EAGLE ON THE STREET

BASED ON THE PULITZER PRIZE–WINNING ACCOUNT OF THE SEC'S BATTLE WITH WALL STREET

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Confrontation

"Be reasonable," Fedders told him over the telephone, but the words only seemed to make Bobby Lawyer angrier.

There is no question but that Merrill Lynch and Company deserves to be publicly charged with fraud, Lawyer kept saying, his voice rising each time he had to argue the point again.

Yet he couldn't get through, and he was frustrated. Lawyer was in San Francisco, where he headed the commission's Bay Area branch office, while Fedders was on the fourth floor of SEC headquarters in Washington. Lawyer could only defend himself and the work of his office by telephone, a limited means of communication for an attorney used to prancing and arguing in a courtroom. It was late in 1984—more than two years after Lawyer's office had initiated a major confidential investigation into alleged securities fraud by a Merrill Lynch broker in San Francisco, and into the failure of the largest Wall Street brokerage firm to detect and stop the broker's wrongdoing. Now Fedders was telling Lawyer that one of the San Francisco office's main recommendations, that Merrill Lynch be named in the case as a defendant, was meeting stiff opposition in Washington.

All Lawyer had was the telephone, so he kept using it. He peppered the commission's headquarters with calls—to Fedders, to the general counsel's office, to the staffs of individual commissioners, to the commissioners themselves. He argued, prodded,

questioned, and generally made himself a nuisance. Lawyer and some of his colleagues in San Francisco had decided that even if their stridency somehow hurt their careers by angering their superiors at headquarters, they would push as hard as they could. Within weeks they had set the stage for a tumultuous confrontation over commission policy with SEC Chairman John Shad.

It came just as Shad was consolidating an uneasy truce with the SEC bureaucracy. The senior staff who on most days of the week drifted in and out of loosely structured meetings in the chairman's expansive office suite in Washington were loyal to Shad. Fedders had a tight grip on the policies of the enforcement division, and he consulted regularly with the chairman. Linda Quinn, who had managed the takeover advisory committee and then become Shad's chief of staff, was indefatigably efficient, able to match the chairman's relentless pace. Dan Goelzer, Shad's first chief of staff, had moved over to become general counsel, a job he had always coveted, and his personal rapport with Shad along with his unique skills as a politician within the bureaucracy gave the chairman a new control over the commission's legal policies. Rick Ketchum in the market regulation division seemed more amenable to Shad's deregulatory approach than his predecessor had been.

There were new and friendlier faces among Shad's four commission colleagues as well. When free market economist Charles Cox came on board as a commissioner, he replaced John Evans, the Republican and former SEC staff member who had so often opposed the chairman on enforcement matters. Shad's rival on budget issues, Barbara Thomas, also was gone. The two Democratic commission seats were occupied by newcomers, former congressional staffer Charles Marinaccio and Los Angeles attorney Aulana Peters. Neither of them shared Shad's ideology but they had no history at the commission, either; no emotional ties to the staff or its agenda. One of the Democrats had replaced Bevis Longstreth, the Manhattan attorney whose friendship with Shad had helped to bridge the political differences between them.

Longstreth's 1984 farewell party in commission headquarters had focused attention on the friction in Shad's relationships with

the other commissioners and especially with the staff. At the party, Longstreth had a piano hauled into the room and he serenaded Shad and the gathered staff with an original solo—"Ruler of the SEC"—to the tune of "When I was a lad" from Gilbert and Sullivan's *H.M.S. Pinafore.*

When Shad was a lad he served a term
As office boy to the Hutton firm.
He crunched the numbers and made deals galore
And fed himself abundantly on free market lore.
He praised the free market so zealously
That Reagan made him ruler of the SEC.

He signed on Fedders as enforcement mate
And pledged him sternly to deregulate. . . .

In laying plans John failed to note
That Congress allotted him just one vote. . . .
Yes, the Congress had decreed for the SEC
A five-headed beast to act collegially.

How we would vote was hard to tell:
Each wanted power, had no vote to sell.
'Gainst inside trading there was broad concensus
But on the budget Shad stood against us.
In budgetary matters we agreed to disagree
With the Reaganomic ruler of the SEC

Our Chairman said I'm for competition
But on 415 to the Street I'll listen. . . .
Yes, shelving the rule might be the key
To industry affection for the SEC.

Commissioners come and Commissioners go
Hemming in their Chairman, be he John or Joe
And Congressmen, feigning oversight,
Holler to the press and pretend to fight.
Yet to each comes this discovery:
It's the staff who rule the roost at the SEC.

"Bevis," Shad declared amid resounding laughter, "leave us.' They could laugh with and at each other in SEC headquarters

bound by mutual dependence, familiarity, and genuine affection. Yet in some respects the import of Longstreth's lyrical insights was greatest for those staff who never heard his song. Out in the SEC's far-flung bureaucracy, among a number of the staff who did not meet with Shad daily, whose careers were not lifted by his patronage, resentments festered. This was especially true in the fifteen SEC regional and branch offices scattered around the country, where hundreds of attorneys, accountants, and investigators worked on enforcement cases and inspections that often seemed tedious and unappreciated by headquarters. Nearly all the headline-grabbing insider trading cases were managed by an elite group that worked closely with Fedders and Shad in Washington.

To some senior attorneys in the regional offices, Shad was only a distant caricature perceived as a knee-jerk, budget-cutting former Wall Street tycoon hostile to the commission he now ran. Shad helped his cause little when, in a speech to a conclave of stock traders in Boca Raton, Florida, he joked that he recently had been told that the definition of a "damn shame" was a busload of government officials going over a cliff—with five empty seats. The remark was reported in the press and Shad apologized, but the incident only reinforced suspicions in the regional offices. All the regional managers struggled because of the budgetary restraint supported by Shad. Secretaries, computers, even desks and chairs, were sometimes hard to come by in the mid-1980s, and it seemed to some that the headquarters staff in Washington didn't much care. It angered and appalled Ira Lee Sorkin, chief of the commission's busy New York office, that while Shad commuted every weekend between Washington and his Park Avenue apartment, in four years the chairman stopped by the New York Regional Office only once or twice—so unknown was Shad that an employee there once mistook him for an intruder and asked to know who he was and what he was doing.

Bobby Lawyer in San Francisco shared Sorkin's indignation about Shad. Litigators possessed of raucous demeanors and politically liberal outlooks, Lawyer and Sorkin talked occasionally by telephone, as did other disgruntled regional office attorneys.

When the Merrill Lynch case erupted into an emotional confrontation with Shad's office, Lawyer's crusade became a vessel for some pent-up frustrations among certain commission staff in Washington and at the regional offices.

Around the time of Bobby Lawyer's crusade, for instance, frustration was also building in the regional office closest to SEC headquarters—the Washington Regional Office (WRO) in suburban Virginia. Though it was just a short distance from the commission's imposing headquarters in Washington, where the flags and the bustle and the sense of urgency in every hallway contributed to the SEC's culture of self-importance, the forty-employee WRO seemed a world apart. Shad apparently never visited the place.

In theory, the WRO was supposed to function like the major regional offices in Los Angeles, New York, and Chicago, all of which had troubles of their own partly because of Shad's neglect. But the WRO's difficulties were even worse. On paper, its mission was to enforce federal securities laws along the Eastern Seaboard in a five-state region that included Pennsylvania, Delaware, Virginia, West Virginia, Maryland, and the District of Columbia. But the truth was that, when a prestigious or politically charged case came along—the sort of case that might catapult the WRO to prominence and attract talented lawyers—senior lawyers at SEC headquarters took over.

The big problem at the WRO wasn't turf, though—it was sex, drinking, and discrimination, or so said staff attorney Catherine Broderick.

Before Broderick filed a formal grievance in 1984, it was hard to know whether the antics she encountered so routinely in the WRO were known to Shad and the senior staff at nearby SEC headquarters. Broderick's grievance was the opening shot in the SEC's Equal Employment Opportunity (EEO) process, in which disgruntled employees had the right to file documents laying out their complaints. The EEO process was lengthy and rarely satisfying, and it was something Shad and many of the other senior level appointees paid little attention to during the Reagan years. In part, that was because those who held political authority at big

agencies like the SEC knew they likely would be in government a relatively short time and felt no identity of interest with the huge class of permanent government employees beneath them. And in part it was because early in the EEO process there was no way to weed routine and illegitimate complaints from those allegations that were serious and meritorious. Moreover, many of the ideological conservatives who held the government's most important posts during the 1980s were utterly indifferent to the issue of employment discrimination.

At the SEC, John Shad said he saw the issue of employment discrimination the way he saw most everything else: through the filter of free market theory. After he came to Washington, Shad said on numerous occasions that he had learned many years before, in a case at the Harvard Business School, that discrimination was bad for the bottom line. He boasted publicly that he was promoting more women to senior positions at the SEC than ever before. His daughter, Leslie, was in law school, and Shad clearly wanted to see her treated with respect whether she worked in private practice or government. Though senior SEC officials praised Shad's handling of EEO issues, there were those inside the commission and out who doubted Shad's commitment to civil rights and the eradication of racial and sexual discrimination. For Catherine Broderick and some other mid-level employees at the SEC, the gap between Shad's public rhetoric and daily reality seemed immense. To them, Shad's priorities had seemed clear since the day that the EEO director's office had been moved to the basement of SEC headquarters to make room for the new Office of the Chief Economist that Shad created.

Broderick found working in the WRO humiliating and embarrassing. Far from a bastion of the public service ideal, the Washington Regional Office seemed at times like an oily swingers' pad from some camp Hollywood movie of the 1960s. As time went on, Broderick discovered that she wasn't the only one in the WRO who had uncomfortable experiences with some supervisors who made crude remarks, solicited sexual favors from subordinates, and granted favorable evaluations and other awards in exchange for sexual favors. Broderick declared on her grievance form that

supervisors in the office maintained a "hostile and oppressive working environment" and discriminated against her by giving her unfair performance evaluations because she refused to take part in office parties and other social activities.

Broderick sent a memo to Shad, outlining some of her complaints, and then waited to see what would happen. EEO Director Phil Savage—the civil rights veteran whose office had been shifted to the basement in favor of Shad's chief economist—was immediately intrigued and amazed by Broderick's allegations of womanizing and boozing during work hours. He began to look into her claims. Typical of the pace of workplace discrimination cases, it would take years before the matter bubbled to the surface and became public, putting John Shad and the SEC's self-conscious traditions of excellence on trial. In the meantime, the matter would remain, like so many other things on the sixth floor of commission headquarters, a closely guarded SEC secret.

To those who knew him and believed in him, including the mostly young and liberal staff in the SEC's San Francisco office, there was nobody at the SEC better qualified to lead a righteous crusade than Bobby Lawyer. He was a balding, energetic, perceptive black man with unruly tufts of hair on the sides of his head, protuberant teeth, and an ego bigger than Mississippi, where he was born. Lawyer had grown up in the racially divided Old South, the middle of seven children. His father was an interstate truck driver and his mother worked odd jobs until the last of her children finished school—all seven went to college, though neither of Lawyer's parents had gone themselves. As a child in Vicksburg, Lawyer had to walk past three of the white elementary schools to get to the segregated school for black kids. There were all-white swimming pools, all-white restaurants, all-white bathrooms, all-white seats on the bus. Later, it was Lawyer's habit to shrug off the obstacles he had faced without bitterness. "What can I say?" was one of his signature phrases around the SEC office in San Francisco. On the topic of Vicksburg, the question posed to himself was followed by: "I was a kid. It was segregated. . . . You knew it didn't seem right. You knew that for sure."

There was no explanation for his peculiar surname, other than the guess that it reflected the occupation of some long-ago slave-owner. Still, Lawyer came to Harlem as a teenager in the late 1950s suspecting that he might become an attorney even if it meant, as it did, that he would have to attend high school and college during the day while working through the night. He lived on 145th Street and took the "A" train down to the garment district, where he pushed hand trucks and delivered dresses to the finest Manhattan department stores, like Saks Fifth Avenue. He started out majoring in chemistry but switched to prelaw, drawn by the romantic image of the trial lawyers he saw on television and at the movies. He told others he wanted to be the kind of trial attorney who could dominate a crowded courtroom and triumph with dramatic cross-examination. After enrolling at Columbia University Law School in 1965, he became active in the civil rights movement, and once he finished, he spent two years working with a group of criminal attorneys in an experimental antipoverty law office in East Harlem. From there he was recruited to be an assistant U.S. attorney—a federal prosecutor—in the prestigious Southern District of New York, the Manhattan office that brought big, complex criminal cases against the city's political bosses, the Mafia, and errant titans on Wall Street. One of Lawyer's officemates was a young, ambitious prosecutor named Rudolph W. Giuliani, who as Manhattan U.S. Attorney during the 1980s would lead, in tandem with the SEC, the most ambitious prosecutions of Wall Street corruption ever.

Stanley Sporkin brought Lawyer to the commission in 1975. After two years as a trial lawyer in Washington, he headed for the West Coast. He was named chief of the San Francisco office, with a staff of forty, less than two years before Jack Shad came to the SEC.

Three thousand miles from Washington, Lawyer had the freedom and autonomy to choose the investigations he wanted to pursue aggressively. He had no particular interest in the insider trading prosecutions urged by Fedders and Shad; his preference was for cases where there were more tangible victims, real people or companies who had been defrauded and whose losses could be

restored or at least avenged. In that respect, at least, the Merrill Lynch investigation was the kind of cause Bobby Lawyer liked most of all. Before it was over, the matter that generated so much controversy inside the SEC that fall of 1984 would bring Lawyer face-to-face with Shad in a dramatic confrontation at the commission table. Lawyer didn't mind that, either.

> He is now [saying]—just get rid of [the customer]—he no longer is of any value to Merrill Lynch—he has no more money! Unconscionable behavior for a Merrill Lynch broker. The customer feels as though he has been taken for a ride—and I'm having difficulty in defending our position. Please review the above and advise what action you want me to take.
>
> —Memo from Merrill Lynch manager Louis Trujillo to supervisor Robert Fisher, July 22, 1981.

On a busy summer weekday, John J. Bruns, an investigator on Bobby Lawyer's staff, strode unannounced into the Merrill Lynch branch office in San Francisco, situated in a financial district storefront amid the towering skyscrapers and Lego-like shopping concourses engulfing the eastern tip of the city peninsula.

Coincidentally, as Bruns walked through the door, halfway across the country the Smith Barney naked-options-writing group was being visited by financial catastrophe in Rhinelander, Wisconsin. But Bruns knew nothing about that case, at least not at the beginning. Soon it became clear to the SEC staff that both the Smith Barney and Merrill Lynch matters revolved around the same question of when to punish an investment house for the misconduct of a stockbroker. But all Bruns knew then was that a disgruntled customer of Merrill Lynch had written to the commission complaining of the allegedly fraudulent sales techniques of a stockbroker named Victor Matl, and of the failure of Matl's supervisors to make amends.

Bruns identified himself and said he was there to conduct a surprise inspection of the Merrill Lynch office on behalf of the Securities and Exchange Commission. He asked to speak to the branch office manager, Robert Fisher, or whomever else might be in charge. He said he wanted to see Merrill Lynch's customer complaint file.

The office managers scrambled to accommodate him, and soon Bruns was flipping through a file of complaints that dated back to the 1970s. The file raised serious questions about stockbroker Victor Matl's conduct and also about Merrill Lynch's decision to keep him on as a salesman in the face of so many fraud allegations by his customers. About thirty-five complaints had been lodged against Matl since 1978—many more than against any other of the approximately seventy-five account executives in the office. At one point recently, Matl had been generating a complaint every week. And the accusations against him were far from trivial. They ran the gamut from forgery to unauthorized trading in brokerage accounts to clearly improper sales techniques.

When he finished reading, Bruns trundled back across Market Street to the SEC's dreary offices in the low-rent Tenderloin district. He told his superiors what he had found. Within days, Bobby Lawyer authorized a full-scale inquiry into Matl's conduct and Merrill Lynch's supervision.

Commission attorneys and investigators fanned out across the Bay area, interviewing customers whose names appeared in the complaint file. The SEC staff was led by Cary Lapidus, a young SEC lawyer who had come to the San Francisco office from headquarters in Washington in part because he wanted to work for Bobby Lawyer. The stories Lapidus and the others heard appalled them.

Max L. Christensen, an Episcopal priest in San Francisco nearing his retirement, said he had opened a money market account with Merrill Lynch by depositing $42,000, nearly all of his worldly wealth, through the mail. Victor Matl soon telephoned, saying that he had been assigned as Christensen's stockbroker. Christensen said he didn't want to do anything with his money except let it earn interest for a few months. Matl said he understood, but then suggested that the priest use his money as collateral for loans that would allow him to play the stock market in a big way. Christensen demurred. A month later he received an account statement showing that without authorization, Matl had borrowed about $30,000 from the priest's account and had sunk it all into a risky oil stock. When Christensen called to protest, Matl assured

him everything was safe. There was a way Matl had of making even the most preposterous ideas seem safe and desirable. There was plenty of hard sell in his approach, but his aggression was tempered by kindly, mollifying assurances. Matl had a thick Czech accent, and he spewed financial jargon as if it were a secret code only he understood. He cajoled, pressured, cajoled, pressured. Christensen explained to the SEC investigators that he had trusted Matl.

"I've been forty years in the ministry and I've seen all kinds," he said. "He had a style that fooled me."

The oil stock plummeted in price, forcing Christensen to sell at a loss to pay off his borrowings. Matl pushed him to invest in another little-known oil company and to begin trading risky stock options. He sent application forms to Christensen so that extensive options trading could be authorized—unsure what the forms were, Christensen and his wife signed them without filling in any of the financial information required. The SEC investigators requested the records from Merrill Lynch and found that Matl had filled in the blanks himself, without permission. Instead of writing in the Christensens' actual net worth of about $50,000, Matl entered a figure of $500,000. The form was approved by an office supervisor, and Matl began trading options aggressively in the priest's account. Christensen had heart trouble, and his health deteriorated along with his finances. He was hospitalized for surgery, and even while Christensen was flat on his back, Matl continued to trade the account without permission, earning commissions for himself while steadily losing the original $42,000 balance. One year after mailing in his deposit, Christensen had only $7,000 left. "That was my inheritance and my savings," the priest said. "It was a disaster in terms of what we thought of as future security. . . . I didn't contemplate jumping off a bridge, although I was quite close."

There were other stories. Albert Iaccarino and his wife, Rose Scalise, both doctors, said that when Matl took over their accounts, he sold off more than $100,000 worth of conservative utility stocks and replaced them with more speculative investments—without telling them or seeking their permission. Robert Reeves, a junior

high school principal, said he told Matl that his investment goal was to help his children buy homes. Matl then pushed Reeves into speculative stocks and he lost $10,000 in three months. Jan Haraszthy, a retired wine merchant, deposited $15,000 into an account assigned to Matl, who quickly recommended that Haraszthy invest in a tax-exempt municipal trust. Haraszthy declined but Matl ordered the trade anyway.*

As they built their case, conducting interviews, organizing documents, and taking formal testimony from Merrill Lynch officials, it became increasingly clear to Lawyer, Lapidus, and the other SEC staff that they had a solid foundation for fraud charges against Matl. What intrigued them as much as the breadth and depth of Matl's violations of securities law, however, was the possible culpability of Merrill Lynch and some of its supervisory officials. What they had in mind was a special type of disciplinary action the SEC could bring naming a brokerage—a 15c4 administrative proceeding commonly called a "failure to supervise" case. Though legally it was not as serious as many other types of SEC charges, a failure-to-supervise action hurt a firm's reputation and was designed for situations where there had been a systemic breakdown in monitoring the conduct of employees.

For the San Francisco staff, the issue seemed measurable in dollars and cents. Victor Matl's boss, Merrill Lynch branch manager Robert Fisher, supervised a booming office in San Francisco, one that generated about $20 million in revenue each year. That was hardly a decisive amount for a worldwide giant the size of Merrill Lynch, the largest brokerage firm in the United States, but it wasn't small change, either. Fisher's own compensation depended to an extent on the profitability of his office. That profitability, in turn, depended on the commissions generated by his brokers, known as account executives. From top to bottom, the retail brokerage business depended on commissions. And that gave Fisher an incentive to ignore the complaints about Victor Matl.

* SEC records do not reflect Matl's response to these specific complaints, but Matl said on several occasions that he was authorized to make the trades that customers were complaining about.

The account executives in Merrill Lynch's San Francisco branch handled more than 25,000 accounts, but as with most sales forces, there were only a handful of exceptional salesmen. These big sellers—producers, as they were called in the brokerage business—generated a disproportionate amount of the office's revenue and profits. Matl was one. He was consistently among the top five producers in San Francisco, and by some measures, he was the biggest producer of all. Between 1977 and 1983, Matl generated about $1.8 million in sales commissions, of which he personally kept about $600,000. A producer like Matl had special leverage over his employer. Not only would Merrill Lynch lose a considerable stream of revenue if he left, but he was the sort of broker who, because of his personal charisma, might take customers with him if he joined a competitor. In that event, Merrill Lynch would lose both commissions and deposits.

Inevitably, there was tension within a firm like Merrill Lynch—Lawyer, Lapidus, and others at the SEC called it a conflict of interest—over the need to generate commissions and the need to treat customers fairly. On one hand, it was in Merrill Lynch's own interest to enforce the rules governing the behavior of stockbrokers. Unhappy customers were no bargain; at the least, they would take their business elsewhere, and at worst, they might sue the firm over rule violations. On the other hand, aggressive salesmanship was essential to making profits. The qualities that made Victor Matl a big producer—the way, as one customer told the SEC investigators, he "brainwashed" and "tranquilized" his clients—also made it likely that people would complain about him. That didn't mean Matl had committed fraud. The question was whether a profit-driven firm like Merrill Lynch, which Shad believed had the industry's best internal compliance system, truly was capable of detecting and responding swiftly to fraud when it occurred.

It appeared to Lawyer and his staff as their investigation unfolded that for three years Merrill Lynch had done virtually nothing to restrain Victor Matl. From time to time, Matl's immediate supervisor, Louis Trujillo, confronted the broker with customer complaints about his more egregious conduct. But Trujillo's ad-

monishings, and his occasional memos to Fisher about problems with Matl, provoked no action from above. Those customers who hired lawyers and pressed a case against the brokerage were either offered a cash settlement—always less than the amount of the customer's losses—or were shunted into a Wall Street arbitration system for settling customer disputes that was stacked against them. Before investigator Bruns walked unannounced into the Merrill Lynch branch, the brokerage had paid $75,000 to six of Matl's customers to settle legal claims.

Bruns's appearance and the document requests generated by Lawyer's office suddenly changed Merrill Lynch's attitude toward Matl. Senior lawyers from the brokerage's Wall Street headquarters were dispatched to San Francisco. When the lawyers read the customer files, they threatened to fire Matl, but the broker begged to keep his job. "Please save me and give me a fresh start," he wrote to Fisher just days after the surprise inspection. "I don't want to be fired." Merrill Lynch's top in-house attorney, senior vice president and general counsel Stephen Hammerman, interviewed Matl for three hours and decided not to fire him. He and other Merrill Lynch executives were impressed by Matl's sincerity and his considerable selling skills. Matl was told to tone down his aggressive tactics and attend a short training course in New York at his own expense. Meanwhile, the SEC investigation of Matl and Merrill Lynch proceeded in secret, with neither Merrill Lynch nor the SEC informing Matl's old or new customers either of the probe or of the complaints.

Merrill Lynch's lawyers claimed afterward that the threat to fire Matl made him into a "changed man." To the staff in Bobby Lawyer's office, that claim seemed absurd. In any event, if Matl did change his ways, it wasn't for long—in the midst of the continuing SEC investigation, new complaints came into the Merrill Lynch office about trades Matl allegedly had made without approval from his customers. After another brief round of handwringing inside Merrill Lynch, Matl was summoned to Robert Fisher's office and fired. He later attended law school in San Francisco and applied for a summer job at the SEC. He was turned down.

* * *

John Fedders faced a sensitive dilemma when the long, confidential memo authored by Lawyer and Lapidus recommending fraud charges against Merrill Lynch and its employees arrived at SEC headquarters in the summer of 1984.

Fedders's power as enforcement chief, and the trappings of his position in government that were so important to him, derived in large part from his continuing good relations with Jack Shad. On the other hand, ever since *Citicorp,* Fedders had been working assiduously to build morale and loyalty among his staff, and to a considerable degree he had succeeded. At the table in closed meetings, Fedders was supposed to be the staff's champion. After reading Lawyer's memo, Fedders had two reactions. First, he thought it needed to be rewritten—the arguments weren't clear enough. Second, Fedders understood that the case Lawyer proposed against Merrill Lynch was likely to lead to conflict with Shad. And there was another memo circulating through enforcement that summer that was likely to exacerbate the conflict: Susan Pecaro and her supervisors in the enforcement division had decided to recommend fraud charges against Denny Herrmann and Smith Barney for failing to crack down on the naked-options trading in its Rhinelander office.

At issue was a basic question about who was responsible for detecting and preventing fraud on Wall Street. The debate within the commission dated to the days of Stanley Sporkin and before, but recently it had acquired new life and urgency at SEC headquarters.

Of all the changes Shad had attempted to implement, there were few that stirred emotions more than his effort to alter the standards by which the commission held big Wall Street firms accountable for wrongdoing by their employees. By recommending that charges be filed against Merrill Lynch because of Victor Matl's conduct, Bobby Lawyer brought the conflict to a head.

Shad was pulling the SEC back from close scrutiny of Wall Street investment firms' operations, particularly in the area of stockbroker sales practices. It was axiomatic of Shad's attitudes about Wall Street that he thought top executives at the major

brokerages were almost uniformly honest and responsible. He believed, too, that the brokerages and the stock exchanges to which they belonged were well equipped to police themselves and that the SEC's resources were too limited to meddle in individual stockbroker disputes.

Federal regulation of stockbrokers and others at Wall Street firms was structured like a pyramid, with the SEC at the top, followed by the stock exchanges and the brokerage houses themselves. The SEC could bring civil charges against anyone or any firm if there was sufficient evidence of securities fraud. The SEC also routinely monitored some operations of registered brokerage firms through filings the firms made to the commission and occasional SEC inspections. As a practical matter, though, it was impossible for the SEC to closely examine all of a firm's operations; during the period of Shad's tenure at the SEC, the number of stockbrokers alone nearly doubled from slightly more than 200,000 to more than 400,000, while total SEC employment remained flat at about 2,000.

Beneath the commission were the other layers of regulation and responsibility. Merrill Lynch, for example, was a member of the New York Stock Exchange, a so-called self-regulatory organization, or SRO. The exchange could discipline Merrill if the firm violated its rules for dealing with customers—rules that were approved by the SEC. Then, too, Merrill Lynch had certain obligations as an exchange member and a brokerage registered with the SEC to oversee the conduct of its employees.

Increasingly, during Jack Shad's tenure at the SEC, the burden of regulation in the sales-practice area was shifted from the commission down to the lower levels of the pyramid. The role of the self-regulatory organizations was emphasized more and more. Shad argued this made the regulatory system more efficient and effective, but no less vigilant. Transferring some responsibility to the stock exchanges would free up SEC resources for other programs, Shad said. The SEC would do its part by monitoring how well the stock exchanges handled their new duties. But a number of the SEC staff contended in internal debates that Shad's approach only exacerbated the conflict within Wall Street firms be-

tween their drive for profits and their obligations to the law. Filing big cases and "jawboning," or talking tough, about charging firms helped encourage compliance with the law. Conversely, shifting enforcement responsibility to Wall Street and resisting proposals to file charges against big brokerage firms for wrongdoing by employees in branch offices could lead to a breakdown of discipline at the largest investment firms, these SEC staff lawyers felt. It was an issue that was already taking on added significance within the commission because of the questions raised by Jack Hewitt's probe of fraud allegations against Michael Milken and other employees in the Beverly Hills office of Drexel Burnham Lambert—a branch office that wielded growing influence across the economy because of the giant junk-bond-financed takeover bids and other transactions it spawned.

Ever mindful of shareholders, Shad sometimes argued that it was the stockholders of the defendant firm, rather than the executives charged, who got hurt most when a brokerage firm was charged, especially if the individual culprits already had been fired. In the absence of bad faith on the part of the company or high-level executive corruption, Shad opposed charges not only against large Wall Street firms but also against major industrial corporations. However, when it came to Wall Street he showed his deepest sentiments, arguing that it was unfair to charge a Wall Street house for bad deeds by an individual broker, because other firms would use the negative publicity to steal clients and because it was simply too costly to demand such perfection. It's the brokerage house customers who ultimately will foot the bill for higher compliance costs, Shad argued. An irony of his position was that consumer-activist Ralph Nader, with whom Shad saw eye-to-eye on very few issues, had pushed during the 1970s for the SEC and other law enforcement agencies to charge individual executives with wrongdoing, rather than the firms and corporations where they worked. Nader thought that approach would give executives in positions of responsibility an incentive to avoid public humiliation by acting ethically and disciplining their institutions. If Shad had cast his own approach in Nader's language, he might have found the SEC staff more receptive.

But some among the commission staff thought Shad's views were affected by his personal identification with potential defendants. Shad must have understood that during his days on Wall Street, had the SEC held senior firm executives responsible for wrongdoing by lower-level employees, he might have been named as a defendant in an enforcement case even though he personally had violated no laws. That assessment wasn't just academic. Around the time that the Merrill Lynch and Smith Barney matters came before the commission early in 1985, Shad's alma mater, E. F. Hutton, pleaded guilty to 2,000 counts of wire fraud in connection with a firm-wide check-kiting scheme to earn additional interest income through illegal overdrafting of bank accounts. As soon as the matter came to the SEC's attention, Shad recused himself; the SEC proceeded to examine the chairman's old firm without his input, due to the conflict of interest his participation would have posed. The Hutton money-management scheme, carried out in branch offices with the support of some members of senior management, began in 1980 while Shad was still at the firm, though there were never any allegations that he knew about the highly profitable, unethical scam. Ironically, while Shad's approach to enforcement involved charging individuals rather than firms, both the SEC and the Justice Department charged the Hutton firm, but no individuals, leading to criticism that the regulators had failed—no scalp, no deterrent, the argument went.

Bobby Lawyer wanted to charge both the Merrill Lynch brokerage and its employees, and in pressing his argument, he tried to utilize his geographical distance from Washington and secure regional office fiefdom to his advantage.

Lawyer's memo about the Merrill Lynch case circulated to Shad's office, the office of the general counsel, and to other division directors. Meantime, Cary Lapidus wrote to Merrill Lynch's lawyers in Manhattan informing them that the staff had decided to recommend fraud charges against the brokerage. Merrill Lynch was invited to make a so-called Wells submission, named for an attorney who originated the idea—the submission was a defense

brief in which arguments against prospective charges were sent in writing to the commission. Lapidus told Merrill Lynch that if the firm wanted to submit a Wells, it had two weeks to do so. A confidential, twenty-page letter from the Wall Street firm arrived at SEC headquarters in mid-August. The document contended that neither Fisher, Louis Trujillo, nor Merrill Lynch itself should be charged with fraud, because the brokerage and its officials had acted responsibly in trying to control Matl.

Merrill Lynch's executives in Manhattan were deeply concerned about the prospect of SEC charges. A big retail brokerage depended on the trust of its customers; publicly filed fraud charges might undermine that trust severely. To press its defense inside the commission, the firm retained two lawyers with personal connections to the SEC: Robert Romano, a former enforcement division trial lawyer who had worked on Fedders's early campaign against insider trading and Swiss-bank secrecy, and Irv Pollack, a former SEC commissioner and enforcement division chief who had been a staunch ally of Stanley Sporkin. Pollack now earned a lucrative living as a legal consultant to those who had trouble with the commission.

Just after Labor Day, Romano called Bobby Lawyer's office in San Francisco.

I just want you to know that we're going to do everything we can to defend ourselves at the commission, Romano said. I've put a call in to John Fedders and asked for a meeting in Washington and it looks like they'll grant it. I'm letting your office know because I don't want you to think we tried to go around you dishonestly.

Lawyer said he appreciated the call. Of course, it was clear to the staff in San Francisco that Romano was trying to go around them—all of them knew that Merrill Lynch was likely to receive a more sympathetic hearing from the Republican appointees in Washington than from the former civil rights activists in San Francisco.

On the appointed day, Romano and Pollack arrived at Fifth and D streets and were cleared upstairs. In a conference room they were greeted by a virtual army of enforcement division staff and other SEC lawyers, led by the towering Fedders.

Merrill Lynch did everything that could be expected to curtail Matl's conduct, Romano argued. When we determined that there were problems with his dealings with customers, we fired him—what more can a brokerage do?

But Fedders and the others inundated Romano and Pollack with questions about Merrill Lynch's internal compliance procedures, and about why it appeared that the firm had done little until an SEC investigator walked into the San Francisco branch and demanded to see the office files. When the meeting concluded, Romano and Pollack were handed a list of about twenty written "interrogatories," or investigative questions, to be answered in writing and submitted later to the staff.

A messenger lugged the answers into the SEC lobby on October 19, 1984—the brief weighed as much as a small phone book. There was a forty-page memo and about twenty-five exhibits attached. To show that Merrill Lynch had monitored Matl closely, the brief quoted from the memos Trujillo had written to his superiors detailing his concerns about Matl's behavior. A copy of the fat document was sent out to Lawyer in San Francisco. Taking account of the Wall Street firm's defense, his original memo was revised. But it contained the same recommendation: Merrill Lynch should be charged publicly by the commission for failing to supervise Victor Matl.

The closed meeting room was packed when Lawyer and Lapidus arrived from San Francisco. Word of their impending confrontation with John Shad had circulated through headquarters, and an unusually large crowd of staff had come to the sixth floor to see who would prevail.

Fedders, Lawyer, and Lapidus took their seats across from the five commissioners. Shad was in the center, flanked by James Treadway and Charles Marinaccio on one side, Charles Cox and Aulana Peters on the other.

Whispered rumors about the case had risen to a crescendo in recent weeks. Shad denied it, but it was said that the chairman, through a subordinate, had ordered Lawyer's case off the commission's closely guarded calendar of closed meetings because he was opposed to naming Merrill Lynch as a defendant.

Moreover, the counseling group under General Counsel Dan Goelzer—the cluster of attorneys organized in Harold Williams's day to contain the power of Stanley Sporkin and which now reviewed all enforcement recommendations—had drafted a memo opposing charges against the Wall Street firm. It was said that lawyers in the counseling group had originally agreed with Bobby Lawyer's proposal that Merrill Lynch be named, but had been told to take the opposite side by the chairman's office. Again, Shad said it wasn't so, but there was little doubt where he stood on the issue. A few weeks earlier, Susan Pecaro's case against Smith Barney had finally wound its way to a commission vote. At that meeting, all five commissioners had supported filing charges against Denny Herrmann and his boss in Rhinelander, Robert Heck. But Shad had argued vigorously against naming the Smith Barney firm as a defendant in the case, and it was only after a heated discussion that the staff's recommendation to charge Smith Barney had prevailed by a 3 to 2 vote.

For their part, Lawyer, Lapidus, and their staff back in San Francisco had little doubt that Shad had tried to quash charges against Merrill Lynch, and as they arrived at SEC headquarters for the climactic meeting, they wondered whether Fedders, too, would be against them. Feelings about the case ran high in the San Francisco office—they had put years of work into it; they had come to know Matl's disgruntled customers well and shared their anger about the money they had lost. Fedders's attitude was more clinical. After urging Lawyer to "be reasonable" and perhaps revise the memo's recommendations about charging Merrill Lynch, the enforcement chief had taken a neutral stance, it seemed to some of the staff in San Francisco. They viewed Fedders as an ambitious wisp who would drift wherever the winds from Chairman Shad's office blew. Lawyer had told his staff that he was going to fight this case without Fedders's help. When the matter was taken off the calendar, he telephoned the office of Commissioner Peters, a black woman and Democrat about whom Lawyer had heard favorable comments from staff in Washington. He urged Peters to pressure Shad about the case. After a series of calls from Peters's office to Shad's, the matter had been restored to the closed calendar for a vote. Originally, Lawyer hadn't been

planning to fly to Washington for the argument—in routine cases it wasn't necessary. But after all the back-channel lobbying, he and Lapidus decided it was essential that they go.

I don't understand how a firm the size of Merrill Lynch—one with tens of thousands of employees and offices all around the world—can be held responsible for the actions of one rogue account executive in San Francisco, Shad declared when the debate began. Shad was convinced there were a thousand other situations that were handled properly by the firm. How could charging the firm be fair?

The facts show that there were serious violations over a period of years, Lawyer argued.

Formal and restrained, Lawyer sat stiffly at the table. His manner contrasted sharply with the way he usually conducted SEC depositions, where he liked to put his feet up on the table and didn't mind addressing a witness with a simple assertion such as "That's bullshit." There was none of his usual bravado, and certainly no profanity, as he responded to Shad.

"This wasn't a systemic breakdown," the chairman said.

Lawyer fired back. Merrill Lynch had only one system for compliance with the securities laws. And in this case, that system hadn't worked. The failure *was* systemic.

The San Francisco staff had assumed coming into the meeting that Shad was against them, while commissioners Peters and Treadway would probably support their position. But they had no idea which way commissioners Marinaccio and Cox would go. Cox initially was seen by liberal staff lawyers as a lackey of Chairman Shad, who had engineered his appointment to the commission. (The views of many early critics of Cox changed over time, and he earned respect as an independent commissioner.) If Lawyer and Lapidus were to prevail, they needed one vote from either Cox or Marinaccio.

"You've got three votes," Fedders said to Bobby Lawyer some ten or fifteen minutes into the meeting, after Cox made a comment indicating that he was in favor of naming Merrill Lynch as a defendant. It was clear to Lawyer and his supporters in the room that Fedders, too, was behind him. The tension among the staff lawyers eased.