SECURITIES AND EXCHANGE COMMISSION
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THE ROLE OF PROFESSIONALS

An Address by

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Securities and Exchange Commission

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San Diego County
Bar Association

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I was most pleased to be invited to be with you today. Because we have a daughter who lives here with her family, and because this area attracts conferences for perfectly obvious reasons, I have been to San Diego a fair number of times. Always with pleasure. But I have had too few occasions to meet people who actually live and work here.

In fact, my first visit was in the summer of 1940. I was visiting a college classmate in Los Angeles, and we took off headed for adventure toward the south. We stopped in La Jolla, where his family had a cottage. It was a separate village in those days. We swam in the cove and speared fish - - that is to say, my friend, who knew how, speared fish - - I speared <u>at</u> fish. Snorkles and Scuba had not yet been dreamt of. We used goggles and a small trident, and the fish were not in great danger.

Moving on, I am ashamed to recall that we didn't pay very careful attention to the City of San Diego. We were headed for the bolder challenges of Tia Juana. There we more than met our match and quickly made our escape on down to Esnenada, stopping both going and coming to skinny-dip and surf - - without boards, of course - - on the magnificent beaches along the way. And returning across the border - - two young punks obviously up to no good - - we were worked over pretty well by U.S. Customs, though the idea of smuggling Mary Jane or any other contraband was as far beyond our thoughts as it was our pocketbooks.

In recent years, of course, I came here properly attired in coat and tie and wear trunks on when I go swimming, but the romantic aura of the area persists in my memory. Frankly, this makes it something of a struggle to keep my mind on the somewhat less romantic reaches of the federal securities laws while visiting here, but I shall try.

Realizing that I would be speaking to accountants as well as lawyers and that many of you are not fully absorbed in a securities practice, I decided that it would be appropriate to devote my remarks to the relationship of lawyers and accountants to the federal securities laws and to our Commission. The subject matter is one which is attracting and generating some controversy on both the government and the private side.

We are told by accountants that we seem to be seeking to make them insurers of the accuracy of financial statements; that our policy seems to be whenever a company goes bankrupt to punish the auditor; that we seem to believe that public accounts in general are grossly inefficient if not corrupt, or at least our speeches and releases generate the suspicion; and that we seem determined to sabotage the new Financial Accounting Standards Board by adopting rules and guidelines on matters within the Board's area of responsibility without giving the Board a chance to get going.

We are told by lawyers that we seem to be intent on repealing the code of the hills by suing lawyers for their professional activities and not just when they are acting as principals; that we seem to think lawyers are insurers of the accuracy of facts related to them by clients and on which their opinions are based; and that we seem bent on ignoring or destroying the traditional lawyer-client relationship by expecting lawyers to act as independent experts with primary duty to the SEC.

We certainly don't intend to be doing these things, even though it may seem to some that we are. But, it certainly is true, that we have been attempting to strengthen the roles you professionals play in our full disclosure process, although, unfortunately, some our recent disagreements apparently will be resolved in a court or hearing room, and not over a conference table.

The full disclosure process of which I speak has functioned quite well over the years, although we have recently been witness to some truly monsterous financial debacles. Hundred of thousands of persons have lost hundreds of millions of dollars because of investments in securities, which together with the issuers had received the full treatment - - ’33 act registration of the securities before public distribution, ’34 act registration for the issuers of those securities, markets conducted by registered broker-dealers, largely NASD and stock exchange members, companies represented by reputable law firms, and financials certified by reputable public accountants.

The record is not in in all of those cases, but it is obvious 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. In these cases, something very wrong was going on - - something wholly inconsistent with the free and fair market system Congress set about to create in 1933 - - and something that defied our existing protective mechanisms.

Maybe we should not have been so surprised. Certainly our critics were not. They believe these events merely confirmed existing doubts about our system - - a system which relies on our small police force, the lurking threat of the imposition of civil and criminal liabilities, the right of investors to prosecute malfeasance or misfeasance in their own names as private attorneys general and, most important, upon private professionals.

These cases enable some nonbelievers 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 penalities 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.

Our use of these tools, however, has not been designed to subvert the role of accountants or lawyers, or even to impose responsibilities not contemplated by the pattern of federal regulation of our securities markets.

This certainly is most clear for accountants, who have a specific and defined role under the securities laws. The Commission's reliance on the accounting profession has been the keynote of an effective partnership that has been evolving for forty years, and one which has resulted in the significant improvement of the quality of public information about the economic activities of companies that have come to our capital markets to finance their activities. This pattern of reliance was established at the outset when Congress included in the Securities Act a provision requiring financial statements to be certified by public accountants.

In the recent, somewhat tumultuous environment - - and, in particular, with the cessation of Accounting Principles Board activities and the advent of the Financial Accounting Standards Board - - considerable verbiage has been expended in an effort to provide more certainty, if not more comfort, about the character of the continuing partnership between the Commission and the accounting profession. Such discussions have not only focused on "who does what," but on "who does what to whom." Considerable concern, and much more, has been expressed by members of the accounting fraternity about those activities of the Commission they construe as upsetting the partnership and undercutting the Commission's reliance upon the profession.

This is understandable in a period when a changeover in private accounting standard-setting bodies is taking place and when accountants are being asked - - and not just by the Commission - - to assume more responsibility in the performance of their functions.

To an extent, the recent activities of the Commission have been directed at filling the vacuum in standard-setting during the changeover period especially in the areas where we felt that further delays would not be consistent with our primary obligation of protecting shareholders. However, the Commission's principal thrust during this time has been to urge the FASB to move with "deliberate speed" to fill the all too obvious vacuum. At the same time, we have urged, and will continue to urge, accountants to assume and exercise greater responsibilities in setting financial measurement standards in a changing financial environment, and to obtain sufficient disclosures for the public.

I suppose, in view of the nature of our "weapons", there is some logic to the charge that we are asking accountants to insure the accuracy of financial statement,

asking auditors to assume the responsibility for bankruptcies or asserting that accountants, on the whole, are a sorry and incompetent lot. The complaints we have filed in our enforcement actions against accountants certainly were not intended to read as commendations of merit.

But those were special cases. Our respect for the accounting profession is high, but, after all, that becomes largely irrelevant. If particular accountants fail to perform minimally, what answer shall we give to the thousands of investors? If independent auditors close their eyes to facts they reasonably should have perceived, what response shall we offer when a massive fraud results in bankruptcy, and destroys the life savings of investors? Shall we tell them that carelessness, gross negligence and a lack of independence are adequate standards for accountants?

Our enforcement efforts should not be viewed as an indictment of an entire profession, or even the assertion of impossibly high standards to which no mortal professional, however competent, can adhere. I think we are asking of you only what the law and common sense already require - - honesty, integrity and dedication. At our end, we are persuaded that most accountants possess and adhere to these attributes. But if standards are to be set and maintained, unpleasant as it is for us, we have no alternative but to work within our existing authority.

The accountants' situation, however, is simpler in many respects than that of attorneys. 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 BarChris 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 lawyers' duty is solely, or even primarily, to protect the interests of the individuals constituting corporate management, when he is retained to serve the corporation. This does not mean that the traditional lawyer-client relationship should be forsaken, and that all attorneys in the securities field owe their primary, if not sole,

allegiance to the SEC. 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.

In that context, attorneys cannot blithely perform their responsibilities in ignorance of relevant facts. The ABA's Ethics and Professional Responsibility Committee has issued an opinion (No. 335), recognizing that an attorney must measure the basis upon which he takes action, or offers an opinion, on behalf of his clients, to be sure that conduct affecting the rights of investors generally is predicated upon an accurate understanding of all the facts. Does this mean corporate lawyers and others cease being advocates for their clients?

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 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 counselor 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. You professionals, however, I think, are 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 in the securities area 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.