

CURRENT DEVELOPMENTS AT THE SEC

Manuel F. Cohen
Chairman

Securities and Exchange Commission

1964 Convention
American Accounting Association
Indiana University
Bloomington, Indiana

September 1, 1964

I want to discuss with you today some of the Commission's current activities and goals as they relate to the accounting profession.

I.

A little over a year ago, the Report of the Special Study of Securities Markets was sent to the Congress; its 175 conclusions and recommendations covered almost every aspect of the securities industry. Since then, the difficult task of implementing the Study recommendations has preempted much of the Commission's time and energy. With the aid of the industry, we have made significant progress. One of the most important achievements was the formulation of the legislation recently passed by the Congress and now known as the Securities Acts Amendments of 1964. About ten days ago, I had the great pleasure of being present as President Johnson signed these Amendments into law.

Under the new law, many accountants will, for the first time, be faced with problems under the Federal securities laws, I consider it particularly appropriate, therefore, to refer to certain of the new provisions which will be of particular interest to members of your profession.

The 1964 Amendments deal chiefly with issues of securities traded in the over-the-counter market and the standards of broker-dealer firms and their salesmen. Let us look first to the reforms covering unlisted securities traded in the over-the-counter markets. As originally enacted in 1934, the Securities Exchange Act established registration, reporting, proxy and insider trading provisions generally only for issuers whose securities were listed on a national securities exchange. While the Commission was given authority to deal with securities traded in the over-the-counter markets, this was to be achieved through regulation of brokers and dealers trading in such securities. This pattern did not prove to be feasible and was subsequently repealed. In 1936, however, Section 15(d) of the Exchange Act was adopted. As you know, it required many companies offering securities under the Securities Act to furnish an undertaking to file reports. Thus, there is no reason to believe that the Congress intended to create a difference in investor protection in the exchange and over-the-counter markets.

Section 15(d) narrowed, but did not eliminate, the gap in investor protection in the two markets. The difference in requirements came, to present an increasingly serious problem with the expansion of the over-the-counter markets, particularly after World War II. The Special Study determined that many of the abuses it uncovered -- irresponsible selling practices, uninformed investor advice, extravagant public relations, and erratic after markets -- could be linked directly to lack of adequate information concerning unlisted stocks traded over-the-counter. The new amendments now cure this long time deficiency in investor protection by extending to stocks of larger over-the-counter issuers the registration, reporting, proxy and insider trading coverage which has proved so effective on the exchange market.

The Securities Act Amendments of 1964 require the Commission to grapple with many problems. The Commission's annual report for fiscal 1963 indicated that over 5,000 companies were subject to the present reporting requirements (including about 500 under the Investment

Company Act). Pursuant to the provisions of the new law approximately 2,700 companies with more than \$1 million in assets and 750 stockholders will initially be subject to the new requirements. After two years, the limit drops to 500 or more stockholders and an additional 800 companies will be covered. Approximately 1,600 of the over-the-counter companies already report under Section 15(d) of the Exchange Act. These companies are not, however, subject to the proxy and insider provisions of Sections 14 and 16. The staff of the Commission is now considering the procedures which will be necessary to implement the new law. I might note that a review of existing forms and of certain provisions of the current proxy rules is also underway.

I am sure most of you are aware that some controversy attended proposals to include banks and insurance companies under the amended statute. Many of the changes made in the bill as originally introduced occurred in this area. Although the pertinent sections of the Exchange Act have been extended to banks, administration has been vested in the appropriate Federal bank regulatory agency--the Comptroller of the Currency for National Banks, the Federal Reserve Board for state member banks, and the Federal Deposit Insurance Corporation for the non-member state banks which it insures. In the case of insurance companies, the new law provides an exemption for issuers subject to certain specified regulation of their reporting, proxy solicitation, and insider trading activities by the states. However, insurance companies which do not meet these requirements will be subject to the provisions of the Act. No change has been effected with respect to insurance companies with listed securities or those now reporting under Section 15(d).

The Commission has always recognized the special problems which the usual patterns of disclosure pose for insurance companies -- problems originating in state regulatory requirements and in different accounting techniques which are applied to such companies. We have made accommodations for insurance companies on these grounds in the past; where appropriate, we will continue to do so in the future with respect to those companies coming under our jurisdiction.

Another matter which has been widely discussed is the treatment afforded foreign securities. Foreign securities will be subject to registration. However, the Congress gave the Commission wide discretionary powers to exempt foreign securities, or classes of securities where appropriate. The Report accompanying the Amendments also clarifies the effect of a foreign issuer's failing to register in a situation where registration is required under the new provisions. It states that failure to register will not, of itself, make trading in the United States of the foreign issuer's securities illegal or give rise to civil liabilities. The Commission can proceed by rule, regulation or order and can provide appropriately modified requirements for foreign issuers that are covered. In this connection the Commission indicated that it will exempt all foreign securities for at least one year to permit a more complete study of the problems of enforcing the statute in whole or in part against foreign issuers.

I think you will also be interested in one of the changes which has been made to Section 14. Under the amended statute an issuer not soliciting proxies in respect of a meeting must, if the Commission so requires, send to stockholders, and file with the Commission, the information which would otherwise be provided if proxies were solicited. This provision is applicable to listed companies and to registered over-the-counter companies.

The second major aspect of the new legislation emphasizes strengthening both the qualification standards for entrance into the securities industry and the controls over those already in the industry. Self-regulatory bodies, such as the NASD, will be required to adopt rules establishing standards of competence, training, and experience for members and their employees. All brokers and dealers not members of self-regulatory bodies will be subject to similar standards to be enforced by the SEC.

Thus, the two main aspects of the legislation are inter-related and complementary; the provisions concerning issuers are designed to provide the information necessary to informed decisions by investors and, by the same token, to make it possible for broker-dealers and their salesmen to provide better advice to their customers. The other part of the legislation is designed to raise the standards of competence and training of those who will use this information in advising investors. The legislation does not embody any new or radical ideas. It is the logical extension of principles previously embodied in the securities acts. Members of your profession have a direct concern in both aspects of the new legislation.

The legislative program was only one part albeit a very important part of the overall program to implement the Special Study's recommendations. As my colleague Commissioner Woodside has so aptly characterized the Study's conclusions, nearly everyone connected with the securities industry--the Commission, the self-regulatory bodies, the brokerage firms, and the issuer's--received something less than a "clean certificate." Much has already been done in the way of correction; a good deal remains,

The Special Study was also critical of certain aspects of the Commission's work. In the spirit of that criticism, we have studied our practices and procedures and have embarked upon a continuing effort to revise, update, and improve our operations wherever possible. The Commission has also taken steps to reorganize its personnel to achieve the implementation of the Study's recommendations.

More important, the Commission has with the aid of the Study, attempted to make a fundamental re-evaluation of basic issues and, where appropriate, to effect the advances necessary to keep abreast of the changes in the securities markets. Introspective programs of this nature can help to prevent the "creeping senility" which some authorities claim is the natural lot of the regulatory agencies. Another of the salutary "aide effects" of the Study was the opportunity afforded interested members of the industry to come forward with their ideas and suggestions and to be heard by the SEC and the Congress. These lines of communication between the Commission and the industry are important and they must be kept open.

There is one specific matter treated by the Special Study which can be appropriately discussed and considered at this time.

As a result of a much-publicized case, the Study recommended that in the preparation of financial statements to be included in reports to stockholders, issuers follow accounting principles and practices which are generally consistent with those required for financial statements filed with the Commission. That recommendation was the basis for the recent

amendment to Rule 14a-3 under the Exchange Act. Rule 14a-3 had previously required only that stockholder reports reflect adequately in the opinion of management, the financial position and operations of the company. The Study, however, noted the occasional inadequacy of management's opinion; in fact, it suggested that in some instances management, opinion was "so far from the requirements of Form 10-K as to be seriously misleading." Under the new rule additional standards are imposed, but financial statements provided to stockholders need not conform rigidly with those filed with the Commission. Omission or condensation of some details will be allowed if the results are not misleading.

We have not adopted a "substantial compliance" test in the amended rule. However, to assure adequate disclosure, we have required that any material differences in principles of accounting or their application be noted in the stockholder report, and their effect fully explained and reconciled with filed materials. In connection with this requirement, the Commission instructed its staff to take into account other information contained in the report. This was not intended to authorize censorship of stockholder reports; it was designed to provide a measure of flexibility in assessing the adequacy of, the disclosures made in the financial statements.

Amended Rule 14a-3 also requires that, in reports to security holders covering fiscal years ending on or after June 30, 1964, the financial statements be certified by independent public accountants, unless; (1) the corresponding statements included in the issuer's annual report filed or to be filed with the Commission for the same fiscal year are not required to be certified, or (2) the Commission finds in a particular case that certification would be impracticable or would involve undue effort or expense.

Finally, the rule now expressly requires that consolidated financial statements be furnished if they are necessary to reflect adequately the financial position and results of operations of the issuer and its subsidiaries. Of course, we recognize that the conditions which govern inclusion or exclusion of subsidiaries in consolidation are subject to change from time to time as methods of doing business change, or because of change in external factors such as political and economic conditions in foreign countries.

In more than the one case cited by the Special Study, the Commission noted that financial statements contained in annual reports to shareholders had been so presented as to give a misleading impression in regard to the financial position and operations of the issuer. The amendment to Rule 14a-3 was directed at the practices of those few companies; it is not contemplated that any changes in the presentation of financial data will be necessary for the great majority of issuers.

I do not intend to convey the impression that the Study found fault with every phase of activity in the securities field--that is certainly not true. In fact, the overall conclusion reached by the Study was that the basic regulatory structure has functioned well and has withstood the test of time. One of the areas singled out for praise was the administration of the disclosure provisions of the securities laws. While the Commission was credited with the success achieved in getting corporations to tell the "whole story" before they sell their securities to public investors, much of this credit, I believe, should go to the accounting profession which, since 1934, has joined with the Commission and its staff in making the financial statements the "heart of corporate

disclosure” a more meaningful and comprehensible tool in the hands of the investing public. The profession has played an important role in the establishment of sound accounting principles on which, are based the financial statements filed under both the 1933 and 1934 Acts, as well as under the other statutes which we administer.

If I may digress for just a moment, I would like to note a rash of similar studies in other countries. In fact, our Special Study may be described as the manifestation in this country of an international trend; a trend which has developed roots in such diverse countries as England, France, West Germany, Canada and several of the emerging nations.

Similar reforms occurred throughout the western world between 1925 and 1935 when much of the currently existing legislation was formulated here and abroad. The Federal securities laws borrowed the disclosure concept from England. Now, other governments have been advised to look to our practices of providing greater disclosure and control in the distribution and trading of securities. Indeed, commissions appointed in other countries have urged the establishment of regulatory bodies similar to the S.E.C. The ideas embodied in our laws are proving to be export items.

Apart from such suggestions, the existing institutions are strengthening their controls very substantially. Thus, accountants and businessmen in England will, like their brethren in this country, soon assume new disclosure responsibilities. As a result of certain corporate failures and takeovers which were accompanied by serious consequences for investors, the London Stock Exchange has recently proposed, and in some cases adopted, new rules calling for greater disclosure of corporate affairs.

I shall not attempt to review other specific areas discussed in the Special Study’s Report. That document will speak for itself and I commend it to you as an important and necessary reference. I prefer to devote the next few minutes to a discussion of the role of the accountant in the important period ahead.

II

As I have noted, accountants--both those on the Commission’s staff and those serving the industry--have played an important role in the SEC’s history. The earliest period in that history was marked by much progress in the development of accounting principles and practices--a process set in motion by the New York Stock Exchange after the market crash of 1929--and a practical acceptance of the need for real independence of certifying accountants. Our forms and rules have been kept current through the joint efforts of the profession and our Chief Accountant’s Office. In a very real sense, the Commission’s accounting rules, especially Regulation S-X, represent a codification of the best practices followed by leading professional public accountants over the past, thirty years. This has been accomplished in a spirit of cooperation and voluntary action.

No one can dispute the assertion that the Commission has the power to decree “acceptable” accounting principles and practices. I think it is common knowledge that we have, at various times, been urged to do just that. However, from its inception, the Commission has preferred cooperation with the profession to governmental action, and has actively encouraged accountants to take the initiative in regulating their practices and in setting standards of conduct. In response, the profession, although not the recipient of delegated power (as are the NASD and the stock exchanges), has performed an important service as a self-regulatory institution.

It may not be out of order at this point for me to comment briefly on the debate over the status of opinions of the Accounting Principles Board. I understand that your president is a member of a special committee charged by the President of the American Institute of Certified Public Accountants to study this subject. The problem, I believe, stems from the vigorous difference of opinion that developed over accounting for the investment credit and, in particular, from the fact that the SEC, consistent with its administrative policy on accounting matters, found substantial authoritative support for a method of accounting different from that announced by the Board as the majority opinion. The Commission was charged by some observers with an irresponsible act, but I can assure you that many hours of study and discussion preceded the decision to accept either of two solutions to this new problem in our experience. We recognized that if an accountant agreed with our alternate solution and his client desired to follow it, the accountant might feel obliged to note an exception in his certificate because of the departure from the Board recommendation.

This episode has been discussed so vehemently that many persons seem to feel we have withdrawn our support of the profession’s efforts to narrow the areas of differences in accounting principles and have abandoned the policy announced in 1937 of issuing “opinions on accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions.” This is not the case. It has been our practice for many years to cite publications of the Institute as authoritative support for generally accepted accounting principles. Exceptions have been rare indeed.

Through our Chief Accountant we have been active participants in the work of the Board and of your committees on research. I understand that several important projects dealing with highly controversial subjects are well along. These deal with major areas in which differences of treatment should be eliminated. While this is more difficult to accomplish than some of our critics seem to think, these projects and efforts are most desirable and should be encouraged. In the meantime disclosure of the methods followed warns the analyst that some adjustment of his comparisons must be made.

III

The concept of cooperative regulation relies heavily on the willingness of businessmen to forge their own standards of ethical conduct, in addition to the prescribed legal standards, and to enforce and comply with those standards. This philosophy was not first developed in the Federal Securities laws. It was adapted from the activities of the professions to educate their members

and enforce ethical standards. Such activities developed, at least in part, from the realization that professional men are charged with a public responsibility which goes beyond the minimum requirements established by laws. Recently, various groups have indicated an awareness of such a public responsibility. Thus, the Public Relations Society of America, Inc., developed and published a Code of Financial Public Relations. Other activities of a self regulatory character have been undertaken by the Financial Analysts Federation and by the Society of American Business Writers.

Of course, the members of the accounting profession have long recognized their responsibility to the public. In 1900, a leading accountant wrote:

“A public accountant acknowledges no master but the publicA public accountant’s certificate, though addressed to president or directors, is virtually made to the public, who are actually or prospectively shareholders. He should have ability, varied experience, and undoubted integrity.”

Those characteristics, and the philosophy embodied in that statement, will have particular significance in the important period ahead.

As many of you know, we have recently proposed revisions to a reporting form used under the Investment Company Act of 1940. The changes would have the effect of expanding the accountant’s responsibilities with respect to annual reports filed with the Commission by certain investment companies. If adopted as proposed, the new form would require an accountant, in addition to certifying the financial statements in such reports, to express an opinion as to the fair presentation of information presented in many of the other items--e.g. asset coverage of senior securities, portfolio turnover rates--and to state, in connection with certain additional items, that he has seen nothing to indicate that the answers supplied are incorrect. This procedure we hope, will further the objective of investor protection and at the same time stimulate a certain amount of self control by the affected companies.

Because of his special status and responsibility, the accountant has a unique opportunity to be a leader in raising standards of Investor protection. The “financials” provide the key information both in the distribution and trading of securities. The work of the accountant in their preparation and publication is vital. Independent accountants lend authority to management’s representations by their opinions as experts, and they operate as a check on management in assuring that the financial data are fairly presented in accordance with generally accepted accounting principles. If you forgive me for pointing a finger, in performing this function, the accountant should not be satisfied when he has done just enough to answer affirmatively the question. “Will this get past the SEC?” The standards prescribed by law are a bare minimum. The independent as well as the internal accountant should be guided by the question, “What does the investor or stockholder need to know to make an informed decision about this company?” And this last question is also important in connection with companies not subject to the disclosure requirements of the Commission or the exchanges. A number of studies have indicated that the financial information supplied by such issuers--when and if supplied at all--is often seriously inaccurate and inadequate.

The 1964 Amendments to the Securities Acts will bring into contact with the Commission many heretofore "unregulated" companies. Undoubtedly, in many cases, the accountant will be a primary bridge between the issuer and the Commission. He will be called on to explain the "hows" of the Commission's rules. He should also explain the "whys". The accountant should advise on the establishment of systems and controls which will promote the most effective and comprehensible form of compliance. A little foresight can avoid many unnecessary, and possibly embarrassing, problems. For example, when it is contemplated that a company will have to register in the future--as when the shareholder limit under the 1964 Amendments drops to 500 after about two years--appropriate internal controls should be established now to avoid potential problems which might preclude the issuance of an unqualified certificate. In short, good practices and procedures should be adopted and followed at the earliest possible time.

I think you will recognize that I have not outlined anything new for the accounting profession; the Commission seeks merely a continuance and furtherance of what it always has sought--and most often received--from the profession.

IV

The Commission has just celebrated its thirtieth birthday. Because I believe that the next thirty years will pose as many interesting, important, and difficult issues as have the past thirty years, I want to emphasize that much of our future success will depend on education and persuasion--matters particularly appropriate for discussion here. Public accountants can, and should, use their persuasive powers to stir managements to better disclosure of pertinent information. And accountants should be prepared to exercise their obligation to take firmer action when persuasion is inadequate. Management should be educated to the advantages of consistently good financial disclosure. At the same time, the accounting profession should and, I am certain, will continue to develop better accounting methods and reporting techniques. With your continued cooperation, I believe we can achieve sounder administration of the Federal securities laws and greater protection for public investors.