occasional series of The Catholic University of America Securities Issues Forum. The Securities Alumni Practice Group of The Columbus School of Law, The Catholic University of America sponsored the Forum, which was held in September, 1992, in Washington, D.C.

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1. See Edward H. Fleischman, *Toward Neutral Principles: The SEC's Discharge of Its Tri-functional Administrative Responsibilities*, 42 CATH. U. L. REV. 251 (1993).

2. The Stuart-James Co., 48 S.E.C. 22, 27 (1991) (Fleischman, Comm'r, concurring) (quoting PRESIDENT'S COMM. ON ADMINISTRATIVE MANAGEMENT, REPORT OF THE COMM. WITH STUDIES OF ADMINISTRATIVE MANAGEMENT IN THE FEDERAL GOVERNMENT 222 (1937) [hereinafter BROWNLOW COMM. REPORT] (Study Report of Robert E. Cushman, *The Problem of the Independent Regulatory Commissions*)).

3. *Id.* at 27 n.1. The Supreme Court first stated its test in *Offutt v. United States*, 348 U.S. 11, 14 (1954) ("[J]ustice must satisfy the appearance of justice."), which was later recognized in *Antoniu v. SEC*, 877 F.2d 721, 724 (8th Cir. 1989), *cert. denied*, 494 U.S. 1004 (1990).

4. See Fleischman, *supra* note 1, at 253 (quoting Bernard Schwartz, *Administrative Justice and Its Place in the Legal Order*, 30 N.Y.U. L. REV. 1390, 1406 (1955)).

5. Fleischman's views would have received no more than a passing glance were it not for his great intellect, unquestioned integrity, and experience and courage as a commissioner. While I disagree with his opinion and analysis, I have given it careful study and research because of my respect for his character and his conduct during six years of service as an SEC

quently, there is no reason to strip the SEC of its tri-functional administrative responsibilities.⁶

Fleischman first articulated his views on fairness under the tri-functional model in his concurring opinion in the SEC decision in *The Stuart-James Co.* case.⁷ In his concurring opinion, Fleischman set forth arguments of bias and the lack of the appearance of fairness by the SEC in its adjudicative duties.⁸ His conclusions are unfounded, and express a concern only of what hypothetically could happen rather than expose the actual existence of an unfair process at the SEC.

While I am critical of Fleischman's concurring opinion in *The Stuart-James* case, the majority opinion itself was self-righteous. The SEC's protectionism is evidenced by the majority's expressed concern with "eliminat[ing] the risk of additional litigation and unfavorable precedent if an appeal is taken [from an SEC decision] to a United States Court of Appeals."⁹ Rather than strive to avoid judicial scrutiny of its opinions, the SEC should never resist reasonable efforts by respondents to have the federal courts scrutinize the SEC's acts as a quasi-judicial authority. More often than not, the SEC will prevail in the appellate process. When it does not, the integrity of the marketplace will be enhanced. Since the tendency of the law always must be to narrow the field of uncertainty, judicial review of SEC actions will assist the "narrowing process" in the securities law area.

If the Supreme Court were to consider the constitutionality of the SEC's quasi-judicial authority, I believe the Court would uphold the tri-functional administrative scheme by a unanimous vote. The Administrative Procedure Act (APA)¹⁰ and the SEC's legislatively granted duties under the Securities

commissioner. As a dean of the securities bar, and one of its leaders, any view Fleischman expresses in the field of securities law merits attention and discussion.

6. Cf. H. REP. NO. 671, 102d Cong., 2d Sess. 9 (1992) ("[W]e are unwilling to change the [FAA's] procedures of the civil penalty program on the basis of perceptions of unfairness, when these perceptions have no basis in reality.").

7. *The Stuart-James Co.*, 48 S.E.C. at 27-33 (Fleischman, Comm'r, concurring). In this administrative proceeding, the eight respondents moved to, *inter alia*: (1) dismiss the proceeding, (2) disqualify those SEC commissioners who accepted an offer of settlement from a former respondent in the action, and (3) compel production of internal SEC staff memoranda and *ex parte* communications between the staff and the commissioners concerning settlement with a former respondent in the action. *Id.* at 22. In short, the respondents argued that the commissioners prejudged the essential facts adverse to them, and that it is virtually impossible for the SEC to entertain individual settlements in proceedings involving multiple respondents. *Id.*

The SEC denied the motions. It concluded that the commissioners' approval of the settlement in question was a proper exercise of its authority to control its administrative docket, and that such action was not a prejudgment and did not interfere in their acting as an impartial and disinterested tribunal in the proceeding against the eight remaining respondents. *Id.* at 26-27.

8. *Id.* at 27.

9. *Id.* at 24.

10. 5 U.S.C. §§ 551-706 (1988).

Act of 1933 ("the 1933 Act")¹¹ and the Securities Exchange Act of 1934 ("the 1934 Act")¹² would be upheld. Fleischman's arguments are unappealing to both judicial activists and strict constructionists, and are therefore unlikely to result in a Supreme Court decision stripping the SEC of any of its duties. Consider the following eight points in support of my analysis.

First, the Supreme Court's prior opinions addressing the APA¹³ and the SEC's tri-functional authority¹⁴ provide no jurisprudential support for Fleischman's views.

Second, the APA and its legislative history unquestionably contemplate that administrative agencies would undertake adjudicatory duties while also exercising regulatory and law enforcement responsibilities.¹⁵

Third, the SEC's administrative proceeding process does not lack due process. Fleischman infers, but does not specifically document, that the SEC's exercise of its judicial duties lacks fairness or the appearance of fairness. While the SEC's adjudicatory process is painfully slow, there is no inherent lack of fairness. Furthermore, in February, 1993, the SEC issued its own *Task Force Report* for improving the efficiency of the process.¹⁶

The internal execution of the SEC's tri-functional administrative responsibilities may be characterized as a debate-oriented process. Each quasi-judicial, quasi-legislative, and quasi-executive decision is first subject to a formal contest of argumentation in which opposing teams defend and attack a given proposition. The SEC commissioners and staff do not function as an intellectually homogenous class. Moreover, these debates of opposing points are not restricted to the SEC internal process. Most often, commissioners and staff widely publicize their differing views on each SEC action in congressional testimony, concurring or dissenting opinions, speeches and papers.

11. Act of May 27, 1933, ch. 38, Tit. I, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77a -77aa (1988)).

12. Act of June 6, 1934, ch. 404, Tit. I, 48 Stat. 881 (codified as amended in scattered sections of 15 U.S.C.).

13. See, e.g., *Withrow v. Larkin*, 421 U.S. 35 (1975) (holding the mere combination of investigative and adjudicative functions not violative of due process); *Porter County Chapter v. Nuclear Regulatory Comm'n*, 606 F.2d 1363, 1371 (D.C. Cir. 1979) (holding that a combination of adjudicative and other agency functions does not violate due process unless sufficient inherent bias exists); *Ash Grove Cement Co. v. FTC*, 577 F.2d 1368, 1377 (9th Cir. 1978) (recognizing a presumption of fairness of adjudicative enforcement procedures), *cert. denied*, 439 U.S. 982 (1978).

14. See, e.g., *Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099, 1105 (D.C. Cir. 1988); *Touche Ross & Co. v. SEC*, 609 F.2d 570, 581 (2d Cir. 1979).

15. See *Administrative Procedure Act: Legislative History*, S. DOC. NO. 248, 79th Cong., 2d Sess. (1946), reprinted in, *Final Report of the Attorney General's Committee on Administrative Procedure*, S. DOC. NO. 8, 77th Cong., 1st Sess. (1941).

16. TASK FORCE ON ADMIN. PROCEEDINGS, FAIR & EFFICIENT ADMIN. PROCEEDINGS: REPORT OF THE TASK FORCE ON ADMIN. PROCEEDINGS OF THE UNITED STATES SEC. AND EXCH. COMM'N (1993) [hereinafter TASK FORCE REPORT].

Fleischman's conduct as an SEC commissioner exemplifies a healthy fifty-nine-year tradition of vigorous debate at the SEC. These debates enhance both the fairness and the appearance of fairness of the SEC tri-functional process.

Of course, lack of fairness at the SEC could occur in an isolated instance by reason of some individualized misconduct, bias, or prejudice. If this occurs, the aggrieved party has an adequate remedy: appeal to a federal court. But even isolated occurrences of unfairness do not justify dismantling the entire tri-functional process. The federal courts are already overcrowded.

Fourth, when the APA and the two principal federal securities acts¹⁷ were passed, there was no expectation that the SEC's quasi-judicial process would have the attributes of an Article III court.¹⁸ Therefore, nothing contemplated by Congress in passing the federal securities laws has been lost from the process available to a respondent in an SEC administrative proceeding. Commissioners at the numerous federal agencies are fulfilling their quasi-judicial roles in exactly the manner contemplated under the applicable laws, and those laws and their legislative histories do not contemplate that commissioners will assume Article III responsibilities.

Fifth, there is no constraint on the administrative agency arising out of the United States Constitution. The Constitution requires due process of law and fairness. The exercise of administrative agency quasi-judicial authority does not fail to meet those constitutional requirements.¹⁹

Sixth, there is a constitutional check and balance on the SEC's administrative process. A party alleging unfairness has recourse through appeal to an Article III court. The federal courts have often deferred to the SEC's expertise and judgment, but when necessary, the courts also have imposed their own views, or existing court decisions, upon the SEC.²⁰ Moreover, there are few, if any, examples of the SEC ignoring existing court precedent while carrying out its law enforcement and adjudicatory duties.

Seventh, there is no convincing evidence that if the SEC's key responsibilities were bifurcated or trifurcated, the separation of functions would materially enhance individual rights or fairness. In fact, bifurcation or trifurcation of the SEC's responsibilities would seriously erode the protection of investors and would not enhance fairness. The extraordinary interdependence at the SEC by the commissioner and the staff of its twenty-one divisions and offices is an everyday event. For any one of the participants in that process

17. *See supra* notes 11-12.

18. *Cf. Freytag v. Commissioner*, 111 S. Ct. 2631, 2644 (1991) (holding that the Tax Court is an Article I "Court[] of Law" within the meaning of the Appointments Clause).

19. *See* cases cited *supra* note 13.

20. *See, e.g., Lowe v. SEC*, 472 U.S. 181 (1985); *Dirks v. SEC*, 463 U.S. 646 (1983); *SEC v. Sloan*, 436 U.S. 103 (1978).

to lose immediate access to the expertise of the others would impede the effective performance of everyone at the SEC.²¹

Eighth, there is a strong and obvious need for institutional expertise in specific regulated industries. The system of government by regulation of functions works well. Our capital markets are extremely complex, as is the myriad of regulations on those functioning in those markets. The SEC's historical and institutional expertise is invaluable when it carries out its tri-functional responsibilities, and that expertise benefits every respondent in an SEC administrative proceeding. The need for this institutional expertise continues to grow, and hopefully someday the entire United States capital market, securities and commodities alike, will be regulated by one agency.²²

In concluding my views on Fleischman's arguments, it is important to note that the former commissioner wrote a concurring opinion, rather than a dissenting opinion, in *The Stuart James* case.²³ If Fleischman truly believed that unfairness and the appearance of unfairness exists at the SEC, one would expect that he would have dissented. That he did not dissent suggests that he believes that the tri-functional process of the SEC meets the constitutional criteria for fairness.

While I have taken issue with Fleischman's arguments, his remarks have served one very important purpose. They have focused increased attention on the administrative process of regulatory agencies. There has been too little commentary on those processes over the past decade.

My concern, especially since 1987,²⁴ has been whether the administrative process has become neglected at the SEC. Thus, I believe the question for debate is whether the SEC is adequately fulfilling its administrative law or quasi-judicial responsibilities. This question arises because of three separate concerns.

First, I often wonder whether the policymaking responsibilities of the SEC commissioners have come to dominate their attention and time, particularly their speechmaking time. Because those who the SEC regulates, and their counsel, rely upon SEC directives and commissioner speeches when determining their future conduct in our capital markets, the SEC must give suffi-

21. For example, if, as Director of Enforcement, I would not have had immediate access to the expertise and historic perspective of members of the commissioners' staff, the Office of General Counsel, and the Divisions of Corporation Finance, Investment Management, and Market Regulation, the efficiency and fairness of the SEC's law enforcement process from 1981-85 would have been materially impeded.

22. Since the early 1980s, no one has ever reasonably explained why there is both an SEC and a Commodities Futures Trading Commission.

23. See *supra* notes 7-9 and accompanying text.

24. The Supreme Court decided *McMahon* in 1987. See *infra* note 26.

cient attention to its non-policymaking and law enforcement duties. However, the SEC has failed to do so in recent years.

The question concerning the SEC's overemphasis of its policymaking role is raised as to the commissioners as a panel of five members, and does not apply to the law enforcement responsibilities of the Division of Enforcement. Fleischman may advocate clipping the SEC's quasi-judicial wings; I, on the other hand, wonder if investors should not simply demand that the SEC pay greater attention to its quasi-judicial responsibilities.

The investment community—namely, those governed by SEC regulations—desperately need the SEC to speak more often, at greater length, and more analytically in its quasi-judicial role. The SEC may regulate individuals, but today, far more than in 1933 and 1934, the SEC is regulating a major part of the world economy. A greater articulation by the SEC of the responsibilities of regulated persons in our rapidly expanding markets will reduce uncertainty in determining the legality of particular conduct, and thus may prevent conduct that the SEC would subsequently find violative of the federal securities laws.²⁵

Second, since reading the briefs and hearing the oral arguments in *Shearson/American Express, Inc. v. McMahon*²⁶ and *Rodriguez de Quijas v.*

25. As the Committee on Independent Regulatory Commissions reported in 1949:

We recommend that the Commission give greater publicity to such rulings, and particularly to the basic underlying principles, as they become fixed. Such publicity would guide those affected by the rulings, and enable them to keep abreast of the Commission's policies and course of thought. By subjecting these rulings to scrutiny, it might also aid the Commission in reaching a desirable result.

COMM. ON INDEP. REGULATORY COMM'N, A REPORT WITH RECOMMENDATIONS 147-48 (1949) (prepared for the Comm'n on Org. of the Executive Branch of the Gov't).

26. 482 U.S. 220 (1987). The Supreme Court held that a broker-customer arbitration provision is enforceable under the Federal Arbitration Act. The Court reasoned that arbitration clauses are favored by federal policy and law, and that the forum made available to brokers and customers did not invalidate or nullify the substantive provision of the 1934 Act. *Id.* at 227-28. The Court further noted that its decision was based in part upon the adequacy of the arbitration forum, and that these mechanisms adequately protected investors' rights to obtain substantive relief for violations of Rule 10b-5 under the 1934 Act. *Id.*

For 34 years prior to *McMahon*, the Court's decision in *Wilko v. Swan*, 346 U.S. 427 (1953), was the law with respect to the enforceability of broker-customer arbitration clauses in Rule 10b-5 actions. In *Wilko*, the Supreme Court held that a contract clause requiring arbitration of 1933 Act disputes was not enforceable in derogation of federal court jurisdiction by virtue of § 14 of the 1933 Act, which rendered void any "condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter." *Id.* at 429 n.6 (quoting § 14 of the 1933 Act, 15 U.S.C. § 77n). Because § 22 of the 1933 Act provided for court jurisdiction over offenses and § 11 provided for suits in courts of competent jurisdiction for false registration statements, the Supreme Court determined that arbitration clauses were not binding or enforceable. *Id.* The reasoning of *Wilko* was carried over to the 1934 Act cases by federal court decisions.

Shearson/American Express, Inc.,²⁷ I have viewed the SEC as having an increased responsibility in the administrative process to address, in reasoned and analytical decisions, the conduct of persons the SEC regulates. Since *McMahon* and *Rodriguez*, there has been an explosion of arbitration proceedings against brokers and their firms, and materially fewer federal district court opinions addressing the conduct of regulated persons. The SEC has failed to fill the absence of federal court opinions with administrative opinions, releases, or commissioners' speeches and writings. It is my view that in its briefs and arguments in *McMahon* and *Rodriguez*, the SEC said, or at least inferred, that if the Supreme Court upheld the validity of mandatory arbitration covenants in broker-customer contracts, the SEC would monitor the arbitration process and actively and publicly articulate its views on the evolving responsibilities of brokers and their firms in the rapidly changing marketplace.

There is a great need, which has not been substantially met, for ongoing SEC commentary about the duties and obligations of regulated persons. Those governing in arbitration proceedings and those whose conduct is being scrutinized, as well as investors in our securities markets, need the benefit of the SEC's views on the legality of new and developing trends of conduct in rapidly changing securities markets. The tendency of the law must always be to narrow the field of uncertainty, and I believe the SEC needs to play a much more significant role in this narrowing of the uncertainty of what conduct is expected of regulated persons.

Third, I believe the SEC is often too protective of its own views and process. It has on occasion failed to welcome judicial scrutiny of its views. I believe this self-protective conduct is adverse to the interests of investors and regulated persons. The majority opinion in *The Stuart-James* case confirms my view of the SEC's protectiveness. Discussing its enforcement duties and adjudicatory role, the majority opinion stated:

When we consider whether to settle a case, we must determine whether the settlement is in the public interest. The decision as to whether to accept a settlement and what sanctions, if any, to impose, involves diverse considerations, and can include factors which go beyond those that would be included in the trial record and weighed in reaching a litigated decision. To determine the public interest we must consider these factors fully. For example, on the one hand, we must weigh the fact that our settlements typically do not require the settling respondent to admit or deny the allegations in the order instituting proceedings against the benefits

27. 490 U.S. 477 (1989). The Supreme Court came full circle from its original *Wilko* reasoning and decided that arbitration agreements are enforceable in claims under the 1933 Act, thus overruling *Wilko*.

of a more definitive resolution, one way or the other, if a case is litigated to conclusion. *On the other hand, we must consider that, by definition, a negotiated settlement eliminates the risk of additional litigation and unfavorable precedent if an appeal is taken to a United States Court of Appeals.*²⁸

The SEC's remarks evidence an unhealthy protectionist attitude toward its own views. Debate, particularly in a judicial forum, benefits the interpretation of law and provides the certainty needed by those who are governed. The SEC should always act to foster debate in a judicial forum, and the SEC should never act simply to protect its institutional views.

28. *The Stuart-James Co.*, 48 S.E.C. 22, 24 (1991) (emphasis added) (citation omitted).