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The SEC at 70: Let's Celebrate Its Reinvigorated Golden Years

Harvey J. Goldschmid

The First Securities and Exchange Commission, July 1934

From left to right: Ferdinand Pecora, George C. Matthews, Joseph P. Kennedy, Robert E. Healy, James M. Landis. Photo courtesy of the Securities and Exchange Commission Historical Society and its virtual museum at http://www.sechistorical.org.

KEYNOTE ADDRESS

THE SEC AT 70: LET'S CELEBRATE ITS REINVIGORATED GOLDEN YEARS

*Harvey J. Goldschmid**

It is terrific to be back at Notre Dame, on this beautiful campus. This has been a first-rate symposium. In many ways, I wish I could put away my text—which I won't do—and just comment on the papers I have heard. At Lisa Casey's request, however, I will comment on Adam Pritchard's paper specifically.[1]

Let me start with what I think may be common ground in the room. The corporate and mutual fund scandals of the 1990s and early 2000s have been the most serious that have occurred in the United States since the Great Depression. It is no coincidence that the past two years have been the most active period in the SEC's history, with the possible exception of the early years following the creation of the Commission itself in 1934.

Historically, the great strength of the U.S. economic and political system has been its ability, in the face of scandal, to reform and heal itself. Indeed, we have often needed scandals to trigger reform. From September 21, 1929, to July 1, 1932, when the nation's worst financial scandals were exposed, the value of shares on the New York Stock Exchange fell from ninety billion dollars to just under sixteen billion dollars. Half of the new securities sold on the NYSE in the 1920s turned out to be worthless, or virtually so. The result was the 1933 Securities Act, the 1934 Securities Exchange Act, and the establish-

* Commissioner, U.S. Securities and Exchange Commission, on public service leave from Columbia University, where he serves as Dwight Professor of Law. This Keynote Address was delivered on September 24, 2004, at the Notre Dame Law School's symposium on "The SEC at 70," which commemorated the seventieth anniversary of the Securities and Exchange Commission.

1 The views expressed herein are Commissioner Goldschmid's and do not necessarily represent the views of the Commission, his fellow Commissioners, or the Commission staff.

ment of the SEC. These acts and the Commission itself remain the fundamental foundations that make our securities regulation system work today.

In historical context, there were reform proposals before 1933–1934. Woodrow Wilson proposed securities laws in 1918–1919, knowing that securities speculation would come after World War I. There were bills introduced from 1919 through 1927, but all were given almost no attention. It took the scandals of the 1920s and early 1930s to bring about reform.

Now, my remarks today are titled, *The SEC at 70: Let's Celebrate Its Reinvigorated Golden Years.* I added "reinvigorated" so Adam Pritchard would not equate "golden years" with feeble old age. Walking over, I asked Adam: "Would you mind if I called you a young academic curmudgeon?" Adam graciously said it would be okay. The curmudgeon reference and my title suggest my emphatic rejection of Professor Pritchard's "time-for-retirement" theme. But let me come back to that. I have great respect and affection for Adam, who was at the Commission a short time while I was there as General Counsel in 1998.

My remarks today come in two basic parts. First, I will provide a "progress report" on what the Commission has been doing during the past two years to respond to the scandals of the 1990s and early 2000s. I believe that the Commission's rulemakings (undertaken, in part, to implement and build upon the Sarbanes-Oxley Act) and enforcement efforts have gone far towards restoring investor faith in the integrity and fairness of our financial markets. At the end of this first part, I'll comment on Adam Pritchard's paper. Second, I will provide a sense, but only a sense, of the major agenda items with which the Commission still must grapple.

Let me begin by stating bluntly the basic bottom line (at least for me) of the scandals of the 1990s and early 2000s. We have witnessed a systemic failure. The checks and balances that we thought would be provided by independent directors, independent auditors, securities analysts, commercial and investment bankers, lawyers, and compliance personnel (particularly for mutual funds) too often failed. During the past two years, serious SEC rulemakings and enforcement efforts have come in each of these areas.

The first item on my "progress report" relates to certifications. Sarbanes-Oxley required them in various circumstances, but the Commission added to those requirements; they have been built into a good deal of what we have done. In reality, certifications do not add significant additional legal exposure. The certifications in Sarbanes-

Oxley—leaving criminal prosecutions aside (which only cover hard-core wrongdoing)—basically pick up what was already in the law.

When I was General Counsel of the SEC in 1998–1999, there was a private case on appeal from a California district court. The CEO in that case was willing to concede—at least during motions practice—that the financials were materially misleading, that they had been intentionally falsified, and that he had signed them. His defense was: "But you can't hold me liable, because I didn't read them." The district judge bought the defense. I instructed the Commission's staff to write an amicus brief, which could be very short. All it had to say was: "If you sign it, you take legal responsibility for it." That is what the Ninth Circuit held in *Howard v. Everex Systems, Inc.*[2] It is also what any sensible court would hold, and it provides the basic legal background to CEO and CFO certifications.

I don't doubt that certifications have greatly enhanced the quality of corporate disclosure in the United States. But they have enhanced it because of spotlighting an issue for CEOs, CFOs, and other senior managers—who now understand the importance of their signatures and have demanded that others further down in the company respond accordingly—not because of new legal exposures.

The panel this morning talked about corporate governance steps taken by the SEC. The most significant area has been the audit committee. The key role of the audit committee is an old SEC theme. It goes back to 1940 and a McKesson & Robbins investigation. The focus here is making sure that dispassionate, independent members of the board monitor the company's management and its independent auditor to help to ensure that the company is neither cutting too close to, nor crossing over, a GAAP or other disclosure line.

What the SEC did with respect to audit committees—in implementing and building on Sarbanes-Oxley in April 2003—was to strengthen what had already been established under former SEC Chairman Arthur Levitt. There had been a Blue Ribbon Committee that recommended effective reforms in 1998–1999. Its recommendations were adopted through listing requirements, SEC disclosure requirements, and accounting industry measures. In April 2003, the SEC built on the Blue Ribbon Committee's definition of independence for audit committee members. Interestingly, when that Blue Ribbon Committee reported in 1999, it recommended that the audit committee take "ultimate responsibility"—words used by the Ameri-

2 228 F.3d 1057 (9th Cir. 2000).

can Law Institute in the *Principles of Corporate Governance*[3]—for the hiring, the evaluation, and the firing, if appropriate, of the outside auditor.

As some in the corporate community read the new listing rule, they saw "ultimate responsibility" as somehow only compelling the audit committee to oversee the audit process, at roughly forty thousand feet, rather than to take hands-on responsibility. Listed corporations too often continued to hire and evaluate auditors in the traditional way: with management making the calls. Therefore, auditor loyalties were still being focused on management and not on independent directors. Sarbanes-Oxley and SEC implementing rules contain very powerful language, requiring the audit committee to take "direct responsibility" for the hiring, evaluation, compensation, and, where appropriate, firing of the independent auditor. This "direct responsibility" requirement, I believe, is producing a dramatic change in the outlook of auditors and audit committees.

We talked about section 404 of the Sarbanes-Oxley Act and internal controls this morning. Let me touch just a bit on the comments we heard. Section 404 is correctly described as the one (though I emphasize the word "one") large-dollar-cost item that comes out of Sarbanes-Oxley. The rest of the cost complaints are largely fanciful or involve relatively small amounts. Section 404 is the one big-dollar item. On the other hand, as the Chairman of the Public Company Accounting Oversight Board, Bill McDonough, correctly keeps putting it: "How can you have a strong reporting and disclosure system—or corporation—without strong internal controls? Won't the expense be worth it?"

Now, the PCAOB worked very hard to create fair and balanced internal control standards for auditors. It may be that by the spring or summer of 2005 we will have had enough experience with these provisions to evaluate how well they are working. Corrections that retain effectiveness—while removing wasteful wheel-spinning—should certainly be made. There is, for example, a legitimate issue about whether the framework for internal controls works as well for smaller public companies as it does for larger ones. Perhaps some costly requirements can be modified or removed without sacrificing effectiveness. But there is no question in my mind that public corporations need truly effective internal controls over financial reporting. The benefits are so large that the cost is clearly worthwhile for individual companies, investors of all types, and our financial system as a whole.

3 *See* 1 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 3.02, 3.05 (1994).

Let me turn to the SEC's enforcement program. Sarbanes-Oxley gave the SEC enhanced powers with respect to civil penalties, disgorgement, officer and director bars, and equitable remedies. In addition, more powerful substantive criminal provisions and sanctions were provided to the Department of Justice. What Congress recognized with Sarbanes-Oxley is that if our securities regulatory system is to work, corporations and other entities, the individuals who comprise them, and the various "gatekeepers" in our system must know that they are likely to be held accountable for wrongdoing. Effective deterrence requires a strong, credible threat. It is that "threat" that creates powerful incentives to avoid wrongful acts and to bring about the cultural, procedural, and process changes necessary to restore integrity and protect investors. For me, accountability and deterrence are the key words in the Commission's enforcement approach today.

Let me give you a feel for how important enforcement has become in the Commission's reform efforts. When I went back to Columbia Law School after having served as the SEC's General Counsel in 1998–1999, I'd indicated to a class that the SEC could bring roughly 350 to 450 cases a year. These covered a broad landscape, including cases involving broker-dealers, investment advisers, insider traders, and disclosure failures. In fiscal year (FY) 2001 (the fiscal year ends on September 30 for the government), the SEC had already become more active. The number of enforcement cases that year had risen to 484. In FY 2003, the SEC brought 679 cases. In general, these cases were more important, larger, and more complex than those brought in earlier years. With respect to financial fraud, in FY 2001, which was a big year, the SEC brought 112 cases. In FY 2003, the number was 199.

Officer and director bars are a powerful deterrence tool. An officer and director bar means that you cannot serve in a public corporation again as an officer or a director, or that there is a time frame during which you cannot serve. In FY 2001, there were fifty-one of these bars. In FY 2003, the number had reached 170. I have not looked at the FY 2004 figures (the year is just closing), but I suspect they will be roughly the same as 2003.

In terms of civil money penalties and disgorgements, the numbers are off the page. In FY 2002, the SEC exacted its first ten million dollar civil money penalty from a public corporation. There were twenty penalties of ten million dollars or higher in FY 2003, and the number will be even higher in 2004. In terms of the dollars involved, in FY 2003, the amount of civil penalties collected by the SEC was higher than during the prior fifteen years combined. Also, in terms of deterrence and accountability values, SEC policy now prevents civil money penalties from being insured, indemnified, or used for a tax deduction. If you—an individual or an entity—are a serious wrongdoer, you will be hit in your own pocket and will be unable to pass the penalty on.

In the criminal area (which is not my area of expertise), let me give you some feel for enforcement policy. Clearly, we should use the criminal laws carefully, but there is no more powerful deterrent than the criminal laws when appropriately used. In 1998–1999, Arthur Levitt crisscrossed the nation trying to get U.S. Attorneys interested in prosecuting hard-core fraud. The U.S. Attorneys never put it quite this way, but, I suspect, they were saying under their breaths: "These cases are major resource users. They are unglamorous. They are dull. Please take them elsewhere." The "elsewhere" was often the Southern District of New York and a few other jurisdictions, but, in general, very few U.S. Attorneys were willing to bring criminal securities cases, even in the most willful, hard-core areas. In FY 2003, there were 246 defendants indicted for SEC-related criminal activity. But the fascinating figure for me is that there were forty-eight different criminal authorities bringing those cases.

Now the large number of criminal authorities willing to prosecute hard-core wrongdoers, and the high-profile of the cases today, brings something very important to mind. There is a basic need for care so that we make sure that the criminal laws are used only for willful, venal activity. The SEC works with U.S. Attorneys to help ensure appropriate balance in the use of the criminal laws.

And I hasten to add that fairness, proportionality, and culpability continue to count. This system will not work unless good people continue to serve as officers and directors of public corporations. We must not unfairly frighten them away from serving.

I must emphasize that nobody at the SEC wants to diminish or interfere with risk-taking, with corporate entrepreneurial activity, or with appropriate corporate autonomy. From corporate risk-taking can come new products, innovation, efficiency, and healthy change. No case, to my knowledge (and I think I know of each and every one), has been brought that second-guesses honest business decisions of directors or officers. A fair number of business decisions to develop new plants or products—or otherwise innovate—aren't going to work out. No one is second-guessing those decisions. The message from the SEC is: if a business decision goes well, report it accurately in your financials; normally, that is easy to get people to do. If it goes badly, report that accurately as well. If you do that, we don't care that it went bad. Numbers of business decisions, as I keep saying, will go bad. But other decisions involving risk will lead to healthy change, to dynamism, to new products, and to all of the entrepreneurial things we need in the U.S. economy.

On the accounting profession, as I'm trying to move quickly in explaining what we have been doing, the new PCAOB is a godsend to the economy, the quality of our disclosure, and to the accounting profession itself. As Joel Seligman began to say in an earlier session, the PCAOB was needed because there had been a basic failure of self-regulation in the accounting profession. The disciplinary system didn't work; the rulemaking and quality review systems were highly questionable. The PCAOB now has the power to make everything work. It has a serious disciplinary process, but, even more importantly, the PCAOB is developing high standards for quality control and rulemaking.

Bill McDonough and his colleagues are a first-rate group. As is obvious, I am very optimistic about the role being played by the PCAOB. Indeed, my sense is that Sarbanes-Oxley, various SEC initiatives, the PCAOB, and the accounting profession's own efforts are now making a large difference. These combined steps have put us on the road to restoring the credibility, honor, and luster of the accounting profession.

Now let me turn to Adam Pritchard's paper. I have great respect for Adam, although his provocative paper obviously raised some questions in my mind. Unfortunately, I have time only to touch a few basic points. Adam argues that the Commission, an independent agency and not part of the administration or executive branch, is independent in name only, due to its dependence on Congress and industry. He wants to put me out of work by getting rid of the Commissioners, though I kept my tenure at Columbia, so I am okay. He maintains that greater independence can be achieved by abolishing the SEC and having its functions and staff incorporated into the Treasury and Department of Justice where, answerable only to the President, it would be less vulnerable to business pressure, industry capture, and political whim. Moreover, Adam asserts that the close connection between the SEC and Congress "fuels [a] cyclical pattern of neglect and hysterical overreaction."[4]

My discussion so far indicates my profound disagreement with Adam's last point. Neither in 1933–1934, nor in 2002 in Sarbanes-Oxley, was there "hysterical overreaction." Indeed, in the 1930s, and again in 2002, Congress provided critically important frameworks for maintaining and enhancing the public's faith in the integrity and fair-

4 A.C. Pritchard, *The SEC at 70: Time for Retirement?*, 80 NOTRE DAME L. REV. 1071, 1074 (2005).

ness of our financial markets. Nothing is more important to capital formation and to the overall strength of the nation's economy.

On the second point, in terms of the quiet life that I would like to lead, I wish Adam would convince the Business Roundtable, the U.S. Chamber of Commerce, and much of the financial community that the SEC has been captured by business interests. Neither they nor I see any current validity in the claim. As a historical matter, Joel Seligman, the author of *The Transformation of Wall Street*, which is the definitive history of the SEC, wisely concluded: "Few have suggested seriously that the SEC has been a 'captive' of the industries it regulates. Quite simply, such a suggestion cannot be sustained by a reasonable reading of the Commission's history."[5]

Of course there are subtleties here. The Commission's rulemaking process, by good sense and statute, includes a public notice and comment period. We want to understand the concerns of affected constituencies. At times, as may have happened with mutual funds, the Commission has been lulled into a false sense of security. At other times, it has made industry-oriented mistakes. But none of this represents "capture." Adam's general assertion of "capture" lacks historical perspective and, for me, has no touch of reality.

With respect to the SEC's relationship to the executive and legislative branches, my Columbia colleague and a former chairman of the SEC, Bill Cary, had the correct analysis. He concluded that "government regulatory agencies are stepchildren whose custody is contested by both Congress and the Executive, but without much affection from either one."[6] That is reality.

I am skeptical, to say the least, about Adam's assertion that the SEC would get more affection—or would be more effective—as part of the executive branch. But I am wise enough (at least while holding my present job) not to express an opinion about Adam's faith in the White House. It is, however, critical to understand that there are real advantages to being an institutional stepchild. While the Commission must obviously try to work well with both the executive and legislative branches, its separation from each of them affords it a meaningful measure of autonomy. Its autonomy and independent status have undoubtedly, in my view, provided the Commission with significant insulation from business and political pressures over the years, and this has worked very much in the public's interest.

Finally, Adam's dismemberment of the SEC would jeopardize the quality, transparency, continuity, and coherence of securities regula-

5 JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET xix (3d ed. 2003).

6 *Id.* at viii.

tion; it would also jeopardize the quality and dedication of the Commission's very talented staff. While reorganizing a weak agency on its seventieth anniversary might make sense, the SEC is now too vigorous and too vital for anyone to take Adam's proposal seriously. As Senator Paul Sarbanes put it recently:

> The challenge is not just to clean up recent scandals, but to create a solid framework for the future. In carrying out its responsibilities, the SEC is fortunate to have men and women of uncommon dedication and competence who have built its standing as the crown jewel among regulatory agencies.[7]

I agree completely with Senator Sarbanes's "crown jewel" point. To the students in the room: think about a career with the agency in Washington or in the regions. The SEC is a wonderful place to work.

I wanted to spend time on the agenda of the Commission, but we really don't have much time left. Let me list key items on a checklist of things to do this fall, winter, and spring. We have got to finish up on mutual fund reform. Much has been done, but there are still some disclosure issues and correctives for abusive timing and late trading that are needed.

Hedge funds, which are a lively political issue, will be coming back to the Commission. But don't pay any attention to those who tell you we are protecting only the wealthy in requiring registration of advisers to hedge funds. Hedge funds are no longer dealing just with the assets of the wealthy. More and more, the general public's savings and charitable funds are being put at risk. Hedge funds are involved with large and sharply increasing amounts from private and public pension funds, funds of hedge funds, and endowments and other charitable institutions. Under the rules of the game now, plumbers, cab owners, lawyers, and pharmacists all are qualified to invest.

Moreover, we know too little about this dramatically growing industry, and what we do know has alarm bells ringing, at least for me. Eight or ten years ago, hedge funds held roughly $100 billion in assets. In September 2003, an SEC staff report put the figure at $600 billion. When the Commission acted on its proposed rulemaking in July 2004, hedge fund assets were estimated to be $850 billion. Most estimates suggest that there will be a trillion dollars in hedge funds by the end of 2004. Furthermore, all of these figures are from industry sources and are unreliable. Some Wall Street estimates have suggested a $1.5 trillion figure. We need accurate information about the aggregate size of hedge funds, about how leveraged they may be,

7 Senator Paul Sarbanes, The SEC: A New Era, Address at the SEC (June 8, 2004).

about their trading patterns, etc. More—and more accurate—information will both protect investors and significantly enhance the Commission's ability to protect our securities markets.

Finally, there has been a recent increase in cases involving hedge fund fraud, both on hedge fund investors (e.g., involving misappropriation, false valuation, and fraudulent promotion) and on others. Canary Capital and too many other unregistered hedge fund advisers had a corrupting influence (e.g., through "sticky assets" and side payments) on mutual funds that resulted in the late trading and abusive market timing scandals. In my view, hedge funds are properly an important part of the Commission's fall agenda.

Rating agencies are on the agenda, as are a critical number of market structure issues involving the stock exchanges. There will be new proposals on disclosure and governance at our so-called SROs. And, of course, we have my favorite, the proxy access proposals, which I strongly commend to you, but will not bother to speak about now.

Finally, I would like to make a new proposal, inspired by a "golden age" at the SEC. From 1961 through 1963, while Bill Cary was Chairman, a Special Study of the Securities Markets was conducted. The Special Study was staffed by about forty full-time lawyers, economists, statisticians, and analysts, only a relative few of whom were SEC staff members. Joel Seligman concluded that the Special Study was "the single most influential document published in the history of the SEC."[8] The Special Study's findings and recommendations formed the basis for the Commission's reform efforts over the next decade or two. Today, globalization issues (e.g., with respect to corporate governance, accounting, and financial markets), the effectiveness of our disclosure and SRO listing and regulatory schemes, market structure issues, the appropriateness of the separate ways we regulate broker-dealers and investment advisers, corporate governance, and a number of other "large" issues could profitably be studied to help chart the Commission's course over the next ten or twenty years.

Let me close on an optimistic note. Over the past two years, serious SEC rulemakings and enforcement actions have occurred in area after area. Disclosure, officers and directors, accountants, lawyers, mutual funds, and others in the financial community have been dealt with sensibly and with balance. Serious commentators from the academic community and elsewhere will have to evaluate how well the SEC has done. I am certainly not an unbiased observer. Nevertheless, I am hopeful—and even confident—that these commentators will conclude that the current Commission has maintained and strength-

8 SELIGMAN, *supra* note 5, at 299.

ened the position of the United States as the world's leader in financial disclosure, financial market effectiveness, and corporate accountability.