NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
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FOR RELEASE: 7:00 p.m., Friday, March 2

THE STATE OF THE SECURITIES AND EXCHANGE COMMISSION -- 1979

An Address by Harold M. Williams, Chairman

The SEC Speaks in 1979
The Practicing Law Institute
Washington, D.C.
March 2, 1979

I. INTRODUCTION

One year ago tonight, before this audience, I delivered the first of what will be five "State of the SEC" addresses. In my remarks last year, I focused chiefly on the concept of self-regulation -- the principle on which much of the Commission's work is premised. Some observers, it seemed to me, had misread the Commission as deliberately distancing itself from those it regulates and as moving away from the concept of self-regulation. In my remarks last year, I stressed the Commission's commitment to this principle and described changes in the legal environment -- largely beyond the Commission's control -- which had affected both the substance of the Commission's work and the dynamics of the self-regulatory relationship.

In the past year, additional developments have, rather superficially I think, been read as the Commission losing faith in the concept of self-regulation. For example, the Commission, under the rather unique statutory dictates of the Energy Conservation Act, in a proceeding concerning oil and gas accounting practices, reached a result which some in the accounting profession felt did not give appropriate deference to work of the Financial Accounting Standards Board. Further, the Commission adopted an important package of rule proposals originating from its corporate governance

an important -- if indirect -- impact on the structure of corporate boards of directors. Moreover, several weeks ago, the Commission adopted two rules to implement the accounting provisions of the Foreign Corrupt Practices Act over the objections of many commentators. And, at the same time that these developments seem to suggest a growing distance between the Commission, on the one hand, and those that it regulates and who practice before it on the other, Congress enacted the Ethics in Government Act of 1978. Many of us believe that Act has a strong -- although apparently unintended -- potential to curtail the traditional and healthy interchange between the Commission's staff and the private bar.

Although these and other developments have led some to conclude that the Commission is moving away from the concept of self-regulation, more sophisticated analysis would reveal that our commitment to this principle remains undiminished. For example, the Commission's first annual Report to Congress on the Accounting Profession, our efforts to facilitate development of the national market system, the Commission's study of investment company regulation, the recommendations in our recent Options Study, and several other Commission actions which I will mention

this evening, should make it clear that we intend to rely heavily on private sector initiatives where they are appropriate and so long as we can be satisfied that such a course will result in effective implementation of statutory goals. I personally believe -- and I think the other members of the Commission share my view -- that this is the soundest course. In my view, the most effective and efficient form of regulation builds upon the strength and commitment of those whom it affects rather than on government fiat.

Indeed, other arms of the federal government are increasingly recognizing the efficacy of reliance on private sector initiative, rather than costly and detailed rules and regulations. For example, just recently the Chairman of the Consumer Products Safety Commission reportedly testified before Congress that mandatory standards in regulating product safety, once thought to be vital, have "proven to be far more costly and difficult to develop than anticipated," and that "[v]oluntary standards are emerging as a more promising mechanism for achieving product safety than in the past."

The fact that there may be confusion concerning the Commission's commitment to self-regulation leads me

to my second point. It is apparent to me that traditional Commission-watchers are finding it increasingly difficult to assess the Commission's performance. One particularly apt example of this difficulty occurred last fall, when on the very same day, a newspaper piece suggested that the problem with the Commission under my chairmanship is that it is hesitant to act, and an article in a national business magazine described me as too aggressive and as moving the Commission "too far, too fast."

Both articles may be right. To understand the paradox one must first understand the fundamental nature of self-regulation. Self-regulation does not mean that the private sector is left alone to conduct its business with unfettered discretion. It could not work this way. There are too many pressures against change -- pressures to leave well enough alone. It's the "if it ain't broke, don't fix it" syndrome. In order for self-regulation to work, government must be active in establishing objectives and in stimulating timely and effective implementation of these goals.

Ideally, of course, there will be a mutual appreciation of the objectives to be reached, and the private sector will then be entitled -- and expected -- to use its best judgment in determining the most effective way to arrive

at the goal. This is an efficient regulatory approach, for the private sector often understands its problems better than does government, and can better tailor specific responses to achieve a general solution.

All of this presumes that the private sector is operating in good faith, that there is the requisite agreement as to principles, and that progress towards shared goals proceeds at an appropriate pace. Thus, an agency like the Commission, which is committed to self-regulation, will and must remain active in the process by which objectives are set, and through which methods are derived to implement these objectives.

It is quite possible that in fulfilling its self-regulatory role, the Commission may be perceived to be more of an irritant -- perhaps even more demanding -- than if it simply mandated adherence to specific and detailed rules and regulations. There is more tension because we are acting in an unfamiliar way -- because we are provoking -- insistent on achieving certain goals, but not on the methods to be employed in their attainment.

This leads us back to the paradox which began the analysis. It is true that the Commission is reluctant

to substitute its judgment for that of the private sector in the selection of methods. Thus, in a sense, we are "regulating" less. In some ways this is being "hesitant to act." But it is also true that we are increasingly aggressive -- even provocative --in establishing self-regulatory goals and in challenging the private sector to find its own ways to meet them. Thus, many feel we are pushing them "too far, too fast," even though they are being urged to follow paths of their own choosing.

This paradoxical approach creates interesting problems. For example, how does one measure the Commission's performance in such a self-regulatory context?

In evaluating the Commission's work, I suspect that there has been a tendency in the past to keep score on the basis of our major pronouncements, the rules we adopt, the cases we bring, and the like. In the new regulatory climate, however, such a traditional measure of the Commission's effectiveness will probably lead to an underassessment of results. For much of the important work which the Commission has done in the past year, and which it will do in the coming years, will not be susceptible of such statistical measurement. Because of our continuing commitment to

encouraging private sector initiative and self-regulation, many of our most significant efforts in facilitating the development of the national market system, in overseeing the accounting profession, in deregulating the investment management area and in enhancing corporate accountability will not take the form of formal Commission action, but rather of stimulating the private sector to use its initiative.

Where necessary, of course, we will step in with a more traditional response. We have never shied from controversy; and we will continue to be activist. But I would expect much of our efforts will remain process-oriented, informal and of lower visibility, and that our true performance can only be judged by the final results that are achieved.

While I am on the subject of assessment of our performance, let me mention a related issue. There seems to be some misperception that the Commission has recently "backed away" from several controversial rule proposals as a result of public pressure brought to bear through the comment process. This is not so. Indeed, those who interpret us this way do not understand the comment process as it is employed at the Commission.

We have proposed rules on several very fundamental issues -- not merely technical or peripheral ones. In our management remuneration proposal, for example, we were inquiring into the very essence of "who is management" and of "what is remuneration?" This is a different and far more fundamental approach than one which merely proposes to require additional information about pension benefits, for example. As a result, we are stimulating increased public response, and we are upsetting some who wonder where our probing questions may lead. But, in my view, this is the kind of proposal that leads to effective rulemaking, and it is the kind of proposal you will see from us in the future.

The fact that we have made such a proposal -- and that it is lengthy and detailed -- does not mean we have predetermined to adopt it as proposed. We have made proposals which raise fundamental questions about which segments of the private sector are deeply concerned -- for example, Rule 390 dealing with the future of exchanges and auction markets, and corporate governance dealing with the composition and structure of boards of directors, as well as management remuneration. The issues involved in such proposals are substantive -- not technical. Any

meaningful analysis of these issues requires that they be articulated, from the beginning, in sharp and decisive terms.

We expect that the comment process will generate thoughtful and well-reasoned responses, so that our deliberations and rulemaking can be well-informed. The volume and thoughtfulness of response tells us that we are indeed ventilating real issues. When we thereafter modify a proposal before adopting it, we do not do so in order to "back away" from controversy, but rather to consider the benefits and burdens our rules will impose and to draw the regulatory line in the appropriate place -- which may be a different place than one might draw one's own philosophical line.

In this framework, I would like to undertake a brief evaluation of the Commission's progress during the past year, placing particular emphasis on our commitment to balance carefully the need for regulation against the advantages of self-regulation.

II. ACCOUNTING AND AUDITING

A. Commission Oversight of the Accounting Profession

Let me first turn to an area in which the Commission has become increasingly active -- oversight of the

accounting profession.

The Commission's approach to its oversight of the accounting profession exemplifies the two themes I have been discussing. First, we intend to emphasize self-regulatory initiatives from within the profession. And, second, we are working with the profession informally to help make self-regulation work.

Thus, in our first Report to Congress, our approach was not prescriptive -- we did not purport to tell the profession what it must do to meet the objectives of self-regulation. Rather, both in the areas of auditor independence and in regulation and oversight, we set forth with particularity the major objectives that we believed the profession should meet in order to be effectively self-regulating. And, while we did not recommend methods of our own to reach those objectives, we told the Congress that the profession was making adequate progress in developing initiatives to achieve the self-regulatory objectives. Consequently, we recommended that these private initiatives be allowed to continue and evolve.

The Chief Accountant's Office and the Commission have worked extensively with the profession over the past year with little public fanfare. Next July, the Commission will be issuing its second annual Report to Congress on

the Accounting Profession and the Commission's Oversight Role, and will update our ongoing work with the profession and our assessment of their progress toward the articulated objectives.

B. Setting Accounting and Auditing Standards

The Commission believes that the private sector should provide the initiative in setting accounting and auditing standards. Thus, it is appropriate that the Financial Accounting Standards Board has the primary role in addressing financial accounting issues -- subject, of course, to Commission oversight.

In the past, however, the profession has sometimes accepted only part of its responsibility to the standard-setting process. Take, for example, the events which preceded the Commission's decision last August to undertake the development of a new accounting method -- reserve recognition accounting -- for oil and gas producers. The accounting profession had recognized for years the inadequacies of the two historical cost-based accounting methods -- full cost and successful efforts -- prevalent in the oil and gas industry. Leaders of the profession -- in auditing firms, reporting companies, and the academy -- had peppered the literature with criticisms of existing methods and proposals for experimentation and change. Users

had long ago made the inadequacies of existing approaches abundantly clear.

Nonetheless, it was left to the Commission, implementing a Congressional directive, to come to grips with oil and gas accounting. Ironically, the Commission has been criticized for proposing reserve recognition accounting, the implication being that the Commission is interested in expanding its role at the expense of the private sector. In fact, however, the Commission would very much have preferred that the accounting profession take the lead.

The Commission's action did not in any way signify a change in the Commission's basic relationship with the FASB. The message communicated by our decision is rather that there is a need for the profession and the corporate community to address fundamental accounting problems in a broader framework than that to which we traditionally have been accustomed.

Disclosure of the impact of changing price levels is another example of the problem. The need to deal with the problems inherent in the interplay between chronic inflation and historical cost-based accounting have been treated in the professional literature for some time. And yet, here too, the Commission provided the impetus

reflected in ASR 190, which introduced a limited requirement for disclosure of the replacement cost of certain assets. The Financial Executives Institute, in a recent study, found that while corporate and financial executives were critical of the need to disclose replacement cost information, they viewed the impact of changing prices on financial statements as an important issue which required experimentation. Paradoxically, the study also found that the Commission's characterization of replacement cost disclosure as "experimental" caused management to be particularly critical of the cost burden of compliance. Short of the commission requirement, however, the experimentation was virtually nonexistent.

On a more constructive course, the FASB conceptual framework project constitutes an exercise in leadership -- a set of principles which can serve as a goal, a visionary guide for the profession to work toward as it develops and refines disclosure principles and methodologies. It is a safe prediction that, during the coming decades, the economic, political and technological changes in this country and the world -- and their impact on the nature and methods of American business -- will be enormous. Accountants and financial managers must have a conceptual

framework sufficiently flexible and broad to accommodate those developments.

In its most recent exposure draft, the Board has not limited its scope to financial statements, but rather has wisely elected to define its task in terms of financial reporting in general. That premise, if reflected in the Board's final product, will bring the accounting profession closer into step with the needs and expectations of the users of financial information and with the realities of the way business must communicate in a complex and sophisticated economy. Second, and just as significantly, the exposure draft reflects the philosophy that financial information is not simply a record of past occurrences, but is equally of value in enabling users to assess the future.

The broader area of financial reporting is an appropriate frame of reference within which to grapple with conceptual problems, and the FASB's recognition that the financial statements are only one element in the complex of financial disclosure is a positive sign. For example, it provides management with the opportunity to distinguish between measurable results typically presented in financial statements and other information which may be equally meaningful to users, but less

precise. Further, this expanded perspective should also encourage the auditor to lend the credibility of his independent expertise to useful, but nontraditional data of this nature.

III. INVESTMENT MANGEMENT

For the past 40 years, the Commission has regulated virtually every aspect of the investment company and investment advisory industries. There has been little, if any, self-regulation. The Commission's presence has been formal and pervasive.

This is now beginning to change. The Commission is rethinking the fundamental assumptions on which our regulatory program in this area has historically been based, and I expect, over time, dramatic changes will be visible in the way we interact with the private sector in regulating investment companies and investment advisers.

The Division of Investment Management is currently engaged in thorough reviews of the Investment Company Act and the Investment Advisers Act and all the rules and administrative practices thereunder. As a result of this re-evaluation, a significant regulatory shifting has already begun. First, we are moving towards simpler rules that are easier to understand, less costly to comply with, and state objectives and policy rather than describe

method; and second, we are encouraging investment company directors -- especially those who are disinterested -- to assume their responsibilities to the companies that they serve. Compare, as an example of our shift in emphasis, the depository rule we adopted with that originally proposed.

I firmly believe that the initiatives begun last year will return to the private sector the responsibility for managing the investment company industry, and will improve investment advisory regulation as well.

IV. MARKET REGULATION

A. The National Market System

The national market system, of course, is another area in which the Commission has adopted a largely self-regulatory approach. As you know, the Securities Acts Amendments of 1975 require the Commission to facilitate the implementation of a national market system for the trading of securities. The Commission believes that such a system should ideally be an industry undertaking, and that the Commission's role should be to identify objectives, stimulate initiatives, assess progress, and fill whatever voids may occur from time to time in the process.

In January 1978, responding to a concern that the industry lacked direction in its efforts to meet the Congressional objectives, the Commission issued a statement proposing a series of initiatives which established

the framework for a continuing dialogue with the securities industry and the self-regulatory organizations and for accelerating progress toward implementing a national market system.

While the Commission's timetable in the January 1978 Statement was too ambitious, substantial progress has been made during the past year, particularly in the development of comprehensive market linkage facilities. Two experimental systems proposed by the industry, the Intermarket Trading System and the Cincinnati Stock Exchange automated trading facility, began pilot operation during 1978. Both of these systems offer valuable opportunities to study the ability of different types of market linkage systems to integrate trading in physically-separate locations and to study the effects of these linkage systems on the structure of the markets.

While these systems were the result of private sector initiatives, the Commission has been playing a significant role in facilitating their development.

Other progress achieved in this past year is reflected in the negotiations between the Midwest Stock Exchange and the NYSE for the use of the NYSE-American Stock Exchange Common Message Switch; the extensive

dialogue regarding the operation of order-by-order routing and limit order facilities; the NYSE project to open its specialists' books and its offer to help the other exchanges automate their specialists' books. This progress has been achieved primarily as a result of informal prodding by the Commission and its staff.

The Commission expects, very shortly, to issue a status report assessing the past year's progress and indicating those issues which have priority for resolution to hasten progress towards a national market system.

I am confident that the objectives of the system will be met during my term as Chairman.

B. Regulation of Options Trading

As you know, a moratorium on the expansion of pilot options trading programs has been in effect since 1977. The Commission announced a moratorium because it believed the time had come to review and assess the efficacy of existing self-regulatory and Commission oversight of the burgeoning options markets. We initiated a general review extending to all aspects of standardized options trading and the regulation of such trading.

The Report of this Study was released on February 15 of this year, and following the release of the report, the Commission approved a plan which will lead to lifting the moratorium. The plan calls for close cooperation

tion among the self-regulatory organizations and the Commission in the implementation, over the next six months, of specific actions designed to correct the deficiencies found by the Options Study in current surveillance and sales practices.

Our goal in the Options Study was to learn enough about the industry so that an appropriate self-regulatory balance could be struck. The theme of our release, and of the recommendations in the Study, is self-regulation. The Study identified specific problems, and established specific self-regulatory objectives. But, we are relying on the industry itself to take the initiatives which will lead to a lifting of the moratorium, rather than ourselves prescribing specific corrective action.

This is especially evident with respect to surveillance. Rather than seeking ourselves to address the inadequacies in this area, we brought the self-regulatory organizations involved in options together in sharing information to enhance the quality of their own surveillance and oversight.

C. Surveillance and Inspection

In order to insure that self-regulation is consistent with our mandate to protect investors, it is important that we know what the self-regulatory organizations -- whether in options or equities -- are doing and how well they are doing it. To this end, the Division of Market

Regulation has recently strengthened its ability to monitor the performance of the self-regulatory organizations. The Division has established a new inspection unit to oversee the activities of these entities in carrying out their own surveillance, inspection and enforcement functions. This unit will advise the Commission, on a regular basis, as to the current performance of the self-regulatory organizations. Further, a consultant has been engaged to advise the Commission regarding improvements in its own surveillance system. Our goal, however, is not to duplicate the surveillance capabilities of the self-regulatory organizations, but rather to insure that the total aggregate surveillance capacity is adequate, that there are no gaps and that there has been an appropriate allocation of surveillance functions among the self-regulators and the Commission.

V. DISCLOSURE POLICY

While disclosure policy is not an area which is typically thought of as providing an opportunity for self-regulation, many of our initiatives in this area reflect, in important ways, our adherence to these principles.

A. Small Business

For example, the Commission has undertaken several rulemaking initiatives designed to ease the burden that the federal securities laws impose on the ability of

small businesses to raise capital. The Commission has amended Rule 144 to more than double the amount of securities which may be sold thereunder and to permit sellers to deal directly with a bona fide market-maker in lieu of engaging a broker. In addition, just yesterday the Commission adopted a further amendment to the Rule which would remove the volume restrictions entirely for sales by nonaffiliates after a certain holding period.

The Commission has also endeavored to make offerings under Regulation A and Rule 146 more viable for small business. Thus, Regulation A was amended to increase the amount of securities which may be sold thereunder within a 12-month period from $500,000 to $1,500,000. In addition, the Commission expects to act quickly on a proposed amendment which would permit the use of preselling documents to obtain indications of interest in Regulation A firm commitment underwritings. Consistent with the raising of the Regulation A ceiling, the Commission also amended Rule 146 to permit Regulation A-type disclosure to satisfy the Rule's information requirement for offerings which do not exceed $1,500,000.

Because of the limitations of Regulation A, there is also a need for a simplified and less costly form for registered underwriting by small businesses. We are hopeful that this need will be met by proposed Form S-18, which

would be available for offerings by nonreporting companies and could be filed with the Commission's Regional Offices. Although the proposed ceiling on the aggregate offering price was $3,000,000, the Division of Corporation Finance expects to recommend that the ceiling be $5,000,000 in order to meet the need for which the Form was designed.

The Commission has also begun the appointment of temporary consultants to the Division who will work to develop fresh approaches to the problems faced by small business. Bruce Mann was the first of our consultants and Bob Howes is currently serving as our second. These experts bridge the gap between the Commission and the private sector and -- we hope -- broaden the perspective of both.

Our goal in all of these initiatives is to deregulate small business to the extent compatible with sound disclosure policy. I believe we have already made significant progress, and we intend to go as far as we can towards removing the frustration that often accompanies the interactions between small business and government.

B. Corporate Accountability

In light of the concern that the Commission's corporate accountability initiatives unduly interfere with internal corporate affairs, it may seem strange that I believe our efforts to enhance corporate accountability

are consistent with our commitment to self-regulation. But they are.

One of the oldest and most traditional of all our self-regulatory frameworks is embodied in the relationship between shareholders, management and the board of directors of a corporation. The effectiveness of this framework has been criticized, and some of the criticism is no doubt valid. But, this structure is fundamental to our society, and I believe it retains a great vitality.

Our efforts to enhance corporate accountability should not, therefore, be viewed as adversarial, but rather as furthering the traditional mechanisms of corporate governance and self-regulation. Our initiatives will hopefully provide disclosures which will enable and encourage the corporate community to better govern itself, and may thus help avoid the need for Federal Legislative intervention into matters which have been historically left to state law. I would urge the private sector to do all it can to enhance the effectiveness of that governance process.

the private sector to do all it can to enhance the effectiveness of that governance process.

VI. ENFORCEMENT

I am sure that most of you consider the Commission's enforcement program to be the very antithesis of self-

regulation. To be sure, a Commission investigation is an active, intrusive, and certainly disruptive federal presence.

Viewed broadly, however, I would suggest to you that even our enforcement program is consistent with reliance on private sector initiatives. Our enforcement resources would be utterly inadequate to the task of policing all securities law violations which may take place. As a result, our enforcement activities are designed not only to correct specific wrongdoing, but also to alert the private sector as to the kinds of activities which we believe to be illegal. We also tend to be programatic in our enforcement efforts, concentrating on a particular area of concern in order that the parameters of appropriate conduct in that area may be fleshed out. In this way, we hope to stimulate the private sector to self-police inappropriate conduct.

We cannot bring every case, but our presence is sufficiently pervasive that a failure to stop practices which have been successfully challenged carries a very real risk. This risk, we have found, provides a strong and effective incentive for voluntary reform.

VII. CONCLUSION

Our philosophical commitment to self-regulation has its practical side as well. Ever-tighter budget restrictions

are increasing the pressure on our already too-limited resources. Reliance on private sector initiatives, therefore, allows us to do more with what we have.

However, as I have tried to describe tonight, a commitment to self-regulation does not require that we abdicate our own responsibilities, nor do we intend to. Our primary goal is investor protection, and we will be quick to act forcefully where we must.

In some areas, of course, regulatory action by the Commission may be desirable to forestall an even greater intrusion by the Congress. The Foreign Corrupt Practices Act may thus be viewed as a legislative response to a failure by the private sector to keep its own house in order. While some will always think that our corporate accountability initiatives are an unwarranted intrusion into the private sector, most of you, I hope, will come to believe that they are most appropriately viewed as a cooperative effort to achieve a necessary result without legislation.

These are interesting times for the Commission, for the industries it regulates and for those who practice before it. I am confident that the Commission, working closely with the private sector, will successfully resolve the issues which face it, and I invite your active cooperation and support in the tasks that lie before us.

Thank you.