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THE STATE OF THE SECURITIES
AND EXCHANGE COMMISSION -- 1978

An Address By Harold M. Williams, Chairman

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It is, I understand, becoming something of a minor tradition for the Chairman of the Commission to use this forum as an opportunity to deliver to the bar a sort of "state of the union address" outlining where the Commission stands, what its priorities are, and what it hopes to accomplish during the coming year. I endorse the idea, and I want to continue in that tradition this evening. My experiences on the speaking circuit during the past eleven or so months that I have served on the Commission have convinced me that the position is one which offers the Chairman a fine platform from which to obtain wide coverage for his views, to describe new directions in Commission policy, and even to throw out some unpopular suggestions -- especially when those suggestions involve such issues as the ideal number of management directors on a corporate board. Nonetheless, I intend to hew to the "state of the SEC" format and refrain from making any new controversial proposals this evening. You should, however, know that, to be on the safe side, I am departing tomorrow morning on a long-planned trip to the People's Republic of China and will not be back in Washington until March 25. That should afford ample opportunity for any storms generated this evening to blow over before my return.

My remarks tonight will be -- God and the 1980 elections willing -- the first of five opportunities for me to offer you my perspective on the direction which the Commission is taking. When I accepted President Carter's invitation to lead the Commission, I believed -- and I still believe -- that the issues which the Commission's Chairman will face between now and 1982 are important enough to merit the five-year commitment he requested -- important not only to our economic future but also in terms of the respective roles of government and the private sector in the future design of our social, as well as economic, structure.

I came to the Commission in large measure because of my concern for the integrity of the capital formation process and the private enterprise system generally. Public confidence has been shaken -- confidence which must prevail if private capital markets are to survive and flourish. Questions have been raised, for example, about the

integrity of corporate earnings, about whether American business is run in the best interests of its shareholders and the larger society of which it is a part, about whether our equity markets are an attractive and fair place for the individual investor to place his after-tax investment dollars, and about the ability of small businesses to gain vital access to capital markets. For these reasons, in my judgment, there has never been a more important time in the history of the Commission to be its chairman.

As much of the balance of this program will demonstrate, the range and diversity of the commission's work is both striking and perhaps unparalleled in government. In the remainder of my remarks tonight, I will not attempt to cover all of the areas of the Commission's substantive responsibility in which important developments are likely to take place during the coming year. That task can best be left to the individual staff members who will treat subjects in which they are expert during the subsequent panels. Rather, I would like to discuss, as I indicated at the outset, a few of the broader areas which will be significant during the next 12 months and which will have far-reaching implications during the years to come. My objective is to examine a few important areas in which private initiatives -- rather than government domination or direction -- are being asked to provide solutions to complex problems. This forum is a particularly appropriate one at which to undertake that type of an over-view, since it draws together a large cross-section of the attorneys who practice before the Commission and who, therefore, share in the responsibility to implement and give content to the federal securities laws.

The State of Self-Regulation

For that reason, I would like to focus first, not on a substantive area, but rather on the principle on which a very large segment of the Commission's work is premised. That concept is self-regulation -- the notion, articulated by Congress in 1934, that, to the degree feasible, the securities industry should regulate itself, but with the guidance,

prodding, and over-sight from the Commission necessary to insure that self-regulation conforms to the principles underlying the federal securities laws.

The Commission, almost uniquely in government, relies on self-regulation to give life to its statutory mandate. That approach, in turn, entails the creation of responsibilities which fall, not just on the securities industry and the self-regulatory organizations alone, but also on accountants, attorneys, and other professionals who practice before the Commission. And, accordingly, in the last analysis, the price which is paid for the independence inherent in self-regulation is that, if the results are unsatisfactory, the private sector shares with government in the responsibility for that failure.

Most in the room this evening are attorneys, not members of the securities industry. Lawyers are not, of course, a statutorily regulated or self-regulated group in relation to the Commission. Nevertheless, it is difficult to speak of the state of the Commission's self-regulatory philosophy without also speaking of the state of our relationship with the bar. In a real sense, that relationship is not distinct from the Commission's relationship with the other groups over which it has regulatory jurisdiction since, by –and-large, it is through lawyers that corporate issuers, self-regulatory organizations, brokers, investment companies, and the other groups which comprise our constituency interact with the Commission. Historically, the relationship between the Commission and the securities bar has been excellent. One of the most important tasks facing the Commission is to preserve that relationship, to build upon it, and to protect it against forces which tend to cause its erosion.

Nonetheless, criticism of the Commission has emerged from sources suggesting that we are deserting the principles of self-regulation, reliance on the private sector, and cooperation with the private bar in favor of a more heavy-handed and adversarial attitude -- the type of attitude which reputedly characterizes the relationship between some other federal departments or agencies and both those whom they regulate and the bars which

practice before those agencies. At the outset, it is important to recognize the free flow of information and criticism between the Commission and its bar and regulatees is itself one of the sources of the Commission's strengths. At the same time, however, I think that changes are indeed occurring in the way that the Commission interacts with the private sector. I would like to approach that issue by examining some of the factors which tend to compel the Commission to hold those who practice before it, and those who are regulated by it, at arm's-length. Consider several illustrations:

First, the Securities Acts Amendments of 1975 inject into the Commission's relationship with the securities industry self-regulatory organizations pockets of formalism and opportunities for adversary stances never before present. Two examples should suffice to illustrate this fact. First, every self-regulatory organization rule change must today be filed with the Commission, published in the Federal Register, and exposed for public comment. Approval requires an affirmative finding that the proposal is consistent with the requirements of the Exchange Act; disapproval, an analogous expression of inconsistency. Further, Section 31(b) of the Amendments requires the Commission to review the rules of every self-regulatory organization to determine their conformity to the purposes of the Act, and to notify each selfregulator of the inconsistencies identified. Failure to make correction triggers its own set of complex, formal proceedings.

Second, the Government in the Sunshine Act, which took effect almost a year ago today, severely curtails the Commission's flexibility in acting on business before it. It is unlawful for the Commission's members to meet and dispose of agency business, whether in public or in private, without providing public notice. Commission meetings must be -- and are -- open to the public, except when the public interest requires otherwise and one of 10 exemptions is applicable -- exemptions which Congress drew to be of government-wide

applicability and which therefore necessarily fail to take fully into account the special needs of an agency which combines regulatory and law enforcement responsibilities in the manner in which the Commission does. When the Commission does meet in closed session, the Act contemplates public access to the record in some circumstances. Mistakes and misjudgments in the application of the Sunshine Act could expose the Commission to the threat of burdensome litigation which might well destroy -- and certainly complicate -- important regulatory and enforcement matters.

Third, the Freedom of Information Act opens the possibility that virtually any document in the Commission's possession may be subject to a request for public disclosure and may, indeed, be required to be disclosed by a court in the exercise of the judicial authority to construe the exemptions to that Act. Obviously, the combination of the Sunshine Act and the Freedom of Information Act enormously complicates the ability of the Commission to communicate informally -- either orally or in writing -- among its members, with its staff, and with the private bar.

Finally, in the Home Box Office decision, the court of appeals for this circuit seems to have, at minimum, cast some doubt around the question of the standards which govern the ability of an agency to exchange information freely and with something less than on-the-record formality with those concerned or knowledgeable regarding regulatory proceedings. Moreover, in the Natural Resources Defense Council litigation, the Commission itself is enmeshed in a judicial challenge to its ability to decide not to adopt rules, even in informal, quasi-legislative proceedings, without mustering the type of record support traditionally reserved for formal adjudications.

I don't mean to suggest that any of these developments are necessarily wrong-headed or ill-motivated. It may well be that the law has previously tolerated cozier relationships between regulators and regulatees than are acceptable or consistent with effective government. That perception is certainly one which seems to be widely held, and its manifestations in legislative policy continue to appear. In any event, however, each of the new legal parameters I have mentioned, whatever its actual impact on our work, rests on important and deeply-held public policy grounds. But each also -- and perhaps the whole more so than the sum of the parts -- has the effect of compelling the Commission to act more formally and more "legalistically" in situations where informal solutions would previously have been possible. The trend of the law has been forcing us into increasingly more formal modes -- even, indeed especially, in dealing with the self-regulators.

For those reasons, I believe that the perception that the Commission is moving away from a spirit of openness and interchange with its bar and its regulatees is in some measure a result of changes beyond our control in the legal environment in which we must function. If the concepts of self-regulation and self-discipline, as the Commission employs them, are subtly changing -- whether for the reasons I have listed or others -- we need to recognize that fact and to understand why it is occurring so that we may explore the causes and determine their remedy. The Commission will endeavor to be as sensitive and as attentive to the needs and the role of the private sector within its jurisdiction as it has been in the past.

With those thoughts as a background, I will not turn to the discussion I promised earlier of some of the broad areas of change and development which will be significant during the coming year.

The National Market System

I want first to look at the securities industry itself. The challenges facing the industry today stem in part from the abolition of fixed commission rates on May 1, 1975, and will extend through the creation of the Congressionally-mandated national market system. Changes in the American economy have unquestionably adversely affected investor confidence in the securities markets -- particularly the equity markets. For whatever reasons, investors who would likely have committed funds to corporate equities 15 years ago seem increasingly to be diverting those funds to other investment vehicles, some of which are tangential to the process by which new capital is formed. In turn, the ability of broker-dealers to command stable income streams from equity underwritings and other equity-based activities has changed and, in many cases, been diminished.

From the viewpoint of the securities industry, these effects, moreover, have been magnified greatly by the elimination of fixed commission rates. For example, the industry has seen institutional brokerage rates drop more precipitously than was generally predicted in 1975. The result has been a virtual elimination of institutional brokerage as an important profit center for many firms. Some firms have been forced to go out of business, while others have merged with larger firms. And, particularly in the last year, we have seen an emerging trend toward consolidation and concentration in the industry as a number of very well known and major firms combined to strengthen or shore up their competitive positions.

While the economic challenges facing the securities industry are complex, in many ways the structural challenges may be still more difficult and unsettling. In 1975, the Congress directed the Commission, "having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets, to use its authority to facilitate the establishment of a national market system for securities" in accordance with specific Congressional findings and objectives. Facilitating a national market system is among the most difficult and challenging of the many tasks that

Congress has assigned to the Commission, and the Commission has moved cautiously, both in the interest of encouraging private sector initiative and also because changes that effect market structure must be carefully considered. On January 27 of this year, the Commission announced a time-table for certain stages in the development of the national market system, including the establishment of various order-routing, market linkage, and limit order protection systems.

Although the subject is fascinating and important, I will not delve further into the development of the national market system this evening. From the perspective of the state of the balance between regulation and self-regulation, suffice it to say that, in my view, the underlying premise on which the Commission's release is based is that the achievement of a national market system should remain essentially a private sector task. During the past several years, the various elements of the securities industry have been unable to work together toward the national market objectives Congress laid out 1975. The Commission believes, however, that its blue-print for the implementation of the system, outlined in the recent release, provides the opportunity for the industry to move ahead if it is so inclined. We will continue to provide guidance where necessary -- indeed, we are required by the Act to do so. In the absence of an affirmative industry response, we will move aggressively and fill any void. The thrust of our plan is, however, to guide the industry in its own effort at developing a national market system, not to replace or displace that initiative.

Options Study

I want also to touch briefly on a second area involving the securities industry. Last October, the Commission announced the initiation of a general review extending to all aspects of the trading of standardized options and the regulation of that trading. This study was instituted because of Commission concern regarding the present ability of the existing surveillance systems to detect and prevent fraudulent, deceptive, and

manipulative activity -- both in options and in related underlying securities -- in a manner which is consistent with the maintenance of fair and orderly markets and the protection of investors. Further, the Commission's study will inquire into the adequacy of existing Commission and self-regulatory rules to prevent fraudulent, deceptive, and manipulative acts and practices in connection with options trading, and the relationship between the development of standardized options markets and the development of the national market system for securities. The Commission has assembled a talented and diversified staff from among its various units in order to conduct this study, and much of the groundwork and preliminary steps in this complex undertaking have already been taken.

The moratorium on further expansion of pilot options trading programs, which was announced simultaneously with the general options review, has engendered criticism from some of those affected. However, the rapid growth of options trading demands careful study before that trading can be permitted to expand freely. One of the chief goals of our review will be a strengthening of self-regulatory efforts as they apply to options trading. Accordingly, I want to emphasize that the moratorium and accompanying review do not signal any sort of change in the Commission's philosophy of reliance on self-regulation and self-regulatory surveillance, either in the options markets or elsewhere.

Accounting Profession

Another area in which concepts of self-regulation are being tested involves accountants. Last spring, a Senate Subcommittee chaired by the late Senator Lee Metcalf held public hearings concerning the accounting profession. Those hearings, the staff study which proceeded them and the committee report which followed, are part of a broad Congressional and public re-examination of the accounting profession. That examination has served to highlight the increasing concern over the important role in our economic life of a profession which, in the past, has enjoyed relative obscurity. Despite

Senator Metcalf's recent death, Congressional scrutiny of the accounting profession seems unlikely to abate. Earlier today, Congressman John Moss, who chairs the Subcommittee on Oversight and Investigations of the House Interstate and Foreign Commerce Committee, called all of the members of the Commission before his Subcommittee in order to discuss with us the pace and direction of the profession's efforts at self-regulation and the Commission's role in the oversight of that segment of the accounting profession which audits the financial statements of public corporations.

I have stated on several recent occasions that I have very little desire to preside, during my years as Chairman, over increased Commission regulation of accountants. Nevertheless, it is quite clear that time is rapidly running on the opportunity for the profession to demonstrate through voluntary initiatives that it can effectively take responsibility for its own self-governance. I do recognize the substantial strides the profession has made in a relatively few months to develop the AICPA Division of CPA Firms as a framework for a voluntary self-regulatory program. The success or failure of the AICPA self-regulatory program will depend ultimately on the commitment, resolve, and dedication of the five individuals who serve on the Public Oversight Board, the body which has been created as a sort of independent board of directors for the Institute's new SEC Practice Section.

There are a tremendous range of developments affecting the accounting profession which will substantially influence its course during the coming years. In addition to the AICPA's fledgling effort at self-regulation, the final report of the Commission on Auditors Responsibilities and the FASB conceptual framework project are certainly among the most important. The Commission has obligated itself to report annually to Congress on the progress of the accounting profession in addressing the issues before it, and the first of our reports is due to be filed on July 1, 1978. Whatever the content of that report and its successors, I think it is fairly clear that, four years from tonight, accountants who practice under the federal securities laws will be members of a

profession structured and disciplined much differently than that which is familiar to us today.

Investment Companies

Another area in which self-regulation may well play a greater role in the coming years is in the balance between Commission and private initiative in the oversight of investment companies. In my view, the Commission should begin a process of re-examining the relationships that have evolved between the Commission and mutual funds, their directors, counsel, and professional advisors. When the relationship is in proper balance, we have an opportunity to play an important role in the orderly development of industry practices and to remain an active, visible, and positive factor in the marketplace. However, through the years it seems that there has developed an increasing dependency on the Commission and its staff to pass upon the legal implications and, more fundamentally, the desirability of general business practices, individual transactions, and available alternatives to respond to real or perceived ethical dilemmas.

When that dependency becomes too great, there is a natural tendency for the regulated entity to disengage from the responsibility of making difficult decisions and to allow the exercise of the regulator's judgment to substitute for that of the private sector. In such an environment, regulation is not playing its proper role. By involving ourselves too directly in the day-to-day business decisions of investment companies, or holding ourselves out as willing to do so, the Commission loses an important perspective and deprives the industry of the rewards that the exercise of its own creativity could bring it. During the next few years, I believe that the Commission will search for ways in which investment companies can assume more of the responsibility for their own future.

Corporate Accountability

I want to turn now to challenges facing the corporate sector of our economy. Questions are being raised concerning the legitimacy of corporate power -- its magnitude, the purposes to which it is put, and how those in the corporate sector who wield what is perceived as massive power should limit its use. In my view, the corporate sector, if it is to retain the degree of freedom and autonomy which it enjoys in this country, must respond to these criticisms and questions -- not defensively and reactively -- but rather by developing, through its own resources, a corporate structure which better assures that those who exercise corporate power are held accountable for the consequences of their stewardship.

Some aspects of the Commission's work, particularly in the area of questionable payments and management remuneration, have served to highlight instances of abuse and undoubtedly have stimulated discussion and examination which would not otherwise have occurred. Further, the Commission does have the responsibility to police the fairness of the corporate suffrage and proxy solicitation process, and, pursuant to those responsibilities, the Commission held hearings this past year on shareholder participation in corporate governance and shareholders' rights. Unfortunately, the corporate sector is not adequately aware of and sensitive to the trends and changes in public attitude toward business, and I believe that the Commission's hearings made a contribution to the educative process. The very existence of the Commission's proceedings, the amount of attention focused on the issues, and the number of people who appeared and covered the hearings contributed significantly to that function. Similarly, shareholder proposals and shareholder litigation can also have a constructive effect in stimulating companies to recognize the problem of accountability.

Beyond that, I think that the Commission's role -- and the role of government generally -- is to help create an environment which encourages corporate accountability and to stimulate the private sector to take advantage of the opportunity which that

environment affords to earn and maintain public trust. In that spirit, rule proposals or legislative suggestions may well emerge from our corporate accountability hearings, although the staff has not yet completed its examination of the the submissions nor made recommendations to the Commission. In many ways, however, government's role in the evolution of the mechanisms of corporate accountability should be very limited.

Government -- and I expressly include the Securities and Exchange Commission -- does not have the requisite wisdom to be prescriptive and, as I have indicated, the area does not, in any event, lend itself to solution by prescription.

Capital Formation

Perhaps the most serious challenge facing our economy, and the one which demands the most in terms of confidence and positive action by the private sector, is the need to generate sufficient new capital to meet our economy's requirements during the balance of this century. A number of recent studies have shown that the economic and social demands that will face us by the early 1980's require that the rate of investment and saving substantially accelerate. The New York Stock Exchange, for example, estimated in 1974 that the gap between actual and required capital formation would grow to \$650 billion by 1985. More recently, in 1975, Treasury Department economists arrived at a still more disconcerting forecast -- a cumulative short-fall of about \$2.5 trillion measured in then-current dollars. The point, I think, of these figures is that, in the final analysis, the future vitality and viability of our private enterprise system depends, not on government action, and not on any other factor external to, and uncontrollable by, business. It is the confidence and courage of our business sector, and the willingness of businessmen to act and to invest on the basis of that confidence and courage, which will determine the kind of economic system with which our country operates in the future.

There are, however, certain steps within the range of the Commission's jurisdiction which can be taken to help alleviate some of the problems frustrating capital

formation today. For example, the depth and liquidity of our capital markets -- and the trust and confidence which those markets instill -- are factors which are closely linked to formation of new capital from the investing public. The evolution of the national market system requires that the linkage be borne in mind.

Further, it is vital that the Commission be sensitive to its obligation to refrain from imposing or maintaining any regulatory burdens on public corporations unnecessary to implementation of the federal securities laws. In that connection, the Commission recently received the final report of the Advisory Committee on Corporate Disclosure -- a body on which I served before becoming Chairman. That report contains a number of valuable suggestions which, as the Commission set forth in a recent release, we are in the process of considering. In particular, the advisory committee recommended that the Commission devote special attention to eliminating some of the obstacles which small and start-up businesses face in utilizing the public capital market. Because of the importance of that issue, we have announced public hearings, which will commence during April and will convene in a number of cities across the country, in order to obtain the widest possible input concerning the steps which the Commission should be taking to facilitate capital raising by small business.

Finally, a theme which I have sounded in a number of recent speeches is the importance of public and business understanding of the extent of our need to generate new capital and of the limited ability of present levels of corporate profits to satisfy that need. I think that the Commission's obligation is to help investors and business to understand the meaning and magnitude, in real terms, of corporate profits; our existing replacement cost disclosure requirements are a small step in that direction.

Enforcement Program

No treatment of either the state of the SEC or of the state of the concept of self-regulation would be complete without reference to the Commission's enforcement

program -- a program to which at least half of our Commission meetings and a substantial portion of each Commissioner's time is devoted to overseeing. During 1977, as in recent years, the Commission has received justifiable praise for the vigor and effectiveness of its enforcement efforts and also some criticism of those efforts. I am committed to maintaining the strengths and creditability of our enforcement program. The enforcement tools which Congress has conferred upon the Commission are potent and have profound effects both on those against whom action is taken and on those who look to those actions to perform an educative process concerning the Commission's conceptions of the standards imposed by the federal securities laws. My fellow Commissioners and I will continue to direct the development and implementation of an enforcement policy which serves the ends embodied in the federal securities laws, and will strive to maintain the careful balance which has prevailed in the past between enforcement remedies and regulatory devices as means to those ends.

Conclusion

I have tried this evening to touch upon some of the issues which I see as the most important and far-reaching in terms of potential impact on the Commission and on those who practice before it during the coming years. My emphasis has been primarily on those areas where reliance has been -- or should be -- placed on private initiative rather than on direct government action. Perhaps I was, at the outset, somewhat too optimistic in promising an outline of "the state of the SEC." Judgments would necessarily vary, and I would not quarrel with those who suggest that other issues should have been included.

In any event, I think that several points are clear. First, many important and complex tasks face the Commission during the next year and during the next four years of my term as Chairman. The manner in which these issues are resolved, both by the Commission and the private sector, will have fundamental and profound impacts on our securities markets and our economy during the coming decades.

Second, the Commission continues to be committed to the principles of self-regulation and the concept that the private sector should have the freedom and the responsibility to shape its own destiny subject to the oversight and guidance vested in the Commission by the federal securities laws. The question, ultimately, is how the concept of self-regulations, as Congress formulated in 1934, can be preserved and strengthened as other elements in the legal environment in which it operates change.

And finally, that observation brings me to the point which I want most to stress to this particular group. In many ways, the private sector, especially in relation to the securities laws, looks to its counsel to aid it in shaping its responses to changes in the regulatory and self-regulatory environment. Accordingly, if the private sector is unimaginative and reactive in attempting to meet the demands and expectations to which it must respond, its counsel must share in the responsibility. For that reason, the corporate lawyer, in his role as counsel and adviser, has a crucial position in the future of self-regulation and self-governance. He can be the mechanic -- a highly skilled but essentially non-professional technician -- and thus a perpetuator of many of the problems which inevitably lead to demands that government be given tighter control over the private sector. But counsel can also chose to bring to bear his broader vision and sense of responsibility. Corporate leaders, and those who advise them, including many in this room, must realize that each issue cannot be treated as a discrete, narrow case, but rather must be seen as a part of a much larger pattern in the mosaic reflecting the relative roles of the public, government, and business in our private enterprise system. We are now mounting the pieces of that mosaic. If the corporate community, including its counsel, does not like the picture at the end, it should begin by blaming itself.