

“Where Are We Headed?”

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26th Annual Manuel F. Cohen Memorial Lecture
The George Washington University Law School
April 5, 2006

It’s a special pleasure and an honor to return to this wonderful law school, where I taught in the early ’80s, to present this year’s Annual Lecture honoring legendary SEC Chairman Manuel F. Cohen. It’s poignant for me, the 26th Chairman of the SEC, to speak at the 26th Annual iteration of this lecture. “Manny,” as he was called by everyone who knew him, was Chairman when I began my legal career at the SEC in 1968. I was privileged to know him, and to work for and with him. For me, it’s an added joy that this event is co-sponsored by an organization near and dear to my heart — the SEC Historical Society.

Manny is universally regarded as one of the SEC’s most energetic, dedicated, and brightest leaders, and I can personally attest to his impressive intellect and work ethic. It made a great impression on me as I was just starting out, especially because I viewed Manny as a role model. We were both from Brooklyn. We both attended Brooklyn College. We both came from lower middle class backgrounds and worked odd jobs, like driving a taxi and selling cookies, to get through college and law school. To me, Manny epitomized Brooklyn College’s motto, one etched in my brain and heart, “Nil Sine Magno Labore” — no achievement comes without great labor.”

One of my dearest friends, and someone who worked at the SEC when both Manny and I toiled there, and then became Manny’s law partner, the late Art Mathews, described Manny in his moving GW Law Review article “Manny, We Miss Your Sparkle,” this way:

“He was vintage Americana: The son of a Brooklyn milk truck driver, he pursued two of our country’s great equalizers — education and government service — and demonstrated how well they provided significant opportunity to any individual regardless of means or influence.”

Manny practiced law in a small law office in Brooklyn before coming to the Commission in 1942, eight years after the SEC had been created. Even at six years out of law school, he was considered a junior attorney, and as such, commanded an annual salary of \$2,300. By way of comparison, when I arrived at the SEC in August, 1968, twenty-six years later, the salary of a junior lawyer had reached the lofty height of \$7,900. Of course, starting legal salaries at Wall Street law firms had just risen to \$15,000, an unheard of sum for folks with no training and no experience.

Manny eventually worked his way up the ladder to become Chief Counsel of the Division of Corporation Finance, and then became that Division’s Director before being appointed to the Commission by President Kennedy, and ultimately being appointed the agency’s Chairman by President Johnson. Participation in America’s securities markets increased dramatically in the ’60’s. Manny took over a Commission that was able but overburdened, and he worked it even harder, to achieve peak performances. He rejuvenated the Commission’s vaunted enforcement program; instituted mutual fund

reforms; took a fresh look at disclosure; addressed market structure issues; and even saw the SEC become the first independent regulatory agency to obtain a computer.

His achievements are far too extensive to permit me to catalogue here, and that's not really the purpose of this lecture, after all. Today, I'd like to take this opportunity to talk with you about where securities regulation is headed, and the critical issues the SEC and our capital markets must confront in the coming months and years, with my emphasis on the concept of self-regulation. If Manny were here, he'd probably remark that, despite the passage of so much time, many of the issues look the same as they did back when he was leading the SEC. Of course, before we can figure out where we're likely headed, it's important to understand from whence we came.

In that context, I'm reminded of the story of Supreme Court Chief Justice Oliver Wendell Holmes, who found himself on a train one morning, but couldn't seem to find his ticket, despite a frantic and thorough search. The conductor, observing all this, tried to reassure the Justice by saying "Mr. Chief Justice, that's okay. I'm sure you'll eventually find it. Just send it back when you do." Holmes, moderately upset, replied: "My good man, my problem is *not* that I can't find my ticket; my problem is that, without it, I don't know where I'm headed!" The Twentieth Century's greatest sage — Yogi Berra — aptly put an exclamation point on that story when he observed, "if we don't know where we're headed, we're apt to wind up someplace else!"

I think we can all agree that, over the past five years, we've wound up someplace else. We've witnessed a breathtaking parade of transgression that reflects an alarming failure of corporate governance and transparency, as well as serious fiduciary misconduct. As scandal after scandal hit the front pages, it shouldn't be any surprise that investors, consumers, clients and customers began doubting the integrity of *all* businesses, not just those involved in the particular scandal. There've been some common themes in all these scandals — a lack of fidelity to fiduciary duties, a gross insensitivity to conflicts of interest, and the elevation of profit-making and profit-taking over client and customer interests. It's no wonder that people began to lose faith in American businesses.

The result has been hastily and poorly drafted legislation — Sarbanes-Oxley, or S-Ox as we lovingly refer to it in DC — an overuse of regulation to attempt to define ethical and moral standards, and pernicious and destructive prosecutorial competition between self-regulatory organizations, the SEC and state prosecutors. All this misconduct, coupled with scandals involving analysts, ipo's, mutual funds, pension funds, and hedge funds, have created a great deal of concern on the part of the SEC and a lot of work for the lawyers who practice there on behalf of private sector clients. In the time available, I'd like to discuss some of the critical issues and some of the solutions that we'll need to find, and then try to respond to your questions.

Given the problems experienced by and in the financial services industry, and the advent of new technology, one of the most pressing issues facing our capital markets involves the future of self-regulation. The dynamics have changed dramatically, especially over the past year. The US boasts two principal equity exchanges — the NYSE and Nasdaq — and both are now public, for-profit, entities. When the securities laws were first passed, no one assumed that stock exchanges would be public entities, subject to the potential of conflicting pressures from both their members and their shareholders. Nor did anyone assume that exchanges would acquire one another, or potentially do so, as we've seen transpire recently.

Manny fervently believed in self regulation. So do I. Even before there was an SEC, so did Theodore Roosevelt. In a speech to the American Society of Corporate Secretaries, Manny echoed the former President's warning. He said: "Many years ago Theodore Roosevelt warned of the danger that governmental business supervision would become governmental interference 'if the business leaders of the business community confine themselves to thwart the effort at regulation instead of guiding it right.'" This is valuable advice, well worthwhile revisiting and following today.

The securities industry's unique. For one thing, it's the lifeblood of our capitalist system, and the engine that drives our standard of living, corporate competition, and the delivery of all the products and services that make up our free economy. For another, Congress gave it the privilege of regulating itself, at least in the first instance. This is a rare public trust, bestowed on precious few industries. It's a trust to which that industry must constantly be devoted, and against which it will continuously be measured. The most important facet of self-regulation — and the one that is also most often overlooked — is that self-regulation provides an *extra* layer of protection for investors. Government can define what conduct is legal and that which isn't. But, government can't legislate ethics, morality and good business practices. Those latter efforts — ethics, morality and good business practices — are the province of enlightened industry. Over the course of the last five years, we've seen far too little effort toward developing these standards.

There are many different means to achieve the same desired goals. In general, my preferred approach to any regulatory issue is one in which the government's participation is as limited as reasonably possible, while vigorously ensuring that the public interest is protected. Congress can legislate new legal standards, as it did in S-Ox. Government can engage in regulatory reform and strong enforcement, as the SEC has done with unprecedented vigor over the past five years. But, in the end, it's incumbent upon the private sector — those who are responsible for making our markets function — to ensure we meet and exceed the highest standards for professional conduct. Regulation can never substitute for people doing their jobs honestly, dedicated to serving their customers as the fiduciaries they are. But, to minimize the need for, and importance of, government regulations, businesses have to be willing to take the lead and self-regulate.

This point is illustrated in the different context of modern medicine. Similar to the securities industry, doctors confront a surfeit of laws, regulations and codes of ethics, designed to make them act the way we expect and want them to act. But no matter how many laws, regulations or codes exist, doctors must do what's right as a matter of habit and ethic, not because someone's looking over their shoulders. There are so many times when no one looks over a doctor's shoulder, frequently involving life-and-death situations. When doctor and patient are alone, the patient's first, last and best refuge is the doctor, not the rulebook. Regulation can't substitute for doctors doing their jobs honestly, in a manner serving the best interests of their patients.

Our markets, and indeed our entire economic system, are the envy of the world because of the tremendous benefits of competition. It is the role of government to provide an environment in which innovation and creativity are rewarded, competition can flourish, and where market participants can compete fiercely but fairly on a level playing field. Through these competitive, creative, innovative markets, the investors we protect can take resources husbanded for retirement, illness, education or better living standards, and cause them to continue to grow, and new industries and technologies can evolve, making our lives more productive and more enjoyable.

As we have moved into a world of for-profit exchanges, it seems clear that the existing exchanges are no longer capable of providing the kind of self-regulation Congress had in mind when it passed the federal securities laws, and that investors continue to need today. As a result of these changes in the marketplace and the SRO ownership structure, the SEC, Wall Street leaders and market members are currently undertaking a significant re-examination of the SRO system, its inherent conflicts of interest, and possible structural reforms. In March 2005, the SEC issued a concept release that sought comments on the role and operation of SROs and proposed a number of alternative approaches to the current SRO

model. The challenge will be for industry participants and government regulators to remember that Congress has been determined to rely on self-regulation as a fundamental component of market and broker-dealer regulation since 1934 – and to work together to rebuild the current SRO system into a self-regulatory system that functions effectively in the 21st century.

In that context, one of the most responsible suggestions I've seen has come from the Securities Industry Association, which has called for the creation of a hybrid self-regulatory organization, one that would consolidate various competing self-regulatory mechanisms under one roof. The critical notion is that, in order for self-regulation to work, and work well, self-regulators must recognize that the goal is to achieve greater compliance, not to simply rack up penalties and fines. Self-regulation works best when it instills in the regulated a true commitment to ethical ideals. Punishment is critical when people cross the line; but compliance, not punishment, is the ultimate objective. A single self-regulatory organization's critical if we are to achieve that result, and that balance.

Achieving that result will also require forbearance. That may seem a strange characteristic for me to suggest for regulators and self-regulators, but I assure you forbearance is essential. Those of you who know me know I'm an ardent football fan. One of the worst penalties in football is often replicated in the world of regulation and prosecution — it's called "piling on." Over the last five years, when misconduct has, at times, been rampant and shocking, we've seen a great deal of piling on. If someone violates the law, he or she should be punished and punished appropriately. Laxity in punishment only encourages laxity in compliance. But, what we've witnessed is a competitive mindset to enforcement, with self-regulatory bodies, regulatory bodies and various prosecutors all seeking to make their mark by attacking those who engage in misconduct. I believe in a system that uses enforcement effectively, but not repetitively.

A principle tenet of self-regulation has to be a division of labors between government and the self-regulator, with government also exercising oversight to make sure the self-regulator does what it's supposed to do. But, if a brokerage firm crosses the line, why is it in anyone's interest to have that firm sanctioned separately, but serially, by a self-regulator, the SEC *and* one or more State securities regulators or State Attorneys General? With all that manpower, we can give investors far more coverage if there's a division of labor, rather than a duplication of coverage or worse, competitive enforcement. I believe it's incumbent upon, and critical for, the SEC to take the lead in assuring that firms that violate the law are punished, and punished appropriately, but not punished again and again.

In addition, the mindset of regulators and self-regulators has to change. In recent times, the entire process of compliance examinations has become an alternative breeding ground for enforcement cases, rather than a collaborative effort to find problems and fix them before they become crises. I've often marveled at the effectiveness of the Federal Reserve Board's bank examination processes. If you ask folks at the Fed why their system works so well, as I have, they'll tell you that, in the first instance, the mind set of bank compliance and examination staffers is to *detect and fix* problems, not merely to expose and then punish mistakes. The SEC's compliance and examination regime has been badly broken for a long time — so much so that there are now legislative proposals to deal with that. But, the best solution in my view is to place the principal emphasis for compliance where it really belongs — in the private sector and with self-regulators, with government exercising careful and diligent oversight.

It constantly amazes me that smart business men and women don't understand that self-examination is the best preventative medicine. When I chaired the Commission, we floated a concept of requiring mutual funds and their advisors to contract for an independent and thorough annual or biennial self-examination, according to standards set by the SEC itself. The results would be reported to the boards of the respective bodies, and to the SEC. In that way, the SEC could become a more effective compliance regulator, and utilize its limited manpower resources much more efficiently. Alas, many businesses adhere to the logic my long-departed mother employed. A health nut who self-medicated,

she finally went to the doctor and learned she had terminal cancer. Her take on that was very simple. She told me, “I was never sick a day in my life until I went to visit the doctor.” What she overlooked was the fact that, just because she didn’t look for health problems, didn’t mean she didn’t have them. It only meant she didn’t know about them, and when she finally learned about them, it was, of course, way too late. Every day, we see that same terrible logic infecting so many otherwise smart business people.

One of the things that amazes me about the current environment is how willing the private sector is to abandon leadership on critical issues. As scandal after scandal has unfolded, the pattern we’ve seen repeated almost incessantly has been for businesses to sit back and wait for government to tell them three things —

- what they’ve done that’s wrong,
- why it’s wrong, and
- how it should be fixed.

And then, these same businesses are shocked when they don’t like the answers they receive from the government! Imagine that. The present climate shouts for additional efforts at self-regulation.

One pet peeve of mine in this context is witnessing how companies react when a government investigation is commenced of one or more of their business practices. Most companies put out a release that says, simply, “we’ve received subpoenas and we’re cooperating fully.” When I see that kind of statement, I sell that company’s stock short! What does the statement mean? It means absolutely nothing. Of course they’re cooperating. If a company receives a subpoena, it has not alternative *but* to cooperate. If you look at the dynamics, otherwise smart companies often sit back and wait for the conclusion of an investigation. But how can directors function that way? What if the potential allegations being investigated are real? Can directors sit still while misconduct may be ongoing? I think the question answers itself, and yet most companies confronted with this situation eschew self-regulation, and let the government tell them how to run their companies.

Congress and the SEC are addressing complex issues including corporate governance, hedge funds, rating agencies and executive compensation. In addition the current environment in the wake of recent corporate scandals has left confidence in business leaders severely shaken. Rather than retreat into silence and then rail against statutes when they’re drafted in a vacuum, like §404 of Sarbanes Oxley, it’s time for business leaders to emerge and to direct the regulatory and legislative effort so that it can efficiently function and restore the trust that’s been lost.

Self regulation of hedge funds, therefore, is essential. The SEC now requires hedge funds to register as investment advisers and intends to initiate examinations of their operations. Unfortunately the SEC has little experience in the operation of hedge funds. While some of the issues are similar to those of traditional investment advisers, many of the issues are more complex such as different levels of transparency for different types of investors, the allocations of trades among various vehicles, and the process of shorting stocks. The hedge fund industry can either band together and establish and adhere to a uniform code of conduct or it will stand at the sidelines as the SEC and the courts hammer one (or more) out for it. The industry will not appreciate the ill-fitting suit of armor that will result from the latter process.

Congress has announced it intends to pursue legislation of the rating agencies. It's become apparent that few people understand the process by which these companies rate debt securities, yet many people rely on their efforts during the purchase of debt securities. Their failures to catch events like Tyco, Enron and Worldcom have vitiated the public's trust in them. To date the agencies have claimed they enjoy First Amendment privileges — their theory being they're merely publishing an opinion that people are free to agree with or disagree. If that's true, I wonder why the accountants haven't pursued the same line of defense! In any event, the SEC has maintained that it doesn't have and doesn't wish to create the expertise to examine this industry. This leaves a vacuum waiting to be filled. Rather than waiting for Congress to fill it, the rating agencies should establish their own self-regulatory body that would be responsible for establishing standards for rating agencies and the people who work for them and to examine the rating agencies periodically to ensure that they are following the standards. That would solve a problem before Congress has an opportunity to give the rating agencies a solution with which they surely will be unhappy. As Will Rogers has noted, let's be thankful we're not presently getting all the federal government we actually pay for!

Executive compensation is another critical SEC issue. Currently executive compensation decisions by public companies resemble the NFL's First Round Draft. The number one draft choice is paid \$43.8 million for seven year, and number 32 is paid \$4.3 million for four years, with the remaining 30 draft choices slotted in between those two. Executive compensation is handled much the same way. Compensation consultants appear before Comp Committees and tell them the five comparable companies, outline what the average compensation for relevant executives is at each of those companies and then recommend that companies award compensation of at least 75% of the average at these five companies. What's wrong with that picture? No one should have any objection to paying people large amounts of money to run modern corporations. Multi-national businesses have been the source of an amazing amount of prosperity and cultural change over the last half century.

But, at least in this Country, people should be paid only if they perform. Most boards fail to articulate what it is they want each senior manager to achieve, or devise a methodology for measuring how these managers have performed. Without those added elements, any compensation system is simply a give away. That's a sure fire prescription for disaster. The SEC's new compensation proposals are an important first step in the right direction. The agency is simply asking that boards disclose to investors in straightforward terms the basis for the compensation they award. If a board decides that the company's objective is improved cash flow or improved governance then the proxy should include that objective, the yardsticks that the board will use to measure the executives' achievement of the objectives and the resultant compensation. If there are no rational standards, then companies must tell shareholders that, but they can't leave it to surmise. Industry leaders can build enormous credentials for themselves if they take the initiative and respond to the SEC's effort by addressing the SEC's real concern that companies articulate objective standards for determining compensation. These same leaders will do themselves a disservice if they simply try to craft more legalese that complies with the letter of the regulations but misses their spirit.

It's perhaps fitting that accounting is the last topic I'll address this afternoon. In addition to his other accomplishments, Manny was the chairman of the Commission on Auditors' Responsibility, formed at a time when, in his words,

“The independent auditor face[d] a continuing challenge from many sources. Criticism in the financial press, the mounting disclosure of corporate scandals, and the astounding rise in litigation against independent auditors provide evidence of the challenge.”

That Commission sought to return integrity to the accounting profession by clearly delineating the roles of accountants, management and regulators, and then allowing each group to perform its job without interference. As we currently face similar issues in the accounting industry it's useful to re-examine the validity of the Commission's conclusions.

Currently there are two bodies seeking to promulgate accounting rules. The typical development is that the SEC requests the FASB to examine an issue, such as hedge accounting. After the FASB spends a significant period of time considering the issue, but fails to reach a consensus and thus a decision, the SEC makes a decision and forces registrants to adopt its accounting treatment. The result is often confusing, costly and illogical. The recent string of accounting restatements over hedging is an outcome of this process. Much time and money has been spent vainly attempting to determine if items are technically eligible for hedge accounting only to realize that no one is sure what the SEC's definitions mean. Then, after restating financials to avoid hedge accounting problems and to comply with the SEC's definitions, pro-forma financials are required to convey the economic results of the business as opposed to the accounting results. Investors are left to cry “a pox on both your houses.”

Once again, Manny and self-regulation provide an elegant solution. If the SEC has a policy issue, such as the abusive use of hedge accounting at Fannie Mae and Freddie Mac, or the activities of PIPES investors, it should alert FASB about its concerns. That organization needs to respond in a timely manner to the SEC's concerns and attempt to provide meaningful advice and instructions, not arcane statements that require an interpreter and an advanced degree. Accounting should not be used to regulate and accounting should be understandable to average investors. Anyone who's ever attempted to understand the pension footnote in financial statements will realize how far we are from that standard and how much work needs to be done!

S-Ox §404 could also benefit from self-regulatory thinking. Currently, auditing costs are skyrocketing as accountants and managements are attempting to interpret Congressional mandates, with the looming specter of plaintiff's counsel in the event the inevitable mistake occurs. Small and foreign companies are eschewing registration in the US because of the burden of complying with §404. The problem lies in the inability to interpret the statute in order to adopt it to different sizes and types of companies. Instead of being a separate law, the statute should be moved wholesale to the Securities Exchange Act of 1934. This would give the SEC the ability to interpret the provisions of the statute and allow the SEC to tailor the requirements of §404 to the risks posed by different classes of companies. Allowing the SEC to interpret and administer the regulation would allow industry to self-regulate, and the SEC to regulate, at the same time removing Congress from the need to tinker with the legislation to adapt to changes in the business world.

Of course, once the SEC is given appropriate tools, it should consider a phase-in of the remaining classes of public companies not yet covered by §404. Those companies could be divided into three groups. The first group could come on line in 2007, and consist of the largest public companies not yet covered by existing requirements. Instead of requiring a full-blown audit of their internal controls, however, or changing the definition of materiality as some suggest, the SEC could simply require that outside

auditors “review” the internal controls statements of management, exactly the way outside auditors review quarterly reports at present. That would diminish the costs of the review, yet continue to provide necessary protections to investors.

Although these issues may seem daunting and the solutions difficult to implement, Manny Cohen and those who went before us faced issues just as difficult and through inspiration, perspiration and a rigid attention to principles managed to survive and prosper. No matter how difficult your situation, with thoughtfulness, creativity, patience and exacting care, you can surmount almost any obstacle. In a difficult environment, tough standards, exacting procedures and policies will be rewarded. Count on it.