SECURITIES AND
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NEW DIRECTIONS IN PROFESSIONAL RESPONSIBILITY

An Address By

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Mr. Chairman, Ladies and Gentlemen. I was slightly shocked at the title given to this Institute.

To one of my generation, the word revolution is likely to bring to mind the holocaust so long planned and predicted by the Third International of the Communist Party and its local members when I was a young man. "Comes the revolution," was not only a hackneyed joke in the vaudeville circuit, but something genuinely feared by many Americans of the day.

So, when I first saw the title given to this Institute and considered that Al Sommer had probably thought it up, I thought once more that you just can't watch these Democrats too carefully.

But when you stop being emotional and start thinking, you have to conclude that the term revolution is not too exaggerated to be applied to what is going on to the securities industry and to our capital markets in these times. We are certainly engaged in a fundamental restructuring of our market system and are moving toward a reordering of our laws and practices in the raising and transferring of capital. It is not, of course, a revolt against a system that was unjust

and evil. I do not think it would be fair to characterize the state of our markets and our law ten or more years ago as being so corrupt that they must be thrown out. After all, the real revolutionaries in this field were the men in 1933 and 1934 and 1940. Surely most of us would agree that the revolution of those days was both necessary and well conceived, laying a sound foundation for the markets of the post-World War II era. But economic and legal institutions must adapt and change to fit the needs of the time. What was not at all evil in its day may become so if it endures beyond the time when it satisfies the present needs of our society.

On the market side, the monumental Special Study headed by Milton Cohen ushered in a period of six or seven years of virtually continuous study of our markets in various phases until they had been examined and debated to the point of weariness on all sides. This has led to the general conclusion on the government side, and on the side of the leaders of the industry itself, that our markets must be made more efficient, taking advantage of rapidly evolving electronic technology. Artificial and unnecessary barriers

on the part of all investors to access to various markets must be eliminated. We are agreed that the markets must be made more competitive in order to achieve minimum cost to investors as well as reasonable profitability to persons conducting business in these markets and,especially, to remove artificially fixed commissions that produced corruptive practices. In the process, we have also worked toward greater investor protection through assuring the soundness of brokers and dealers and insuring investors against loss through broker-dealer insolvency to a large degree.

This process, of course, is still continuing. The end may be in sight conceptually, but there is still a long way to go. In Churchill's famous phrase, it may be too much to say that this is the beginning of the end of the process, but perhaps we could say that this is the end of the beginning.

On the 1933 Act side, I think it is fair to say that Milton Cohen again played a key role in first articulating, in a systematic fashion, the consequences of the 1964 Amendments to the 1934 Act. His criticism of the old system and his speculations on what can be achieved with continuous registration of publicly-owned companies was followed by

staff studies by George Michaely and others, Carl Schneider's article, the Wheat Report on Disclosure Policy, Professor Loss and his work on the Federal Securities Code, and the Commission's 140 series of rule-making and related form revisions.

Putting all of these things together, we are surely engaged in a revolutionary process, not aimed at punishment or revenge, but rather aimed at adapting our markets to the fullest use of available means for fairness and efficiency in the raising and transfer of capital funds.

While certain concrete goals may now be ascertainable, the revolutionary process may continue for some time because, as I once remarked, everything in this area seems to have come unglued at about the same time and the facts of financial markets, to which the system must be adapted, continue to change. This is certainly true in the international sphere. The growing changes in the international markets, the relative position of the United States and the dollar, and the continuing growth of multi-national corporations, lead some to dream of the day, not too far distant, when our markets must be adapted to an international system that will permit the free flow of capital among all the nations of the free world.

The same process, of course, is raising nationalistic and protectionist hackles. The accumulation of dollars by certain foreign countries or individuals in those countries has generated some fears that tend to move in the other direction.

At the same time that we are considering these more obvious revolutionary developments in our securities markets and laws, I think we must also consider, preserve and improve those portions of our present system with demonstrated effectiveness. As a result, the role played by professionals in the entire process, and the proper way for them to be treated by our laws, is exposed as a critical attribute of the system.

From the Commission's point of view, this is the sort of picture we get. In the last few years we have seen some truly monstrous financial debacles. Hundreds of thousands of persons have lost hundreds of millions of dollars because of investments in securities which, together with their issuers, had received the full treatment -- securities issued pursuant to 1933 Act registration, issuers registered under the 1934 Act, markets conducted by registered broker-dealers who were NASD members and also stock exchange members, represented by reputable law firms, and financials certified by reputable public accountants.

On the surface, perhaps, this might not seem so bad. Our system of securities regulation, even when working at its best, has never promised investors a rose garden. But I am not referring just to cases where the market price went down instead of up, as is it will from time to time. And I am not referring to the occasional small crook that can probably never be eliminated altogether.

We have had cases of fraud and of mismanagement and disregard of investor interest that rival anything known to the men of 1933 who set about to construct a system that would make the world safe for small investors against the depredations of the robber barons, the princes of privilege, the malefactors of great wealth and the just plain bandits of earlier days.

Take a most recent case of epic proportions. Stockholders of Equity Funding Corporation have apparently lost something like $250 million in the aggregate just from the market price of February, 1973, to date. Stockholders of National Student Marketing lost in excess of $400 million in 3 months. Penn Central Stockholders have lost an aggregate of over $1 billion at least.

The record is not in in these cases, but it is obvious from the publicly available facts that these are not simply cases of the normal vicissitudes of a fair and free market. These stock values did not just go up and then down because of the ebb and flow of human events. The stockholders of Four Seasons did not lose $110 million in a matter of days just because in our system you win some and you lose some.

In these cases something very wrong was going on -- something wholly inconsistent with the free and fair market system we set about to create in 1933 -- and something that defied all of our protective mechanisms. In these cases, the whole system flopped, on the government side and on the private side, in many instances fooling, among others, some of our institutional investors and research firms with the most glittering reputations.

Can we write off these experiences by saying that the market in the late 1960's went crazy and everyone lost his head? Since this was true in the late 1920's, the observation does not help much. Anyway, the later collapses did not occur in runaway bull markets -- certainly not Equity Funding.

Can we explain them by observing that our regulatory system, magnificent though it is, is naturally not perfect, and so a few bad apples naturally slip by? As the accounting

profession properly observes, auditing procedures designed to uncover all possible deliberate frauds would not stand up under cost-benefit analysis. Perhaps there are a few bad apples in the sense that only a few corporations are involved, compared to the several thousand publicly-owned companies in the United States. But these were not just any little old companies. They were big companies, and the darlings of the market place, highly esteemed by professional analysts. Furthermore, entirely too many dollars were lost to let us shrug our shoulders and simply observe that you can't win them all.

These cases are, in fact, grist for the mill of those chronic non-believers in our whole structure of investor protection through disclosure and maximum reliance on private policing and self-regulation. They enable some to say that our system of securities regulation is an elaborate farce. Except, perhaps, for those features that make it easier for investors to sue, they might urge that we have accomplished nothing significant and that it would save the taxpayers and everyone else a lot of money to junk the whole mess and revert to 1932 and the far more satisfactory philosophy of caveat emptor.

These cases enable others to say that the system has failed by placing too much reliance on the private sector and that those who argued in 1933 that the federal government should play a heavier role were right. These critics might urge that we cannot, among other things, rely on Section 11 liabilities to produce adequate disclosure; we cannot rely on public accountants to examine financial statements; we cannot rely on private counsel to guide their clients into full compliance; and, indeed, we cannot rely on informing prospective investors as adequate protection against their making fools of themselves to an extent that amounts to a public disaster.

Our system of securities regulation -- permitting to the maximum extent the allocation of capital through the independent decisions of unfettered, but fully informed, individuals -- is passing through a dangerous period.

We at the Commission are keeping the faith. We believe strongly that this is the best system, over the long run, that man has devised for optimum economic freedom and growth.

And we continue to believe that this, like any other legal system, works best where primary reliance remains on the private citizen.

But a predominantly self-enforcing regulatory system requires several things if it is to work well. It requires that the system appear reasonable and fair to those who are expected to comply, and it requires that they understand with reasonable clarity what is necessary for compliance. It also requires the presence of adequate penalties to stimulate proper behavior, penalties imposed both by government action and through civil liability. And, because of the complexities of modern corporate affairs, heavy reliance must be placed upon the accountants and lawyers who participate in the system on the private side.

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. While the system has, on the whole, worked amazingly well for forty years, there have been those spectacular recent failures that give us grave concern.

We are not entirely happy with the means at our disposal to cause higher standards of professional conduct for investor protection. It is true that we can legislate rules governing the contents of financial statements filed with the Commission, but that won't insure a careful audit, and it certainly won't improve standards of professional conduct by lawyers. Our tools in this context, aside from informal comment and criticism, are enforcement weapons -- suspension or disbarment from practicing before the Commission, under Rule 2(e) of our Rules of Practice, and an action for an injunction on the ground that the accountant or lawyer has participated in or aided and abetted a violation of the securities laws, including Rule 10b-5.

As you know, we have a larger and deeper history of proceeding against accountants than against lawyers. There are many reasons for this, and perhaps they include the common accountants' observation that, after all, lawsuits are brought by lawyers and tried before judges who also are lawyers.

Whatever the historical reason for this, recent enforcement activities should persuade everyone that lawyers are obviously not immune.

The accountants' situation, however, is simpler in many respects. Their necessary independence and the obvious significance of their product to investors make it relatively clear where their duty lies, even though the reach of their potential civil liability has produced proximate cause and priority problems when it comes to money damages.

The lawyers' position in corporate and financial matters is subtler and less obvious.

To date, the problems that the SEC has had with the legal profession, and the actions that it has brought against members of that profession, have not been directly related to matters of professional proficiency. While our proceedings against members of the accounting profession have characteristically raised questions of the proper diligence of their examination, we have not so far proceeded against lawyers for failure to find the leading case or to have read the rules properly or things of that sort. This is not to say that such actions might not some day be brought. Certainly Judge McLean's Opinion in the <u>BarChris</u> case spent a good deal of time

considering whether the lawyers for the underwriters and for the issuers had adequately done their research, although he avoided, because it was not presented to him, the question of lawyers' liability.

Lawyers, however, do have serious problems of client identification and ethical and even emotional problems as to whom their duty and loyalty are owed. Within certain limits, which are not always that clear, lawyers are supposed to be advocates for private interests and, on occasions which seem to be increasing, adversaries of government and its attorneys. But lawyers also serve as counselors, and in that role whose interests should they hold paramount? As I think the Commission has made clear, when it comes to matters affecting public stockholders and investors, we are not prepared to agree that the corporate lawyer's duty is solely, or even primarily, to protect the interests of the individuals constituting corporate management, when he is retained to serve the corporation.

Our actions against lawyers have involved themselves more with this problem of client identification. Consider, for example, a typical case of an offering document to be filed under the '33 Act in which a question arises with respect to

whether a particular fact must or must not be disclosed. Several possible situations may obtain. The issuer's lawyer, and the issuer's management, and the underwriter and the underwriter's counsel, if there is an underwriter, may all agree that the fact is not material and therefore agree to exclude it. We have not challenged the lawyer's part in such a situation, although of course we might if the judgment of all parties concerned was clearly beyond any reasonable man's opinion on such question. But suppose the issuer's lawyer thinks that the fact is material and management of the issuer either denies that it is material, or, what is more likely in some cases, admits that it might be material but, because it is exceedingly embarrassing, would prefer to try to get by with leaving it out. What is the issuer's counsel now supposed to do?

When a lawyer is retained to represent a corporation and to be paid out of corporate funds, the ABA's code of professional responsibility would say that the lawyer's client is the corporate entity -- not the individuals that constitute corporate management nor the individuals that constitute its stockholders nor any other specific persons. How does this help us with our disclosure problem? Who

speaks for this corporate abstraction? If the offering document we are referring to happens to be a merger proxy statement, who has the ultimate decision as to what should and should not be disclosed to the stockholders of the issuer? Is it the lawyer or is it corporate management?

We might rephrase the question by asking what is our goal with respect to the ideal lawyer? Our goal is certainly not the genial fellow who will put his name on anything the that the client wants so long as the fee is adequate. On the other hand, I doubt that our goal is the arrested infant who will scream and stamp his feet and run to teacher whenever he does not get his way on every little point. I presume our goal is the mature and reasoned counsellor who is able to view and to weigh properly the legitimate interests of management and also to view properly and to weigh the considerations that are important to investors.

I have observed in the past that I think our enforcement weapons may be overly crude, or at least not well tuned to achieve our objective. The use of Rule 2(e) has theoretical attraction. In some cases it has clearly seemed like

the appropriate remedy with respect to lawyers whose sins have extended to misrepresentations if not outright lies in their dealings with the Commission itself. But I doubt whether it can ever serve as an appropriate vehicle for enunciating professional guidelines.

The injunctive action also presents problems. If the injunction extends, as the Commission has frequently requested, to all future behavior of the professional person or firm in matters affecting the Commission and its laws, it may be too much. If the injunction is limited to only further affairs of the specific client that produced the professional misconduct, it may be too little, because so often in these cases that client will be bankrupt, otherwise cease to exist or discharge the attorney.

And I think our law as to civil damages may be anachronistic as applied to affairs of a magnitude so far exceeding the resources of the professional individual or firm.

I think we have got to work toward trying to solve this problem on a more reasonable basis than it presently stands. We at the Commission are determined to do our job in achieving higher standards of performance on the part of professional persons whose work affects the investing public. We have to do this with the weapons we have at hand, even though the results are not always exactly the way we would like to have them be. The profession, however, I think is overdue in taking this problem seriously and thinking through to an appropriate solution. It is absolutely essential to the brave new world that we are creating that the professional persons so involved perform in a manner that instills justifiable confidence in accountant's certificates and in lawyer's opinions and in the other work that lawyers perform.

We are indeed working our way through a revolution in securities regulation. Most of this revolution I think we can view with excitement and enthusiasm. But one revolution I do not want to see is the overthrow of our continued reliance on the small governmental police force and big

voluntary compliance from the private side. Preservation of this most fundamental American characteristic depends heavily on the accountants and lawyers. We must work to increase their effectiveness in these critical roles.