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FEDERAL REGULATION AND REGULATORY REFORM

R E P O R T

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CHAPTER 2

SECURITIES AND EXCHANGE COMMISSION

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Later, during the same hearing Chairman Moss asked: "Now do I understand that the present levels of staffing and budgeting are, in your judgment, Chairman Hills, adequate?" Mr. Hills responded:

> Given our present look at the things we can do to improve our capacities in terms of modernization, that recordkeeping and what-have-you, it is our best judgment we will have sufficient staff to do the job in the long run.
>
> There are a couple of big "ifs" in that. If our basic form revision works so that the handling of information and filings in Corporate Finance can be facilitated when we have again a large bulge in the corporate registration statements, which we see coming, we will be able to do that job with fewer people. I am anticipating—it may be we can't improve our methods that much. . . . [The SEC budget] is the kind I would like anybody working for me to have, recognizing we are cutting very close and may have to come back to Congress.[118]

The Commission is to be complimented for its efforts to increase its productivity and efficiency. Nevertheless, the Subcommittee is concerned that the Commission's commitment to reduce the FY 1978 staff level to that of FY 1976 will compound the difficulties arising from the backlog of badly needed but unfilled positions. The failure to achieve the targeted increases in staff during the 1973-77 period must be contrasted with the dramatic increase in responsibilities which are in addition to those anticipated in 1972. Moreover, it is unwarranted to assume that a 1978 staff reduced to the 1976 level can keep pace with its increasing responsibilities to assure public investors that the expanding markets are orderly and operate in the public interest.

V. Conclusions and Recommendations

A. OFF-BOARD TRADING

With respect to its statutory mandate to review off-board trading rules and abrogate those which are found to be anticompetitive and otherwise unjustifiable, the SEC should act promptly to carry out the clear letter of the law. The subject matter at issue is of particular importance to regulatory reform since abrogation of these exchange rules would remove anticompetitive regulatory restrictions. Where, as is the case here, over-regulation (by the exchanges, with the acquiescence of the SEC) stifles competition and interferes with free market forces, it should be withdrawn. In the present situation, the Congress has made that judgment, absent a finding by the SEC that there are countervailing justifications necessary to carry out the objectives of the Securities Exchange Act of 1934. The SEC should act promptly to enforce the law.

B. CORPORATE ACCOUNTABILITY

With respect to its role in assuring an adequate system of corporate accountability, the SEC should take the following steps:

1. Accounting standards, principles, and practices.—Independent accountants and auditors should become neutral corporate financial reporters. Thus, to the maximum extent practicable, the SEC should prescribe by rule a framework of uniform accounting principles. In instances where uniformity is not practicable, the SEC should require the independent auditor to

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[118] *Ibid*. at 711.

attest that the accounting principles selected by management represent financial data most fairly. He should also prescribe supplemental data to permit a translation from one set of assumptions to another, thereby permitting comparability among companies in a particular industry.

2. Internal controls.—The SEC should act promptly to promulgate rules necessary to assure that:

(a) publicly owned corporations adopt and enforce codes of business conduct that conform to the laws of all countries in which a corporation operates and that are disclosed publicly to shareholders through filings with the SEC;

(b) procedures which allow corporations to develop off-the-book accounts are eliminated;

(c) uniform financial controls are applied throughout every department and operating division of the consolidated corporation and complementary accounts among subsidiaries and between subsidiaries and the parent are reconciled regularly;

(d) communication is strengthened among in-house accountants and auditors and the appropriate levels of management;

(e) falsification of books and records is penalized;

(f) a certified public accountant who falsifies or contributes to the falsification of books and records will be suspended from practicing before the SEC; and

(g) independent auditors attest to the quality of internal controls and the quality of enforcement of those controls in the annual report.

3. Boards of directors.—The SEC should promulgate rules necessary to assure that:

(*a)* a director of a publicly owned corporation receives compensation and independent staff sufficient to perform responsibly his board duties;

(b) a majority of the board is independent of senior management and operating executives and from any other conflicts of interest.

(c) the board reviews and approves the corporation's code of business conduct and system of internal controls;

(d) the board's auditing and nominating committees are comprised of a majority of independent directors;

(e) the board's auditing committee has available to it independent expert advisors; and

(f) the board has the authority to hire and fire the independent accountant, legal counsel, the general counsel, and senior operating executives.

4. Auditing standards.—(a) The SEC should prescribe by rule auditing standards to be followed by independent accountants who certify financial reports filed with the SEC.

(b) The SEC should prescribe by rule standards of conduct for independent accountants and auditors and for accounting firms practicing before the Commission and should take disciplinary action as may be necessary to assure adherence to such standards.

(c) Legislation amending section 10(b) of the Securities and Exchange Act of 1934 is needed to protect the public against negligence by accountants and others, regardless of intent to deceive or defraud.

5. SEC enforcement of Federal disclosure laws.—(a) To assure that SEC action is sufficient to elicit all relevant facts and to ascertain the frequency and extent of violations of Federal laws the SEC should:

(i) confirm its authority to pursue all such investigations and to examine the accuracy of voluntary disclosures through access to corporate books and records in a consent

judgment filed in a Federal court and thereby enforceable, if necessary, by contempt of court sanctions;

(ii) verify through its Division of Enforcement or by other means, the accuracy of all published corporate disclosures and publish the results of its follow-up investigations; and

(iii) seek through supplementary appropriations funding sufficient to augment its enforcement staff for the purpose of such follow-up investigations and for new investigations.

(b) The SEC should refer to the Department of Justice cases where senior management or the corporation's independent accountants or auditors had knowledge of or participated in illegal payments or any substantial payments which were not truthfully disclosed in corporate books or records. Injunctive relief, while important, is not a sufficient deterrent in such circumstances.

(c) To inform the public of the nature and extent of illegal and questionable activities in which corporations may be engaged,

(i) more detailed public disclosure is necessary as to all companies which have maintained false or inaccurate books or records or which have engaged in any illegal payment (under the laws of the United States or any other country), any substantial questionable payments, or any form of domestic or foreign political contribution;

(ii) disclosure must include at a minimum a detailed description of the nature and purpose of the payment, the amount, the basis of its illegality (or the surrounding facts which make it questionable), and the identity of all corporate officials who participated or had knowledge of the payment;

(iii) disclosure must tell how much corporate employees and particularly senior management and directors knew about all illegal or questionable corporate payments; and

(iv) disclosure always should be in appropriate communications to the shareholders and to the media.

C. WHITE HOUSE PERSONNEL PRACTICES

With respect to intervention by the White House in personnel selection at the SEC, the Subcommittee recognizes problems can arise from referrals from any source which might use its influence to hire biased or otherwise unqualified candidates. The Subcommittee also believes that there can be significant benefits to the SEC, in the form of qualified staff, from well-intended referrals. It would be unwarranted to suggest that no referrals could be made by the White House or any other source. The Subcommittee does recommend that all referrals, letters, or memoranda, whether from the Executive Branch, the Congress**,** or private sources, be placed in a file available for public inspection, in order to reduce or eliminate the effect of referrals that represent improper pressures upon the agency. The Subcommittee commends the SEC for its demonstrated ability to withstand the pressure of a continual stream of political referrals as evidenced by the data set forth in the third case study.

With respect to the matter of clearance by the White House, the subcommittee recommends that action be taken to terminate political clearance of staff of the SEC and of the other independent regulatory commissions. In light of the important policymaking and quasi-judicial functions which the SEC and its sister commissions perform, there can be no

justification for requiring political qualifications not prescribed by statute. However, the problem may be more fundamental than determining whether one office or another should or should not clear candidates for positions. In light of the characteristics of Schedule C and NEA positions which have been assigned by the Civil Service Commission, the Subcommittee concludes that no NEA positions should be assigned to the independent regulatory agencies and that the Schedule C positions should be limited. It may be appropriate to assign Schedule C for confidential secretaries or personal assistants to the Commissioners. Even for these positions, there is no basis for tolerating political clearance, although it would be proper to allow the principal to select personal staff or to allow the Commission to select a limited number of senior officials on a noncompetitive basis.