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REMARKS OF JAMES R. DOTY*
GENERAL COUNSEL, SECURITIES AND EXCHANGE COMMISSION

TO THE AMERICAN BAR ASSOCIATION
FEDERAL REGULATION OF SECURITIES COMMITTEE

ANNUAL FALL MEETING
WASHINGTON, D.C.

NOVEMBER 9, 1990

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Mr. Chairman, distinguished members of the Committee on Federal Regulation of Securities, let me say that I am most flattered by Jim Cheek's invitation to speak to you this evening. I must admit, however, that in looking over the schedule and the descriptions of highlighted topics for the Fall Meeting, for the first time I began to approach this evening a bit like the mouse, who suddenly ceases to concern himself with the cheese, and focuses instead on the task of getting away with his head. That is, the dinner was excellent, and the company delightful. But what is next in store for the poor government lawyer who has to face this august group and deliver remarks that will be judged against the brilliance of today's panelists, commentators and speakers, to say nothing of those who come tomorrow?

This matter of weighing the consequences of after dinner speaking for government employees has become a more serious business in the nation's capital. The senior officials at independent agencies have long lived in fishbowls, in which their actions are subjected to the rigor of public analysis and comment. We regard this state of affairs as healthy, indeed indispensable to our public life. Now, however, a new dimension of risk for the public servant has been added, a fact which may have been obscured by the budget negotiations and other events leading up to this week's election.

I refer, of course, to the fact that certain of us in the independent agencies are being "shadowed." The Republic is now blessed with a "shadow Federal Reserve Board," and as recent news items advise, will soon have a "shadow SEC," as well. This informal group of luminaries is headed by Greg

Jarrell, formerly of the Commission's Office of Economic Analysis, and includes former Commissioner Charles Cox. What does this mean? Is this imitation the most sincere form of flattery? You may well ask. Our colleagues at the Federal Reserve are said to be well along with several macro-economic studies to show the effects on the highly competitive European banking systems of the <u>rapid</u> implementation in <u>piecemeal</u> fashion of shadow agencies and the volatility which that introduces into the regulatory system. Unfortunately, those studies are confidential.

On the other hand, at the SEC when we learned of the establishment of the "shadow SEC" we handled it in our usual direct manner. First we called the few numbers on the Street that would still return our calls. When they couldn't tell us a thing the papers hadn't carried, we did the next best thing -- we hit the books. The most relevant information was produced by a very junior staffer in the Division of Corporation Finance, or was she in the Division of Market Regulation, who was trying to avoid collating public comments on one of the rules I'll be discussing later.

Based solely on her research, I can tell you that The Random House Dictionary of the English Language (the 1966 unabridged edition) contains a definition of the term "shadow cabinet." In this concession to current curiosity, the Random House is joined by the Webster's New Collegiate Dictionary (the 1989 edition).

A "shadow cabinet," Random House tells us, refers to "a group of prominent members of the opposition (in the British Parliament) who are expected to hold positions in the cabinet when their party assumes power." (Note it is not 'if' but 'when!')

Clearly, these "shadow agency" guys aren't fooling around. And consider the fact that, at the real SEC, even our advisory committees have to be public, whereas these shadow guys don't even <u>have</u> to tell us <u>who they are</u>! It has heretofore been my habit to take counsel with my distinguished predecessors -- Dan Goelzer, Ed Greene, Ralph Ferrara and Harvey Pitt. Now, with a shadow SEC, having shadow Commissioners with a shadow Chairman, I've got to be worried -- do they have a shadow General Counsel too? And what about a stealth Enforcement Director? Ah, well, perhaps one can worry too much about these things. But I do wonder who is going to put a bell on this cat.

On a more serious note, it is an eventful time in the affairs of the agency to which so many of you have, over the years, contributed so much. This is, from my position, an opportunity for me to share with you some views about what the future may hold for all of us, as members of the securities bar, and to talk among friends and colleagues about how some trends appear to be shaping up from the vantage point of the General Counsel's Office.

<u>The Accounting Issues:</u>

It is time again for securities lawyers to think about accounting issues. As you know, the Senate Banking Committee has recently held hearings on the role of accounting principles and practices in the collapse of the savings and loan industry, and the House Subcommittee on Telecommunication and Finance has held hearings in connection with proposals to increase the responsibility of independent accountants to detect fraudulent activity. The proposed legislation, introduced by Congressman Wyden of Oregon as the "Financial Fraud Detection and Disclosure Act of 1990" would have required: <u>first</u>, that every annual report filed by Exchange Act reporting companies include an evaluation of the company's <u>internal control structure</u>; <u>second</u>, that the company's independent accountant examine and report on management's assessment of the <u>internal control structure</u>; and <u>third</u>, that the independent accountant report certain continuing illegalities directly to the Commission.

The imposition of a separate auditor's report on management's assessment of the internal control structure raises, in my view, significant cost/benefit questions in the case of smaller and even medium-sized businesses. The extent to which different internal control structures, and even different review procedures, may be appropriate for different issuers should be considered. Indeed, this organization should perhaps consider whether it is clear that a separate auditor's report on control structures should be a statutory requirement for all issuers, even if they have a well-designed legal compliance program that is periodically reviewed by outside counsel. In such an instance, how much real, additional assurance for the investing public is obtained, and at what cost, by an auditor's report on management's assessment of its internal control structure?

The Wyden Bill -- "Wyden IV" as it was code named -- was attached to the House Comprehensive Crime Bill, and did not become law. There is, I understand, a good chance it will be reintroduced with Chairman Dingell's strong support and sponsorship. When a bill goes from being "Wyden IV" to "Dingell I", it is to be taken seriously. My point is that there are serious issues here for which practical, workable solutions will have to be found, and the best efforts of lawyers such as yourselves will be required to do that.

You should also look to see the issue of Accountants' Independence revived, in a new and troubling context. I am reminded by the Office of the Chief Accountant of the text of Statements on Auditing Standards ("SAS") No. 1 (dated October 1939), which reads:

> "It is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors. Public confidence would be impaired by evidence that

> independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. * * * Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence."

As U.S. businesses have expanded into foreign markets, the major accounting firms have developed international practices. As a means of dealing with the competitive pressures that have developed within the auditing industry, the accounting firms have diversified and expanded the professional services they offer and the scope of their activities. This has led independent auditors to enter into subcontracting relationships, directly or indirectly, with affiliates of clients. The Commission's standards of independence, evolved through years of published staff interpretations, now are perceived by the accountants as either too vague to be of any use, or too detailed and specific to be workable in today's business climate. I would expect that a concept release, addressing the difficult question of "Accountants' Independence," might be issued in the near term.

Changes in Governmental Structure:

These are, however, the more technical aspects of what we all now recognize as profound, transforming forces working on the landscape of securities law. At the level of governmental structure, the Commission continues to seek modification of the fragmented regulatory structure for banks and thrifts, through repeal of Exchange Act Section 12(i) and amendments to Sections 3(a)(2) and 3(a)(5) of the Securities Act. And, as banks expand farther into the marketing of collective trust funds and securities brokerage activities, the Commission will, I expect, continue to urge that these sales activities be subjected to its regulation. In response to the "lobby sales" abuses which surfaced in Charles Keating's Lincoln Savings & Loan empire, Congressmen Schumer and

McMillen introduced a bill to regulate these activities. As it now stands, banks can engage in retail brokerage activities without compliance with the broker-dealer examination process, and without becoming a member of any self-regulatory organization. Why banks should enjoy this freedom from the application of the "just and equitable principles of trade" that govern regulated broker-dealers has, I believe, become an unavoidable question.

Mark-to-Market Issues:

And then, of course, there is the issue that has brought out the sumo wrestlers -- mark-to-market accounting. In the simplest terms, the question of whether financial institutions should value their portfolio securities at amortized historical cost or market has depended on the subjective state of mind or "intent" of management, and that principle is now very much in question. I would expect the Commission to continue to press for greater transparency in disclosure where banks and their holding companies are concerned.

A separate, distinct issue in bank disclosures concerns loan portfolios. In the Commission's Industry Guide 3 (containing disclosure guides for bank holding companies), attention has focused on the disclosures of nonaccrual, past due and restructured loans (Item C.1. of the "Risk Elements" disclosure). I understand from the Office of the Chief Accountant that relatively few issuers appear to be responding to a related item on "Potential Problem Loans" (Item C.2.), which requires a description of the nature and extent of loans "where known information about possible credit problems of borrowers causes management to have some serious doubts as to the ability of such borrowers to comply with the present loan repayment terms" (emphasis added).

This is not to suggest that the Commission's staff is unmindful of the complexities of the issues raised by mark-to-market accounting for the financial services industry. On the other hand, I think it is safe to say there will be some tough questions asked of those who say that different rules of accounting and more lenient standards of disclosure should apply to banks and bank holding companies in precisely those contexts where the information is intended to be relied upon by the public trading markets.

It is now clear that no small part of the mischief in the S & L story resulted from a regulatory accounting practice that enabled insolvent institutions to present themselves as healthy. In this "let's pretend" story, the ability of thrifts to speculate with federally insured deposits was enhanced by suspect accounting. I believe the new Congress will be unwilling to allow banks to repeat that experience.

Nor is it clear that the banking industry will be better off if it is shielded from mark-to-market accounting. The <u>perception</u>

that bank financial statements are suspect may simply have gone too far for that to be a satisfactory alternative.

Finally, I believe that, as securities lawyers, we should become wary when a public policy of disclosure becomes the hostage of an unstated national industrial or financial policy. If we should fear the competitive effect of consolidation in the banking industry, or the increased foreign ownership of our financial institutions, those issues should be addressed head-on -- not indirectly by limiting the information received by the investing public.

Market Reform and Penny Stock Rules:

To turn from the "accounting and financial disclosure" areas to the regulation of trading markets, both the Market Reform Act and the penny stock reform portion of the Enforcement Remedies Act impose an ambitious rulemaking agenda on the Commission. The penny stock provisions, which I suspect may not have been studied by the industry as carefully as the other provisions of the Securities Enforcement Remedies and Penny Stock Reform Act, are worth the attention of the bar. For the first time, the Commission will be considering rules under the 1933 Act to impose special restrictions on the use and disposition of the proceeds of a registered offering.

In all of this, there is a large role for the Federal Regulation of Securities Committee.

If my facetious remarks in opening this discussion suggested to anyone that the Commission staff is not interested in the views of economists, let me disavow that. There are, however, some people who need to be heard from more often than others; and the people from whom the staff needs and wants to hear -- often and on a range of regulatory issues -- are many of them in this room now.

Thank you for your attention. I shall be pleased to attempt to answer any questions that you may have, or to respond to your comments.