

NEWS

**SECURITIES AND
EXCHANGE COMMISSION**

Washington, D. C. 20549

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AN INSIDE VIEW OF THE SEC REGULATORY PROCESS

ADDRESS BY

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Business and the Securities
Laws Seminar
Continuing Legal Education,
Utah State Bar Association
Co-Sponsors:
Brigham Young University
University of Utah
Salt Lake City, Utah
February 14, 1980

I appreciate the opportunity to participate in this seminar with such an impressive group of individuals. As we have already seen this morning, the subjects on the program will be discussed competently and in detail by experts in their respective fields. Therefore, it seems to me that the best contribution I might make is to provide my perspective on the regulatory activities of the Securities and Exchange Commission, and share some of my views as to how the regulatory process might be improved.

You should be aware that my comments do not necessarily reflect the views of my colleagues. Members of the Commission have different backgrounds, interests and biases and, sometimes strong differences of opinion. I am sure that my economics background, as compared with that of other Commissioners who are attorneys, has an effect on how I respond to the issues we consider. Coming from Utah, a state in which, by some definitions nearly all businesses are small businesses, and having participated in a small business as an investor, employee, and manager, as well as having done research reports on small business problems for the Bureau of Economic and Business Research of the University of Utah, I am sympathetic to the problems of small businesses. No doubt the general attitude against government regulation that has always existed in the inter-mountain area has also had an influence on me.

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Moreover, my experience has been that competition and the market forces of supply and demand generally regulate economic activities better than can be done through government intervention.

As a result of this background, I am not predisposed toward regulatory solutions to problems in the marketplace. However, abuses I have seen while serving on the staff of a Senate Committee and on the Commission have convinced me that market forces alone cannot be counted on to ensure the maintenance of business or professional standards and practices needed to protect the public interest. Thus, I believe that minimum acceptable standards must be established by private organizations with government oversight or by the government itself and that such standards must be vigorously enforced.

Congress has established certain minimum requirements by law and has instituted agencies such as the SEC to provide flexible day-to-day administration of these requirements. Those who are appointed by the President with the advice and consent of the Senate to serve on such agencies have been granted the authority to promulgate rules and regulations, to bring enforcement proceedings, and to adjudicate certain matters in order to carry out the public interest purposes for which they were formed.

Recently, government regulatory agencies have become the target of severe criticism. It is alleged that decision makers in such agencies are not accountable to the electorate, continually seek to expand their regulatory

jurisdiction, and are exercising power beyond what Congress intended. There are some who apparently believe that government agencies are hostile toward business. Others are concerned that while Federal regulators may have good intentions, they lack the experience necessary to understand business operations and thus promulgate unnecessary burdensome regulatory requirements.

It is not surprising to me that some businessmen and professionals who maintain responsible practices and are not aware of the abuses we see daily, may conclude that SEC regulations are unduly burdensome. Moreover, one would expect those who are subject to our enforcement actions, and those who represent them in a legal capacity, to claim that our enforcement staff is too zealous and that we bring enforcement actions without sufficient factual justification.

Six years ago, before the now popular cry for deregulation, I cautioned that:

we must avoid the sometimes natural tendency of regulators to so emphasize restrictions on improper activities that legitimate business activities are burdened with unnecessary regulations which impede and stifle private initiative and innovation.

At the same time, we do have a responsibility for the administration of securities laws which were enacted to prevent fraudulent, deceptive, and manipulative acts and practices in securities transactions, to provide sufficient disclosure to enable investors to make informed decisions, and to facilitate securities markets which are fair, efficient, and orderly. These responsibilities cannot

be fulfilled without imposing recordkeeping and reporting burdens on business organizations and establishing and enforcing certain standards for those who are engaged in the process of offering securities to the public.

In order to assess the validity of the concerns which have been raised and determine whether regulatory agencies are striking a reasonable balance in their efforts to fulfill their responsibilities without unnecessary burdens, it is most important for the public to understand how the regulatory system operates. I would not attempt to defend or speak for other agencies, but using the subjects for discussion at this seminar as examples, I would like to describe the process by which we at the SEC try to develop regulations and bring enforcement actions that are in the public interest.

Let's begin with our responses to the problems and needs of small businesses. While most small businesses seek to comply with securities laws and regulations and provide appropriate disclosure to shareholders and prospective investors, every year we see hundreds of examples in which unscrupulous or uninformed promoters use small business offerings to entice investments in risky or fraudulent schemes. Particular abuses, such as those seen during the "hot issue" markets of the late 1960's, or in certain tax-shelter or oil and gas offerings as well as in pyramid schemes, have caused the Commission to respond with additional enforcement actions and regulatory requirements. We continually attempt, however, to reduce regulatory burdens whenever we believe

we can properly do so. In addition to our own internal studies and analyses, which often make use of outside experts, the Commission periodically appoints advisory committees in order to obtain an evaluation, by persons outside the Commission, of the need and effectiveness of an entire regulatory program in a given subject area.

In February of 1976, we appointed an Advisory Committee on Corporate Disclosure, which after 21 months of effort issued a report with information and recommendations as to how the Commission could better fulfill its corporate disclosure responsibilities. Responding to one of the Committee's recommendations, in March of 1978 the Commission solicited public comment on the effect of the Federal securities laws on the ability of small businesses to raise capital and how to minimize any adverse impact in a manner consistent with the Commission's mandate to protect investors. In recognition of the fact that small businesses often do not have sufficient time and resources to participate in proceedings held in Washington, the Commission made itself more accessible by holding 21 days of public hearings in major cities across the country. We received testimony from 170 witnesses, including small businessmen, venture capitalists, lawyers, accountants and state securities administrators.

The hearings confirmed our view that Federal securities laws and regulations play a relatively minor role in the capital formation problems of small businesses. More

critical are factors which diminish the propensity of investors to take the risks involved in small business investments such as unstable political and economic conditions, inflation, high interest rates, and tax policies on securities profits. Nevertheless, our requirements do place a comparatively heavier burden on small business and we received suggestions as to how these burdens could be alleviated.

In response to the concern that the volume restrictions under Rule 144 acted as a disincentive to the purchase of restricted securities issued by small businesses, the Commission amended the rule to more than double the amount of securities that could be sold thereunder and eliminated the volume restriction entirely after a specified holding period for persons not in control of the issuer. In addition, the registration of securities for offerings of up to \$5,000,000 has been simplified and made less costly with the adoption of Form S-18 which can be filed and processed in our regional offices. For cases where even this simplified form of registration is impracticable, but a public offering of securities is necessary, we have raised the ceiling on the amount of securities that can be sold under Regulation A from \$500,000 to \$1,500,000 to make it a more viable alternative. Also, firm commitment underwritings have become possible under Regulation A as the result of amendments which permit the use of pre-selling documents. In many cases, however, a public offering is not feasible for a small business either because of the costs involved or other

factors and the \$100,000 limitation on private offerings under Rule 240 does not allow sufficient capital to be obtained. The Commission has attempted to alleviate this problem by permitting Regulation A-type disclosure to be used to satisfy information requirements of Rule 146 for offerings which do not exceed \$1,500,000.

Recognizing that even with this revision to Rule 146, the conditions for its use cannot be met by many small businesses, last month we adopted Rule 242 to permit certain corporate issuers to sell up to \$2,000,000 of unregistered securities in any six month period to an unlimited number of accredited persons and to 35 non-accredited persons if the issuers meet the conditions relating to the manner of the offering, the furnishing of information, and the filing of notice of sales.

We have been asked by some commentators to be more bold in our actions to reduce regulation but, it must be recognized that the steps we have taken to ease the burdens on small business embody considerable risk. Unlike Rule 146, Rule 242 permits sales to be made to 35 purchasers in a six month period without any consideration of their ability to evaluate the merits and risks of the proposed investment. Similarly, under Rule 242 there is no staff review of material used by the issuer in conducting the offering and no requirement that such information be filed with the Commission. Form S-18 may not provide disclosure of decision-making information considered to be important by some investors,

and raising the ceiling in Regulation A without additional requirements, such as certified financial statements for offerings above a certain size, was a questionable decision to some who are familiar with abuses in such offerings during the hot-issue days.

I believe that it is appropriate for the Commission to take such calculated risks, but we must monitor the use of these relaxed provisions closely. If they do not result in abuses we should consider further reductions in our requirements. If we find, however, that the additional freedom we have provided results in unacceptable practices, we must be ready and willing to take prompt and remedial action.

The actions the Commission has taken in the area of small business capital formation indicate our willingness to determine whether we are over-regulating. On the other hand, from time to time we discover new problems which require a regulatory response. The Commission's experience during the past several years with internal accounting controls illustrates this point.

One of the most basic concepts underlying the securities laws is that public corporations should properly account for corporate assets in documents used in securities offerings and in periodic reports. Yet in a series of cases in the mid 1970's, the Commission found that millions of dollars were either not recorded or were inaccurately recorded in company books and records to facilitate illegal or

questionable corporate payments. We also found that although top management was often aware of such falsified records and payments, these facts were generally concealed from outside auditors and directors. In a May 1976 report to Congress we stated our belief that we had adequate authority to effectively enforce the federal securities laws. But, in response to congressional requests, we expressed the view that limited purpose legislation was desirable to demonstrate clear congressional policy in this area and offered a legislative proposal based on authoritative accounting literature dealing with internal accounting controls.

When Congress enacted the Foreign Corrupt Practices Act ("FCPA") it included provisions requiring companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions occur only as authorized by management and are recorded in a manner to permit appropriate financial statements and account for assets, that access to assets is properly restricted, and that recorded assets are periodically compared with actual assets and action taken with respect to any differences. The Commission was given rule making authority and the responsibility to administer these accounting provisions. We considered the desirability of adopting internal control standards but rejected that as being too rigid and impracticable. Instead, in April of last year, the Commission proposed for comment the concept of a management report on internal controls which would give investors meaningful

information upon which to base an evaluation of the internal controls in their company. The proposal would have ultimately required the management report to include management's opinion as to whether the internal control system provided reasonable assurance during the relevant periods that the specified objectives of internal control were achieved. In addition, the management statement would have had to be examined and reported on by an independent public accountant.

The April rule proposal was intended to carry forward the work of the Cohen Commission, the Financial Executives Institute and the Special Advisory Committee on Reports by Management of the American Institute of Certified Public Accountants, all of which endorsed the concept of a management report to shareholders assessing the company's internal control system. Although we viewed our proposal as giving management flexibility in complying with the requirements of the FCPA, many of the nearly 1,000 commentators viewed it as a report on the extent of compliance with the Act. The proposal was also criticized for requiring disclosure of weaknesses in internal control which had been corrected, and for not being limited to material information. In addition, there was almost unanimous opposition to the requirement that independent accountants examine and report on the statement of management.

Because of the many thoughtful comments, the Commission and staff are now reevaluating our proposal in an effort to respond to the legitimate concerns raised,

but still facilitate appropriate internal controls. I cannot predict what our final conclusions will be but I am confident that we will not adopt the rule as proposed.

Another recent example of how the public may have an important effect on our final decisions is the change we made in our proposal that corporate directors be labeled as to their independence from management on the basis of objective affiliation criteria. Our purpose was to inform investors of any relationships that might affect the independent judgment of members of boards of directors. It was thought that a shorthand label of "management," "affiliated nonmanagement" or "independent" might be less burdensome than requiring specific disclosure of all relationships. Many commentators opposed the proposal on the basis that a board member might not meet the criteria necessary to be labeled independent and yet exercise disinterested oversight and independent judgment. The resolution which fulfilled our purposes and avoided the labeling problem was to require the disclosure of actual relationships.

In my view, these examples indicate that the rulemaking process at the Commission is working in a responsible manner. It must be recognized, however, that the development of appropriate rules is only part of our overall responsibility. Our rules, or any rules, become dead letters unless they are effectively enforced. Thus, an essential element in achieving our regulatory objectives is an effective enforcement program.

Because of comments about our enforcement program, which indicate that it is misunderstood, I would like to explain how it operates. All of our divisions and offices participate to some extent in our enforcement effort through inspections, reviewing filings, and commenting on proposed disclosure, but it is our Regional Offices and our Division of Enforcement that are most directly involved.

We receive indications of possible violations of Federal securities laws from inspections, market surveillance, public complaints, informants, news reports, other governmental authorities and self-regulatory bodies. A preliminary inquiry is conducted and the substance of possible violations is evaluated. When this inquiry substantiates the indications of possible violative activity, our staff generally prepares a memorandum describing what they have found and recommends the issuance of an order of private investigation, citing specific sections and rules that may have been violated. The Commission considers the staff recommendations and determines whether to issue the order. If we do, the staff then has authority to issue appropriate subpoenas for the production of records and testimony under oath. If a properly issued subpoena is not complied with, we may authorize the staff to seek subpoena enforcement from a district court.

Upon completion of an investigation, the staff reviews and analyzes the evidence, and if it appears appropriate, prepares a memorandum to the Commission setting

forth the results of the investigation and recommending enforcement action. The Commission considers the enforcement recommendation, comments from other Divisions or Offices, and submissions made by those against whom the enforcement action is recommended.

While we have a great deal of confidence in our enforcement staff, I can assure you that consideration by the Commission of whether to proceed in an enforcement matter is not superficial. Depending on the case, such consideration may take hours or even spread over several days or weeks. We realize that our public interest goals do not justify short cutting proper procedures, fairness, or decency. In each instance, the Commission determines the appropriateness of the recommended action from many standpoints, including whether it is justified by the facts and whether bringing it would be going beyond our statutory authority. Thus, in my judgment, allegations that our enforcement staff is running rampant and bringing cases without adequate factual justification are not well founded.

With the limited resources that can be devoted to enforcement, we attempt to maximize our effectiveness by concentrating our efforts in those areas which will be most productive. Our market access strategy is an example of this approach. Securities offerings must have access to the marketplace in order to be successful. Such access frequently requires the active participation of various industry professionals such as brokers, accountants, and attorneys.

By instituting enforcement actions against professionals who are involved in violations of the securities laws, we encourage them to discharge their responsibilities with care and diligence. With a minimum expenditure of public funds we are thus able to reduce the risks that dishonest promotions will be offered to the public while, at the same time, maximizing private self-regulatory opportunities.

Enforcement actions which the Commission brings are intended to be remedial rather than punitive. The penalties provided in the Federal securities laws for violations thereof must be sought by the Department of Justice in a criminal prosecution. Our goal is to prevent current and future violations and remedy existing abuses through the initiation of injunctive actions, administrative proceedings, and public reports of investigations, as well as by obtaining ancillary relief. By obtaining negotiated settlements of many of the cases we bring, we are able to fashion remedies which suit the needs of particular cases and both the Commission and respondents are able to save time and money while also protecting the public.

Having discussed SEC rulemaking and enforcement activities as an example of the present regulatory system, I would like to turn to the subject of how the process can be improved. I believe our experience, while not beyond reproach, indicates that a major restructuring is not necessary. In my view, the imposition of proposed new external limitations on rulemaking such as a legislative or presidential veto or

shifting the burden to federal agencies to justify their rulemaking actions in a Federal Court raise serious constitutional questions relating to the separation of powers, and would undermine the ability of regulatory agencies to fulfill the purposes for which they exist. This doesn't mean that changes aren't necessary, but I believe they can best be made within the present structure through an increased commitment from Congress, from the agencies themselves, and from those who are the subjects and the beneficiaries of regulation.

To the extent that there are agencies which do not fill a public need, Congress should abolish them or change their responsibilities. Where agencies have conflicting or overlapping legislative mandates, Congress should accept the difficult responsibility of resolving them. As far as agency accountability for their actions is concerned, we are presently subject to appeals in Federal Court and Congressional oversight. The SEC, for example, is called upon by the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Interstate and Foreign Commerce to explain our actions and problems. These Committees, through the legislative process, increase or decrease our responsibilities and authority as they determine appropriate. They also set a limit on the amount of funds that can be appropriated for our activities. In addition, the Office of Management and Budget gets involved with our budget requests and we must then justify the amounts requested in written submissions and testimony before House

and Senate Appropriations Committees. Just last week we appeared before the House Appropriations Committee and the general tenor of the comments of members present was that considering our responsibilities we should probably have more funds than we requested.

Some may question whether Congress exercises adequate oversight over agencies. That, of course, is for Congress to determine. From my experience of eight and one-half years as a senior staff member of a Senate Committee, I know that monitoring agency programs is difficult, requires a lot of time and expertise and doesn't have near the political appeal that other Congressional activities have. Nevertheless, more informed oversight by Congressional Committees would improve the system and could be done with far less burden on Congress than would be required to responsibly exercise a veto power over specific agency actions. Perhaps better oversight by the Executive Office of the President over agencies that are part of the administration would also be an improvement, but that should not extend to independent agencies. Being one step removed from political pressures provides for more independent, impartial and evenhanded regulation.

Agencies themselves can improve the process by assuring that their requirements are geared to present needs. There is a natural tendency to impose new requirements to meet specific problems, but often a reluctance to remove requirements which may have outlived their purpose. We must

be willing to accept constructive criticism and be able to conclude on the basis of our own empirical studies, analyses and any other information we can obtain, that the benefits of each requirement appear to exceed its costs. I use the word appear because while cost-benefit analysis can be helpful, in most instances costs and benefits are not subject to precise measurement and agencies should not be subjected to cost-benefit requirements that are impossible to fulfill. As difficult as it is to reach agreement on the costs of a regulatory approach in an area like the Federal securities laws, it is even more difficult to quantify for purposes of comparison the intangible benefits of the protection of investors and confidence in securities markets. A greater degree of empiricism and economic analysis such as we have obtained through our studies in connection with Rule 144 and are seeking through new Form 242 can be useful as part of the decision-making process, but we must all recognize that we are not dealing with an exact science and that informed judgment will continue to play the major role in our decisions as well as those of other agencies.

Finally, members of professions, those who are subjects or beneficiaries of regulatory programs, and the general public bear part of the responsibility for effective regulation. Problems you see should be brought to the attention of agency officials and Congress. You must also be willing to devote time to giving meaningful responses to our proposals. I have found during my years of government

service that Westerners often feel that they have very little input on decision making in Washington because they generally can't attend agency hearings and believe that their written views are given little, if any, consideration by the nameless, faceless, bureaucrats who do the regulating. I cannot speak for other agencies, but I can assure you, and I believe our actions indicate, that we are sensitive to your views.

Comments which explain just how the respondent believes a proposal may be detrimental and how it would affect his own operations, whether the avowed purpose is legitimate and whether the proposal is the most effective way of accomplishing that purpose, receive full consideration and have a definite impact on what the Commission does. To be sure, we do not alter or withdraw proposals solely on the basis of a large number of negative comments, nor do I believe the public would be served by such an approach because, human nature being what it is, we hear primarily from those who believe they will be adversely affected. Comments which obviously are the result of a campaign, do not give a specific basis for the criticisms, include arguments which appear to be beyond the personal experience of the writer, or show a lack of understanding of the issue can usually be discounted rather heavily.

Thoughtful comments dealing with specifics require considerable time and effort. But, those who are not sufficiently interested to do more than respond in platitudes about regulatory burdens, should not expect their comments to have much impact.

Good regulation requires the conscientious involvement of all of us. If the Congress, agency officials and the public all do our part, I believe that major modifications of the regulatory process will not be necessary. I can assure you that we at the SEC intend to do our part. We will continually review our requirements, we will listen to what you tell us, and we will consider it carefully along with legitimate competing interests, because we intend to remain what we, and many outside our agency believe to be the finest and most effective agency in Washington.