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PROFESSIONAL RESPONSIBILITY: THE PUBLIC CLIENT

An Address By

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Since my appointment to the Commission, I have spoken fairly extensively with respect to the obligations of auditors and attorneys under the federal securities laws. It is only fair to say that these remarks have met with "mixed reactions." In some cases, I have been highly complimented by remarks which have come to me; others have suggested to me that I have in some fashion betrayed my profession by advocating novel extensions of their responsibility. Similarly, I have been chastised by accountants. In Cleveland last week a very dear friend, the resident partner of a "Big Eight" firm, quoted to me from an article which appeared in the March 1, 1974 issue of Forbes Magazine remarks attributed to me and suggested that I had blackened the entire profession. The statement quoted was:

> "I have been astonished by the willingness of auditors to put aside their good judgment and uncritically follow the lead of management . . ."

And it has been suggested by some that perhaps my public remarks concerning the responsibility of auditors have been more harmful to the profession than all of the complaints that the Commission has filed against accounting firms.

It is probably not sufficient for me to simply say that my remarks with regard to lawyers and auditors are not intended to delineate new limits or extensions of responsibility, but are simply an effort to limn the

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boundaries to which courts and other and other bodies concerned with these problems are pushing. I would suppose that to some extent Commissioners at the Securities and Exchange Commission, despite their avowals that they speak only for themselves and do not necessarily express the opinion of the Commission or other Commissioners, nonetheless may have some impact upon the development of law. However, I would strongly assert that my remarks in the past have only been for the purpose of interpreting the trends of the law as I see them and alerting practitioners to the sort of treatment they may expect from courts if they are caught up in litigation stemming from the federal securities laws.

Without in the slightest intending to retreat from the positions that I have expressed, I would like again to discuss the roles of attorneys and accountants with respect to federal securities laws. Absolutely basic to any discussion of this is the fact that our entire system of federal securities laws is based upon the integrity of the disclosure process. When Congress in 1933 and 1934 established a system of federal regulation with regard to securities, it very carefully avoided the then common "blue sky" type of regulation, which would give authority to an instrumentality of the government to make qualitative judgements with regard to securities involved in offerings, and instead opted for a system of disclosure supplemented by prohibitions against fraud.

While the scheme of the Securities Exchange Act of 1934 contemplated the registration of broker-dealers, and the Investment Company Act of 1940 contemplated the registration of investment companies, and the Investment Advisers Act of 1940 contemplated the registration of investment advisers, there is nowhere in the federal scheme a requirement that attorneys practicing before the Commission or accountants involved with financial statements constituting a part of filings with the Commission be specially licensed in order to practice their professions with the Commission. The Commission has under Rule 2(e) of its Rules of Practice the power to bar from practice before the Commission auditors and lawyers. These proceedings have been relatively rare with respect to auditors, and they have been extremely rare with regard to lawyers, although the number is increasing. By and large, the Commission has regarded as competent to practice before it any attorney who is licensed by a state to practice in its courts and any accountant not deemed unqualified for practice by his state. As you probably know, under the statutes it is not required that an accountant who gives an opinion with respect to financial statements filed with the Commission be a <u>certified</u> public accountant; rather, it is only required that he be a public accountant -- and, of course, he must be independent.

Thus, there is no special test of competence with respect to appearances before the Commission in the role of attorney or auditor. It is somewhat, in my estimation, out of step with modern conceptions which increasingly recognize that not everybody who is given the accolade of "LL.B." and "CPA" is necessarily expert in every area of his profession. I for one would be extremely reluctant, despite my law degree, to undertake the defense

of a capital charge in a criminal case and I would imagine that many accountants would be extremely reluctant to give an opinion with respect to financial statements of a complicated conglomerate. Nonetheless, while probably on the balance it is better that such matters be left for now to the respective professions rather than that special standards of competence be imposed by the Commission, I think we must give attention to this matter in the future if we are to provide adequate protection to the public.

However, this absence of express standards imposed by the federal statutes or the Commission does not mean that the legal and accounting professions do not have very great responsibilities. Chairman Ray Garrett, Jr., in his address to the American Bar Association National Institute last October in Washington, indicated the essential role of the lawyer and the accountant in the Commission's regulatory process. He said:

> "Because we rely on a small government police force -- we want to adhere to that premise -- we think we must keep the pressure on the professionals to do a major part of the job -- the protection of investors. This requires both the establishment and preservation of high standards of conduct and suitable incentives through punishment as well as reward to encourage the maintenance of those standards by individuals engaged in the professions."

This reliance upon the lawyer and the accountant to implement the disclosure and regulatory process is, to my mind, extremely important.

Many times the Commission is asked, how did you let Equity Funding happen? How did you let a National Student Marketing come about? How did you let a U. S. Financial occur?

The glib and simple answer, of course, is that the Commission simply does not have the statutory mandate or the people capacity to discern

frauds as they develop. Its principal statutory mandate, other than regulation of the securities industry, investment companies and investment advisers, is to see to it that adequate disclosure is made in connection with distributions of securities, and this mandate does not particularly equip it to perform the sort of function that many think is imposed upon it, the detection of fraud in its incipiency.

However, accountants and lawyers are peculiarly situated to perform this function. The auditors pre-eminently are in a position where they can discern irregularities in company accounting and reporting practices, and very frequently counsel for a company are in a similar position. Thus, in a sense, the professionals are called upon to perform the kind of regulatory job that the Commission is unable, because of limited staff and limited mandate, to do. In many instances, the opinion of the auditing firm or the opinion of the law firm is the absolutely essential prerequisite to the private placement or public offering of securities into the hands of the public. The public relies upon financial statements and it relies upon opinions of counsel, and if these are deficient, or if they are predicated upon erroneous assumptions, or if they are reflective of insufficient investigation, then the public has been misled and no amount of Commission enforcement of disclosure requirements can undo the harm that is frequently done to public investors. In a very real and a very important sense, auditors and lawyers perform a function that the Commission cannot under its statutory mandate perform. They are in a sense regulators, they are the ones to whom everyone, including the Commission, looks to prevent the imposition upon the public of ill-founded and misleading investments.

The concern we have at the Commission is how well auditors and lawyers have performed this function which, while perhaps not contemplated at the time the 1933 and 1934 Acts were enacted, nonetheless has as a consequence of developments within the financial and legal community become the role of the auditors and the lawyers.

With respect to attorneys, this new role of responsibility to public investors has not been easily adopted. Historically attorneys have been advocates; they have not been expected to be "independent"; they have been expected rather to single-mindedly advance and promote the interests of their clients. The idea that now they should regard as secondary the interests of their clients and instead act to protect the public is alien and strange and difficult to assimilate.

However, I think that in this day and age it is necessary that lawyers take a somewhat more discerning look at their roles, not role, since I think in this picture lawyers perform many functions. When a lawyer represents a client in an administrative or judicial proceeding, then I think he should be an advocate. He should be tough, demanding, aggressive; he should utilize procedural skills when they can benefit his client. I find nothing wrong with strong and vigorous and forceful and imaginative advocacy; as an example, I find it absolutely incomprehensible how it can be suggested that James St. Clair somehow or other violates Canons of Ethics when he fights vigorously for the interests of his client.

However, in securities matters it seems to me that frequently the role of the lawyer is different from that of the advocate. Very frequently,

as Morgan Shipman has said, the lawyer is the "passkey" by means of which securities are introduced into the market place and remain outstanding and traded in the market place indefinitely. He is the one whose opinion loosens the gates to permit offerings without the benefits of registration and frequently he is the one who has the final word about the contents of registration statements and prospectuses and thus has the final word with regard to the quantum and quality of information available in the market place with regard to a particular offering. When an attorney is in the role of writing an opinion with regard to an exemption under the securities laws, or has the role of the principal scrivener with regard to a registration statement, I would suggest that he is not an advocate; rather, he has a duality of loyalties: his loyalty is not only to the company, but it is also to the public. In many instances a lawyer's opinion is not heavily freighted with public interest. For instance, when a lawyer carelessly gives an opinion with regard to a clear title of real estate, if that opinion is wrong he may have a liability to the purchaser. Similarly, if he negligently indicates that a contract is enforceable he may have a liability to his client if it turns out that it is not. When he functions, however, in the role of counsel and gives an opinion with regard to an exemption from the necessities of registration, he may unleash upon a public market, and ill-informed investors, millions of dollars of securities which may be traded extensively on the basis of his opinion without regard to compliance with the federal securities laws. I would suggest that to some extent the lawyer's responsibility must be defined in terms of the ultimate consequences of his failure to meet that

responsibility. A lawyer preparing a registration statement, a lawyer preparing an opinion with regard to an exemption under the federal securities laws, cannot be and is not an advocate on behalf of his client. He must of necessity assess the realities of the situation objectively and this objectivity must be reflected in the registration statement and in the opinion -- and anyone who thinks that there is no difference between this role and the role of advocate, in my estimation, is simply begging for trouble.

The simple fact is that lawyers have in many instances played this role with singular success -- and tremendous benefit to the public. In the Commission's staff report on "The Financial Collapse of The Penn Central Company" there is detailed the commendable conduct of counsel for the underwriters of a proposed issue of debentures of the Pennsylvania Company. In the course of his investigation as counsel for the underwriter, a young partner of a prominent Wall Street firm discovered the critical problems of Penn Central and insisted upon their disclosure. A high officer of Penn Central went to the superiors of this lawyer and insisted upon his removal from the account. Much to his credit, and I am sure to the relief of the firm, the senior partner involved refused to dismiss him. This intransigence of this young partner was a major factor in the unmasking of the deplorable situation at Penn Central. He played the role not of counsel for the underwriter, not as advocate of a position; rather, he was, in the words of Justice Brandeis, "attorney for the situation." We have had other instances in the Commission in which attorneys have conducted themselves with remarkable integrity and responsibility.

No discussion of lawyers' responsibilities under the securities laws can take place these days, of course, without mentioning and discussing the National Student Marketing case. Since this matter is presently in litigation, it would be inappropriate for me to discuss in any manner the merits of that case. However, there is one aspect of it upon which I think I may permissibly comment. Unquestionably the most troubling aspect of that complaint was the assertion that counsel for the acquiring company should, in addition to taking other action to preclude the closing, have notified the Commission concerning the misleading nature of the financial statements in the proxy statement. Since the time this complaint was filed, there have been many cries of alarm. It has been asserted that the Commission wishes to make the legal profession into "squealers"; that such a contention, if sustained by the court, would undermine the historic confidentiality of the relationship between counsel and client; that clients will be wary about discussing many matters with their counsel.

I do not intend to discuss whether the court will sustain the Commission's position in this regard. However, I would suggest that the excessive attention which has been paid to this aspect of the complaint has diverted lawyers from considering the rest of that complaint and the other allegations of misconduct it contains which, I think, are extremely important for lawyers in considering their responsibilities in complicated financial dealings. I suspect that if the complaint did not contain that controversial suggestion most lawyers would be far less alarmed at the implications of the case than they are presently. Concerning that particular aspect of the

complaint, I think everyone should avoid the temptation to give it broader significance than was intended; rather, I would opt for a rather narrow construction of that allegation. I for one, and I emphasize that I speak only my own opinion, do not believe that a lawyer is always required whenever he has knowledge of a client's improprieties to apprise the authorities of them or even resign the account. I do not think there is anything in the National Student Marketing complaint which should cause clients to change the confidential relationship which they have always enjoyed with their lawyers and I do not think that there is anything that should make the legal profession into a band of "squealers" on their clients. There are situations in which client conduct is of such a nature that under the Canons of Professional Responsibility information concerning the misconduct or proposed misconduct must be conveyed to a proper party or tribunal; that concept is not new with the securities laws or National Student Marketing. In short, I think it is a cop-out for lawyers to suggest that the Commission in any way wants to prevent them from becoming privy to the secrets of their clients or rendering full assistance in the resolution of problems, including particularly securities problems, which may have involved unlawful acts. What the Commission is saying is that attorneys cannot let themselves become part of their clients' misconduct.

With regard to accountants, they, almost by definition, occupy a different position from lawyers. They are officially designated as "independent" and it is expected by society that they will adopt a posture of independence. There is a conceptual, and in many instances practical, contradiction in the

concept of an auditor being independent, but nonetheless being paid by his client. However, innumerable firms in this country have overcome this contradiction and have performed and fulfilled their responsibilities in manners that are truly exemplary. Since the institution of the Commission's requirement that there be disclosed in the Form 8-K details with regard to the change of auditors, there have been numerous 8-K's filed which disclosed that a change of auditors was related to disagreement with regard to accounting principles. In each of these cases an auditor bit the bullet and gave up a client -- either by resigning or getting fired -- in the interests of his own integrity and responsibility. The Commission has identified a number of instances in which auditors refused to give an opinion, resulting in the client going to other auditors who often unfortunately chose to give the opinion refused by the first auditor. It is very easy to focus upon the sometimes questionable conduct of the second auditing firm in giving an opinion that had been refused by another auditing firm, but I would suggest that it should be recognized that the first (and in some cases second and third) auditing firm gave up a client representation and revenue rather than give an opinion that was inconsistent with their judgment.

In numerous cases the Commission has first become alert to a fraud as a consequence of the signals put up by auditors. In one particular instance, involving a fraud mounting into the millions of dollars, the Commission first became aware of the existence of the improper conduct through the opinion of the auditor which contained very serious qualifications, following the rendition of which the firm was fired. I would not suggest that in any fashion the accounting profession <u>as a whole</u> has been remiss in its duties; there are far too many instances in which the accounting profession has acted

in accordance with everything the Commission and the profession could require or suggest. It is a very small fraction of the total number of audits that has been the subject of Commission investigation and Commission complaint. In probably 99% plus cases the auditors of publicly-held companies have performed in proper and often heroic fashion. The unfortunate part is that when their confreres perform with less than this measure of integrity and competence, the consequences are huge losses to the investing public and damage to the standing of the profession.

I have tremendous faith in the accounting profession in this country. I think it is very easy to recognize that its standards of responsibility and performance equal or exceed those of accountants in any other country. It would be easy to become complacent in the face of this record of performance. The American public prevents that by demanding from auditors, as from all professionals, higher standards of performance, higher measure of reliability, greater assurance that financial statements have all of the hallmarks of integrity.

No profession as a whole can or should be tarred with the dereliction or the improprieties or the failings of a few of its members. I think lawyers and accountants have in general performed well under the strictures of the securities laws. They have often been superb guardians of the public interest. However, should this conduct on the part of the largest portion of the professionals provide an immunization to their erring brethren against charges of improper conduct? I would suggest that that would be a most unfortunate consequence. I think, rather, the accounting profession and the legal profession, stimulated by the Securities and Exchange Commission and other governmental and quasi-governmental forces, should seek steadily to raise the standards of conduct of the members of their profession. I think the accounting

profession is doing that and hopefully the same is happening among lawyers. In my estimation it is far better, day in, day out, if professional organizations and professionals recognize their problems and take effective action to eliminate them rather than leave this to governmental bodies.

I think it is extremely important that the professions and the Commission do everything they can to discourage what has become the practice of "opinion shopping." As I indicated earlier, there has been a significant number of instances in which auditors have been displaced because of disputes with management concerning the application of auditing principles. To some extent the Commission has strengthened the hand of auditors by requiring disclosure in Form 8-K with regard to changes of auditors, and if there had been disputes over accounting principles during the preceding eighteen months, there are required statements from both the old auditors and the company with regard to them. Recently Business Week has proposed that this information contained in the Form 8-K should become a part of the annual report where it would be visible to all shareholders and I would suggest that there is some merit in this. It has been suggested that perhaps auditors should be elected for a fixed term, say five years, and their tenure would be assured short of a clear showing of professional misconduct, excessive fees or something else of an ascertainable nature which would be arbitrated by the American Institute of Certified Public Accountants. It has also been suggested that auditors should not be dismissible without the consent of shareholders and this again has considerable appeal as a deterrent upon management to play fast and loose with their auditing services.

In many instances today there are counterchecks and balances which tend to minimize the capacity of professionals to do wrong. In a typical public offering there will be counsel for the company and counsel for the underwriter, and counsel for the underwriter in many instances acts as a particularly effective monitor of the practices of company counsel. Similarly, he acts as a critic of the accounting practices of the accounting firm and very frequently operates as the conscience of the public in disavowing and disapproving accounting practices that may seem perfectly adequate to management.

However, there are innumerable instances in which there are not any representatives of an underwriter or other adverse party. In these instances it is imperative that counsel for the issuer be peculiarly sensitive to possible improprieties on the part of his clients. And I think it is terribly important that inside counsel of corporations, particularly when they are involved in stock offerings, be sensitive to the necessity of disclosure and the consequences of non-disclosure or inaccurate disclosure.

The professions' concerns, of course, are not limited to enforcement actions by the Commission; they are also very much concerned by the dangers of civil suits, many of which seek damages in astronomical amounts. While this danger of civil liability is a very effective deterrent to misconduct, it may well be that some realistic dollar limits on exposure, high enough to continue as a deterrent, but sufficiently restrictive to avoid calamitous results, should be legislated. It might be noted that the proposed codification of the federal securities laws sponsored by the American Law Institute would do that. In a word, a single bad audit should not pose the threat of ruin for a large accounting firm.

Notwithstanding these comments, I would have to say I think that professionals are excessively up tight about the potentials of liability. If you examine the securities cases that have been decided over the years with regard to auditors, directors and lawyers, I think it would be very difficult to come to the conclusion that any of those groups had been mistreated in court. Surely they have had inflicted upon them substantial financial sacrifice as a consequence of legal fees and court costs, but in very few instances, if any, can anyone say that the ultimate determination by a court was unjust.

These are fairly described as perilous times for professionals. In my estimation they can become more perilous if professionals refuse to admit or recognize the role that society is carving out for them. In many roles attorneys must become as independent as auditors. And auditors must become more independent of their clients. If this necessitates in some fashion artificial constructs such as those I have suggested -- terms of office, public disclosure of disagreements to a greater extent than presently prevailing and so on -- then that must be done. But it seems to me that a far better way is conscientious adherence by professionals to high standards of public responsibility. In that lies the best hope for the professional.