NEWS

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CHALLENGES AND COOPERATIVE REGULATORY EFFORTS

Address by

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I appreciate your invitation to participate in this Conference, which provides all of us a further opportunity to discuss common problems and exchange ideas so that we can more effectively accomplish our important, mutual goal of protecting investors. Over the years we have coordinated our enforcement efforts and have established a relationship of trust and confidence. We have also developed a cooperative approach in other areas and have had notable successes such as: the joint development and adoption of Forms BD and U-4 providing for uniform applications for regiatration, license or membership as a broker dealer and securities industry agents; and the widespread use of the FOCUS Report, which provides a uniform system for reporting financial and operational information by brokers and dealers. Admittedly, we have had, and may continue to have, a few differences of opinion, such as in the area of tender offers; but these debates should not obscure the fact that state and federal cooperation and coordination has been and will continue to be highly beneficial.

Our joint efforts to establish a computerized system compiling information from various forms and reports will enable participating states, the Commission, and self-regulatory organizations to improve regulatory efficiency, while

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substantially reducing reporting requirements and the cost of regulation through the coordination of surveillance programs and joint examinations. Also, the development of uniform examinations for the qualification of industry principals and registered personnel will help upgrade qualification standards, and the implementation of uniform and simplified procedures for the transfer of registered personnel from one broker dealer to another will reduce unnecessary paperwork and delays. We must, however, continue to seek new ways to better protect investors yet minimize regulatory burdens if we are to withstand the rising tide of criticism against regulatory agencies, which is typified by the statement that "private enterprise is endangered by a ponderous and over-restrictive government." That viewpoint is widely shared as is evident from last year's political campaigns, numerous public opinion polls and many critical articles with such titles as "Curb the Bureaucrats," "Beware the Watchdogs" and "Who's Regulating the Regulators."

Although the SEC has occasionally been mentioned in the widespread general criticism of regulatory agencies, the Commission has been pleased with the results of two comprehensive Congressional studies which have been published recently. Last October, a House Report on Federal Regulation and Regulatory Reform ranked the SEC's performance as first among those federal agencies studied with respect to

"fidelity to public protection mandate defined by Congress; quantity and quality of agency activity; effectiveness of agency enforcement programs; and quality of public participation." In a Senate Report on the Regulatory Appointments Process, which was released eleven days ago, the SEC "received measurably higher positive marks" than the other agencies included in the study. That report covered such categories as the Commissioners' past experience, interest and commitment, fair and impartial decisionmaking, effectiveness, judgment, technical knowledge, impartiality, integrity, and hard work.

These studies confirm, and perhaps add to, the SEC's longstanding reputation for excellence. While I believe this reputation is deserved, in my opinion it is the result of numerous factors such as statutes patterned on disclosure and self-regulation. The Commission's reputation is also based, in a very real sense, on the efficiency of the entire securities regulatory system which, of course, includes the activities of state securities administrators. I also believe that our emphasis over the past few years on deregulation of commission rates and the removal of anti-competitive barriers in our securities markets have struck a responsive chord.

In any event, we are very much aware that there is much to be done, that our performance can be improved, and that none of us has any basis on which to relax in our efforts to protect investors and assure that our securities markets

are fair, equitable and efficient. In the area of market regulation, the SEC has played a limited, but active, role in restructuring the securities markets. Our efforts have been, and I believe they will continue to be, directed primarily towards the removal of anti-competitive barriers, thus facilitating the ability of market forces to bring about improved markets. In the area of investment management, the SEC is currently re-examining the comprehensive regulations under the Investment Company Act to determine whether investment companies are at an unnecessary competitive disadvantage, when compared with other collective investment vehicles, and the extent to which regulation can be reduced without sacrificing investor protections. In the area of corporate finance, the Commission has never attempted to restrict access to equity capital markets, provided there has been full and fair disclosure of all material facts which are necessary for an informed investment decision. I recognize, of course, that some of the "blue sky" laws have different philosophical underpinnings than those which we administer, and that your laws have been an essential adjunct to the federal system of securities regulation, particularly in areas such as real estate syndications and other tax shelters.

The Commission has recently published some rulemaking proposals which should be beneficial to investors and the functioning of our capital markets and which, I believe,

should be of interest to you. In the past, we have sporadically received letters of comment from various state administrators and your associations. I can assure you that those letters have been carefully considered and have been of great assistance to us because as fellow regulators, you have a unique perspective and can offer us valuable insights based on your day-to-day experiences. While I can appreciate the demands which are made on your limited time and resources, I hope you will comment individually or collectively on as many of our rulemaking proposals as practicable.

The first set of proposals which I will discuss are the proposed Truth-in-Bookkeeping Rules. I believe these rules, if adopted or if enacted in legislative form, would be helpful in restoring the investor confidence that has been jeopardized because some companies have engaged in illegal or questionable practices. Thereafter, I will discuss other proposals which may be of assistance both to you and to the Commission in detering illegitimate business promotions from defrauding the investing public, particularly in schemes designed to take advantage of the nation's energy shortages.

The Commission's Truth-in-Bookkeeping proposals, which were published for comment in Exchange Act Release No. 13185 on January 19, 1977, had their genesis in the Watergate Investigation. As a result of that investigation, the

Commission was made aware of a number of instances in which public companies used corporate funds to make sizeable illegal domestic political contributions. The Commission's Division of Enforcement set up a Management Fraud Program to look into the questionable payments and on April 15, 1974, we filed our first complaint along with a consent settlement. That complaint alleged that the company involved had filed reports which were false and misleading with the SEC and that false and fictitious entries were made on the company's books to conceal the purposes for which corporate funds had been used. The relief obtained in the consent decree and court ordered undertaking included the establishment of a special review committee by the company to examine all books and records to determine the extent to which there were expenses or payments for purposes other than those recorded. The findings were to be included in a report which was to be submitted to the court, the Commission, and the company's board of directors.

By October 1975, the Commission had filed law suits against seven large corporations, each of which alleged false and misleading reports and false and fictitious entries on the corporate books and records and requested the same type of relief, including an investigation and report by a special company review committee. Perhaps the best known of the reports received is the so-called McCloy Report, which

detailed the subterfuges and ruses resorted to in connection with some $12 million in political payments by a major oil company. Interestingly, the McCloy Report pointed out, as the Commission had asserted and as we had been told by other responsible individuals, that so-called "off-the-books" funds, regardless of their purpose, "have no place in any publicly-owned company." The Report went on to state that: "the opportunities for abuse in the operation of such funds are manifest. Moreover, the practice of keeping everything on the books is in itself a built-in deterrent to improper importunities from outsiders."

The mounting number of Commission cases revealed a widespread pattern of clandestine corporate payments to both domestic and foreign interests. These payments included bribes, campaign contributions, kick-backs, so-called grease payments, and sham bonuses and commissions. No issue in recent SEC history has been more controversial or more topical. Many revelations became front page news. Abroad, several foreign governments were affected; at home, such fundamental issues as corporate morality, business integrity and management accountability were heatedly debated. There was a great deal of interest in the Commission's reasoning for the actions it had taken and the disclosures it had required and a desire that disclosure guidelines with respect to questionable activities be given to the business community.

On May 12, 1976, the Commission released a report entitled "Questionable and Illegal Corporate Payments and Practices" which was submitted to the U. S. Senate Committee on Banking, Housing and Urban Affairs. The report did not establish guidelines. It did, however, describe the situations we had encountered, the actions we had taken, and noted that virtually all of the questionable payment matters involved the apparent frustration of the system of corporate accountability through the deliberate falsification of corporate books and records or maintenance of inaccurate records. It also contained a proposal for legislation to deal with this problem and suggested that the creation by public companies of audit committees comprised of independent directors would serve to improve corporate accountability. Following our report, the New York Stock Exchange considered and approved a requirement that companies listing on the exchange establish independent audit committees.

In addition, legislation embodying our books and records proposals was passed by an 86-0 vote in the Senate last year, but the House did not pass such legislation before adjournment. The Commission continues to support the enactment of the legislation we recommended last May. Believing, however, that the serious record keeping abuses require prompt remedial action, last month the Commission published its rulemaking proposals to bring about the same

objectives. In doing so, the Commission cited its 1976 Report that:

> Many of the defects and evasions of the system of financial accountability represented intentional attempts to conceal certain activities. Not surprisingly, corporate officials are unlikely to engage in questionable or illegal conduct and simultaneously reflect it accurately on corporate books and records.

We also stated our belief that the proposals, while not directed solely to the problem of questionable or illegal corporate payments and practices, would serve to create a climate which would significantly discourage repetition of such abuses.

The first of a series of proposed rules requires public companies to maintain books and records which accurately and fairly reflect the company's transactions, including dispositions of its assets. The second proposed rule requires every public company to devise and maintain a system of internal accounting controls designed to provide reasonable assurance that all transactions are executed as authorized by management, and to meet certain other objectives articulated in the AICPA's Statement on Auditing Standards No. 1. The third proposed rule prohibits the falsification of corporate accounting records; and the fourth prohibits a company's officers, directors and shareholders from deceiving or obstructing accountants in

the discharge of their responsibilities in connection with the examination of the company's financial statements. In addition, the Commission has proposed amendments to its proxy rules requiring disclosure concerning the involvement of executive officers, directors or nominated directors in specified types of questionable or illegal corporate payments and of any corporate policy concerning such matters, because the proxy solicitation is the most direct opportunity that shareholders of a large corporation have to endorse or reject the stewardship of directors entrusted with the management of corporate assets. The comment period on these Truth-in-Bookkeeping Rules ends on March 11, 1977, and we would appreciate any comments you have by that date.

The Commission has also recently proposed another rule which should be helpful in deterring fraudulent promoters from preying upon the investing public. Our country's energy crisis has created an environment which is conducive to promotional abuses and excesses such as we experienced during the uranium boom of the 1950's, the hot issues markets of the 1960's and other speculative periods. We have already seen a virtual epidemic of fraudulent offerings of fractional undivided working interests in oil and gas leases by unscrupulous individuals, who have in recent years grossly abused the SEC's Regulation B, and who now improperly claim to be relying on statutory exemptions

and on Rule 146 for their unregistered offerings. I believe that the results to date of joint federal-state efforts in attacking certain Schedule D operators in literally hundreds of proceedings is a clear example of what we have been able to accomplish together, but it is obvious that there is much yet to be done.

There have been massive scandals in connection with several large tax-oriented oil and gas programs, but possibly the Tax Reform Act will dampen some of the unfounded enthusiasm for these programs. Unfortunately, it appears that the Tax Reform Act has heightened the popularity of tax shelters in the form of limited partnerships in coal leases. Moreover, securities are being offered on the basis of inventions which claim to increase horsepower and decrease the energy consumption and pollution of internal combustion engines or to make efficient use of other energy sources. I am sure you are also aware of other securities schemes in this area.

While we must be vigilant against those persons who abuse the capital formation system under the guise of energy development, we must also be careful that our regulatory and enforcement activities neither deter legitimate entrepreneurs and established companies in energy-related industries nor frustrate our country's developing energy policies.

On January 21, 1977, the Commission proposed a rule dealing with the so-called "issuer's exemption" which is not an exemption at all, but arises by implication from the definition of the terms "broker" and "dealer." There have been longstanding interpretive questions regarding self-underwritings under the Federal securities laws which have been exacerbated by the proliferation of tax shelters and somewhat exotic investments such as scotch whiskey warehouse receipts. Accordingly, the Commission determined to codify 40 years of interpretative lore in the form of proposed Rule 3A4-1 under the Exchange Act. The adoption of this rule may be helpful in curbing some abuses in these areas.

The proposal, which is in the nature of a "safe harbor", is intended to clarify the circumstances under which the so-called "exemption" is available to those persons directly associated with an issuer. The rule gives no comfort to issuers engaged in a pattern of offerings which is either so continuous or so repetitive as to suggest that the issuer is in fact engaged in the business of creating and selling securities. Under the rule, bona fide employees engaged in the securities offering efforts of an issuer must overcome three hurdles in order to avoid being deemed brokers. First, they must not have engaged in the distribution or sale of any securities in the preceeding two years. Secondly, the employees must perform substantial duties other than selling

the issuer's securities. This requirement is principally aimed at those firms that hire employees only to sell the employer's securities.

The rule is not, however, intended to penalize "start-up" firms in which the initiation of operational duties of employees is dependent upon raising sufficient proceeds to conduct business. In that instance, the "other duties" requirement will not preclude employees from selling securities on behalf of such a firm where regular business operations are to begin upon completion of the offering. Lastly, employees may not be paid on a basis related to transactions in securities, such as sales commissions. Those employees who only transmit prospectuses or respond to inquiries or other essentially ministerial functions in connection with securities sales are also "exempted," as are certain kinds of transactions such as those executed through a registered broker dealer or in connection with a merger. Notwithstanding any of the aforementioned provisions, the safe harbor of the rule is not available to persons who are disqualified under Section 3(A)(39) of the Exchange Act which includes those enjoined by a state or federal court.

In view of your extensive dealings in this area of broker-dealer issues, your comments concerning the proposal would be particularly helpful in determining its probable effectiveness. As we all know, the broker dealer regulatory

scheme instills a degree of professionalism among salesmen in the securities industry. Hopefully, proposed Rule 3A4-1 will assist in more effectively extending such standards to salesmen of tax shelters and exotic investments; and permit the Commission and state securities administrators to identify and examine the selling entities, and thus serve to deter abusive selling practices. The registration requirement may also have the effect of discouraging some undesirables from entering the business and the power to revoke registration should enhance the regulator's ability to put the unscrupulous out of business. While broker dealer registration does not guarantee good behavior, it may result in bringing selling practices more in line with legal and ethical norms, so that greater attention will be paid to suitability, recordkeeping and general supervision of salesmen. The deadline for written comments on this proposal is March 21, 1977.

Because fraudulent Schedule D operators have been driven underground and are claiming Rule 146 as a shield, you may wish to respond to the Commission's December release soliciting comments concerning the effectiveness of the rule and whether it should be revised, rescinded or retained. Ironically, Rule 146, which was designed to provide objective standards for determining when offers or sales of securities constitute a non-public offering, has been severely criticized by some members of the public as hindering venture capital.

Because the Commission does not have sufficient data upon which to rely to determine the rule's effectiveness, we have requested that comments and information with respect to the volume of transactions effected as well as practices that have been used in reliance on the rule be submitted by the end of this month. You should be aware that in the near future we will probably propose an amendment to Rule 146 which would require the filing of notices in connection with offerings made in reliance on the Rule.

There are other Commission proposals and activities which are of interest to you, and will be discussed in depth during the sessions of this Conference. We all recognize that no matter what rules and regulations are promulgated, there will be those who continue to defraud investors. However, if we rededicate our efforts and utilize our enforcement powers wisely and justly, we will promote investor confidence and our country will continue to have the finest securities markets in the world.