# THE SEC AND INVESTOR PROTECTION UNDER ARTHUR LEVITT

**Restored Trust in the Nasdaq Market.** An 18 month investigation of the Over-The-Counter market revealed that traders were fixing prices in violation of antitrust laws – to the detriment of investors. Quoted spreads were artificially wide and a two-tiered market had developed for institutions and individuals. Customer limit orders that would have narrowed spreads were hidden from public view. In addition, Nasdaq market makers were trading within-the-spread in private trading venues not accessible to the general public. The NASD board, however, refused to adopt the necessary changes to regain investor trust. The SEC acted.

First, the Commission censured the NASD – the parent of the Nasdaq – and placed it on probation for three years, forcing the group to answer to an outside monitor. The NASD also was ordered to create an independent subsidiary, called NASD Regulation to separate market surveillance from stock trading. The SEC required NASDR to spend $100 million over five years to install new audit systems to detect late reporting of trades and other rule violations. The Commission brought civil suits against 28 companies and 50 individual dealers.

In addition, the Commission enacted rules to correct the price quotation flaws and two-tiered pricing with a new rulebook to reinforce the framework for competition. Through the adoption of new Order Handling Rules, we insisted that customer limit orders in all markets be publicly exposed and two-tiered pricing eliminated. In the OTC market, a single public quote stream developed which, among other things, gave ECN quotes greater public exposure. The rules also placed new obligations on market-makers and brokers to obtain "best execution" for their customers. This means that it's not good enough just to fill an order; dealers must also try to get their customers a better price. As a result of these reforms, spreads soon declined by more than 30 percent, transferring billions of dollars from dealers to investors. (Notice of Filing of Proposed Rule Change To Rescind Exchange Rule 390; Commission Request for Comment on Issues Relating to Market Fragmentation; *http://www.sec.gov/rules/sro/ny9948n.htm)*

*"We have found a widespread course of conduct among market makers to coordinate their quotes. Investors paid too much, and received too little, when they bought and sold stock on Nasdaq… This culture of collaboration subverted the price mechanism and curtailed competition. It raised the cost of capital and undermined market efficiency. It hurt investors and damaged the reputation of Nasdaq. Where was the NASD, the cop on the Nasdaq beat? The NASD was not blind to these practices in the marketplace. It simply looked the other way."* Arthur Levitt, August 8, 1996

**Took on Corruption in the Municipal Bond Market.** Though both formal rulemaking and voluntary initiatives, the SEC, under Arthur Levitt, stopped Pay-to-Play -- the practice of giving campaign contributions to public officials or to candidates for local office, to influence the award of lucrative municipal bond contracts. In April 1994, the Municipal Securities Rulemaking Board adopted rule G-37 barring municipal bond dealers that contribute to state and local candidates from underwriting negotiated bond deals for their localities for two years. In January 1996, the MSRB adopted rule G-38 requiring bond dealers to have written agreements with consultants and to disclose the arrangements to the public on a quarterly basis. The ABA in 2000 adopted a resolution asking lawyers to cut the tie between campaign contributions and selection as counsel in government bond transactions.

The SEC between 1993-2000 went after more than 20 brokerages for overcharging municipalities for Treasury securities. The Commission secured over $170 million in so-called yield burning settlements. (http://www.sec.gov/news/press/2000-45.txt)

*"The enormous power of the municipal market demands that it operate with complete honesty and integrity. And yet certain practices in the industry remain closer to the back-room deals and "honest graft" of George Washington Plunkitt and his ward captains in 1905, than to the full disclosure and unimpeachable integrity demanded by our markets in 1995. I'm speaking, of course, of what's come to be known as "pay-to-play" -- the practice of tying public financing business to political contributions. Left essentially unchecked, this particular form of corruption has grown brazenly, and in recent years has tarnished the reputation of bankers, lawyers and public officials alike."* – Arthur Levitt, June 5, 1995

**Helped Protect Investors Through Education.** Under Chairman Levitt, the SEC created an office solely dedicated to investor education – The Office of Investor Education and Assistance. Investors could now call an 800 number to and ask questions to 30 investor assistance specialists. In 2000, the Office received more than 80,000 calls, e-mails, and letters from investors who had complaints or questions. The SEC also established a place on its website for investors to get information from everything from arbitration to variable annuities. Levitt hosted 43 investor town hall meetings across the country during his tenure. He answered investor questions about how to choose a broker or mutual fund or where to get company information and alerted them to conflicts of interest in analyst recommendations and consulting and auditing relationships. These town halls routinely drew thousands of investors. One of his last meetings, which was sponsored by the Los Angeles Times, attracted over 7,000 people. In 1996, Senator Gramm of Texas indicated he didn't see much value in spending money on SEC investor education efforts. Chairman Levitt persuaded him that such funding was crucial to protecting investors. (http://www.sec.gov/investor.shtml)

*"But in the celebration of today's prosperity, I'm concerned that some of the basic but important fundamentals of investing are being lost on investors. Or, even worse, simply ignored. There is still much we don't know about what drives today's economy and even less about where it's heading. Unless investors truly understand both the opportunities and the risks of today's market, too many may fall victim to their own wishful thinking"*. –Arthur Levitt, February 12, 2000.

**Plain English – Helped Investors Better Understand their Investments.** Years earlier, the SEC tried with limited success to simplify the language in the fund prospectus. But many fund groups and their allies in the legal community were comfortable with the current rules and resisted change. In 1993, Chairman Levitt began a campaign for plain English disclosure in the face of industry and legal pressure. Eight major fund families agreed to volunteer for a pilot project to develop a standardized summary prospectus that highlights key information about a fund. In January 1998, the SEC adopted a rule requiring plain English for the cover page, summary and risk factor sections of mutual fund prospectuses. Those efforts were extended to include corporate disclosure.

*"In the last 8 years, the SEC has pushed companies, broker-dealers, investment advisors, and mutual funds to communicate with their customers in Plain English. Instead of talking above the heads of investors with legalistic words, these same groups must now communicate with the public in sentences everybody can understand – not just corporate lawyers."* – Arthur Levitt, January 2001.

**Fought to Protect the Independence of the Accounting Standard Setting Process.** In the fall of 1995, the Financial Executives Institute sought to influence the choice of chairman for the Financial Accounting Foundation, which is the governing board of the Financial Accounting Standards Board (FASB). The FASB issues standards to ensure that company financial reports clearly reflect the underlying financial position and the results of operations. It does not favor one type or size of company over another, nor does it take public policy stands. Its aim is neutrality and transparency. The FEI argued that the FASB had an antibusiness bias and a lack of "concern" for the realities of business. It proposed to reduce the size of the FAF, impose strict time limits on projects to establish new rules, close some of the FASB's meeting to the public, establish a separate organization to set the FASB's agenda, and subject existing standards to a time limit.

In response, the SEC fought to increase the number of independent trustees on the FAF. Of the then fourteen FAF trustees, only two could be considered truly disinterested public representatives. Four were auditors; three were corporate officials; three represented state and local governments; and one was an investment manager. The accounting firms, securities industry and much of Corporate America fought back. The SEC in turn threatened to end FASB's role as the SEC's standard-setter if its demands were not met. An agreement was reached where the size of the FAF would remain the same and the accountants and corporate executives agreed to each give up a seat. Fifty percent of the trustees would now represent the public interest. Arthur Levitt recruited former Federal Reserve vice-chairman Manual Johnson, former SEC Chairman David Ruder, and John Biggs, chairman and CEO of the TIAA-CREF to fill the vacant slots.

*"It is compellingly clear to me that the objectivity and fairness of standard-setting can only be guaranteed if the process is insulated from political agendas, special interests, and bureaucratic convenience. If that independence is compromised, or perceived to be compromised, we would pay a heavy price in declining investor confidence in the markets… Nonetheless FASB critics are working hard in Washington to limit its independence. They sometimes take the ironic tack of arguing that the Board is anti-business. To me, that's like suggesting the College of Cardinals is anti-Catholic."* -- Arthur Levitt, October 8, 1997

**Took on the Numbers Game.** After consultation and meetings with various groups, Chairman Levitt initiated a program to combat the growing practice of managing earnings to meet Wall Street quarterly expectations. The program was outlined in a speech entitled, "The Numbers Game," which was delivered on September 28, 1998. The speech received widespread attention and became a standard part of the teaching curriculum at many universities. Many executives claimed that the SEC was overreacting.

*"Earnings management… has evolved over the years into what can best be characterized as a game among market participants. A game that, if not addressed soon, will have adverse consequences for America's financial reporting system… Increasingly, I have become concerned that the motivation to meet Wall Street earnings expectations may be overriding common sense business practices…As a result, I fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. Managing may be giving way to manipulation; Integrity may be losing out to illusion."* – September 28, 1998

*"Today, American markets enjoy the confidence of the world. How many half-truths, and how much accounting sleight-of-hand, will it take to tarnish that faith?—September 28, 1998*

Below are the elements of the wide-ranging initiative to improve the quality of financial reporting which were met with significant private sector and Congressional resistance:

***Accounting Standards and Financial Disclosures.*** The Commission staff issued three important Staff Accounting Bulletins (SABs) to curtail common aggressive accounting practices : SAB 99 on materiality (August 1999), SAB 100 on Big Bath Restructuring Charges (November 1999) and SAB 101 on revenue recognition (issued in December 1999, but delayed because of Congressional pressure until December 31, 2000), the number one cause of financial restatements. **SAB 99** made it clear for the first time in the history of the accounting profession that intentional errors in the accounting books would be material, regardless of size. No longer could management and accountants claim simply something was immaterial in order to make Wall Street's numbers. **SAB 101** clarified the existing accounting revenue recognition rules. As a result, the number of revenue recognition restatements fell from 69 in 2000 to 48 in 2001. The Commission was forced to delay SAB 101's implementation twice because high technology companies lobbied Congress heavily. As a result, the SEC received a number of letters from Phil Gramm, Michael Oxley, Rod Grams, and others questioning the purpose and need for such guidance. Because of the delay, Tyco, for instance, was able to shield the effect its aggressive revenue recognition policies had on its bottom line to the tune of approximately $1 billion.

In addition, the SEC requested that the accounting profession publish additional guidance on revenue recognition and the immediate expensing of technology under development in a business merger. As a result, the AICPA published "Auditing Revenue In Certain Industries – An Audit Guide" and "Assets Acquired in a Business Combination to Be Used in Research and Development Activities:" under the oversight of the SEC Staff.

In January 2000, the SEC proposed new rules improving the transparency and disclosure of "reserves" by public companies.

Starting in 1996, the Commission requested that FASB improve the accounting for business combinations, the accounting for liabilities and special purpose entities, as noted in the Commission's reports to Congress. (For SPE request, see 2000 SEC Annual Report).

***The Quality of Audits***. The SEC requested that the Public Oversight Board establish an independent panel to study how audits of public companies could be made more effective.[1] Known as the Panel on Audit Effectiveness (or the O'Malley Panel for its chairman Shaun O'Malley), the Panel published its list of over 200 recommendations for the accounting profession in August 2000. These recommendations included the need for the profession to rewrite most, if not all of its auditing standards, requiring more forensic type auditing procedures, enhancing the peer review process and strengthening the oversight of the accounting profession by the Public Oversight Board. The General Accounting Office published a report chronicling the lack of progress of the accounting profession in implementing these reforms in May 2000.

[1] The Public Oversight Board (POB) was a five member board established in 1977 to oversee audit firms who audit public companies in America. It ceased operations May 1, 2002.

The O'Malley Panel recommended new authority and power for the Public Oversight Board. Chairman Levitt pushed the accounting firms to grant such authority and powers to the POB but the firms refused to accept many of these reforms. Indeed, it would have required legislation, which some members of Congress opposed, for the SEC to unilaterally implement some of these reforms. Nearly a year after the POB and the SEC asked the profession to improve self-regulation, the accounting profession agreed to a new charter with the POB that included only some of the O'Malley Panel recommendations.

***The Quality of Auditing Standards.*** The SEC twice also requested the Auditing Standards Board (ASB) to take action to stop accounting firms from structuring accounting transactions, such as special purpose entities, to get around the rules and create off-balance sheet arrangements. The ASB refused to take these actions.

***Earnings Management Task Force.*** The SEC established at the end of 1998 an earnings management task force within the Division of Corporation Finance to review the filings of companies that might appear to be engaging in improper earnings management. In response to the Division's focused attention in this area, more than **50 companies** revised their financial statements or earnings releases to adjust downward the amounts allocated to purchased R&D, requiring the reinstatement of goodwill and other assets in an aggregate amount exceeding **$5 billion.** The task force also was responsible for more than **40** other cases in which financial statements were revised to correct the timing of recognition for revenues or restructuring costs. Restatements such as Rite Aid were identified as a result of the Division of Corporation Finance's reviews.

***Enforcement of Financial Fraud.*** Financial fraud became a top priority of the SEC under Chairman Levitt. The SEC brought approximately 112 financial statement and reporting actions in FY 2001, a 30 percent increase over the 79 actions brought in 1998. The cases covered a broad spectrum of conduct – from pervasive frauds to more subtle instances of earnings management to situations involving violations of auditor independence rules.

To more effectively focus its limited resources, Chairman Levitt established the SEC's Financial Fraud Task Force that was a dedicated group of enforcement lawyers and accountants investigating possible financial fraud.

The SEC also brought its first ever financial fraud sweep in September 1999. On the one-year anniversary of Chairman Levitt's "Numbers Game" speech, the SEC announced the filing of 30 enforcement actions against individuals and companies for engaging in financial fraud. Fifteen companies were found to have engaged in fraudulent financial reporting. Major enforcement cases were brought against companies, their executives and/or auditors including W.R. Grace, Livent, AOL, Microstrategy, PricewaterhouseCoopers LLP and KPMG LLP. Cases were also initiated against Ernst & Young LLP, Arthur Andersen, Waste Management, Sunbeam, Microsoft and Rite Aid. In the matter of PricewaterhouseCoopers, the SEC assessed a $2 million penalty against the Big Five accounting firm, the first ever such penalty levied against a major international accounting firm.

***Sanctioning Accountants.*** In November 1998, with resistance from the accounting profession, the Commission adopted a new rule – 102 (e) – which clarified how and when it would sanction auditors and accountants for professional misconduct.

***The Profession Cuts off Funding to its Oversight Body.*** After PricewaterhouseCoopers was found to have violated the independence rules 8,000 times, the SEC asked the POB to conduct similar investigations at the other four accounting firms. When the accounting profession cut-off the funding for the POB's special investigation of these firms compliance with auditor independence rules, the SEC negotiated a review of the firms by independent counsels. The firms also agreed to a review of their quality controls by the POB, which was thwarted by the accounting firms subsequent to the change in administration.

***Developing Strong International Standards.*** The SEC issued a concept release in February 2000 setting forth for comment a framework for financial reporting by foreign companies wanting access to U.S. capital markets.

Chairman Levitt chaired the international committee that established the new International Accounting Standards Board and selected Paul Volcker as chairman of its trustees. The SEC also played a leading role in negotiating the structure for this new board. Already the IASB under the leadership of Sir David Tweedie is playing an integral and important role in improving the quality of financial reporting on a global basis.

***Sought to Improve Corporate Governance.*** In 1998, at the request of Chairman Levitt, the NYSE and NASD formed a Blue Ribbon Committee on Improving the Effectiveness of Audit Committees. This Committee issued its final recommendations in 1999 to the stock exchanges, accounting profession and SEC. After SEC prodding, the recommendations were adopted by the respective organizations at the end of 1999 or the first of 2000. Audit committees are now required to adopt charters to govern their oversight, to discuss with the independent auditors and management the quality of the company's financial reporting, to recommend to the entire board whether the audited financial statements should be filed with the SEC and for the first time ever, to be involved with and review the quarterly financial statements filed with the Commission.

***Fighting for Greater SEC Resources***. Chairman Levitt passionately pursued greater funding and resources for the Commission. This included requests for pay parity to allow the Commission to pay its accountants and attorneys at compensation levels on parity with other government agencies. Sadly, to date, Congress has yet to fund pay parity for the agency.

**Worked to Improve the Independence of the Accounting Profession.** Accounting firms once devoted almost exclusively to auditing now resemble large and diversified professional practices. Where non-audit services for traditional audit firms once represented only a small portion of total revenue, today such services account for nearly *one-half*. Revenue from auditing services, in the meantime, has declined to only *one-third* of total revenue. The Commission became increasingly concerned with the dramatic growth in the volume and nature of non-audit services that auditors provide to their SEC-registered audit clients, significantly with regard to whom the accounting firm is beholden: the auditors' obligation is to shareholders while consultants' serve management. When these two obligations come into conflict, the independent audit—dwarfed by the more lucrative consulting business—too often may be compromised.

In the summer of 2000, the SEC proposed rules that would have placed significant limits on the type of non-audit work accountants could provide to their clients. Chairman Levitt, before the rules were announced, asked the profession to work with the SEC to effectively deal with the growing concerns over the independence of the accounting profession. His entreaties were rebuffed. Instead, the American Institute of Certified Public Accountants and three of the Big 5 firms vehemently fought the rule proposal and refused to engage the SEC in discussions until the very end of the process. Instead, they focused their energies on Capitol Hill seeking to block the SEC from promulgating any rule through Congressional intervention. Chairman Levitt received letters of opposition from more than 50 Members of Congress including every Republican on the Senate Banking Committee and almost every Republican on the House Committee on Energy and Commerce, which have oversight responsibility for the SEC. Many of the letters called on the Commission to extend the comment period to at least February 2001, after the Presidential election, "in order to fully evaluate the impact" of the proposal. The accounting profession also lobbied Republicans on various appropriations committees to introduce a Congressional rider thwarting SEC action in this area. This was the first time the SEC's independence was challenged in its history.

The threat of a rider had reached such a point that the Clinton Administration in a 10/6/2000 Statement of Administration Policy for the Departments of Commerce, Justice and State, and Related Agencies Appropriations Bill, FY 2001, wrote that, "The Administration would strongly oppose any amendment that would prevent the SEC from moving forward with its proposal relating to its requirements for auditor independence, which have not been updated in 18 years. The SEC is currently receiving public comments on the proposed regulation and has held several public hearings to ensure concerns of all interested parties are considered. An amendment that prevents the SEC, a well-respected independent regulatory agency, from completing its legal regulatory process could undermine its ability to ensure confidence in our Nation's financial markets." (http://www.whitehouse.gov/omb/legislative/sap/106-2/HR4690-s_1.html)

The Commission reached an agreement with all 5 firms on new auditor independence rules in the fall of 2001 that allows them still to perform most non-audit work as long as the those fees are disclosed and the audit committee considers whether the non-audit services are consistent with an auditor's independence.

*"It baffles and sorrows me to see an apparent willingness by some to discount the very ideals that*

*give the profession its credibility -- a willingness to reap the benefits of this public-mandated franchise, but largely ignore the premise of its responsibilities… I keep asking myself, "Why hasn't the profession taken its own steps long before?" "Where," I've been asking myself, "is the initiative?" The fact is, many of the concerns we have today were raised almost 25 years ago when the same Congressional report concluded, "Public confidence in independent auditors has been seriously eroded." In two and a half decades, where is the initiative? If the leadership of the profession will not even stand up and establish effective self-regulation, how can the Commission -- how can the American public -- expect anything less than a profession paralyzed by its own inaction?"* – Arthur Levitt, September 18, 2000

**Helped Reveal Wall Street Analyst Conflicts.** In an April 1999 speech before the Securities Industry Association, Chairman Levitt first called attention to the issue of analyst conflicts of interest. In October of that year, Chairman Levitt said, "I think the time has come for the SROs to consider whether investors are told – in a meaningful way – when the analyst's employer has a recent investment banking or advisory relationship with the company that is being recommended. We cannot settle for boilerplate disclosure, cloudy language that masks a firm's position, or small type disclaimers at the end of the document. In addition, firms should reexamine their compensation practices for analysts and ask themselves this simple question: Do our payment practices ensure unbiased and quality information?"

SEC staff then met with the New York Stock Exchange and the NASD to discuss an effort to improve the current disclosure rules regarding analyst recommendations. In December of 2000 with the SROs still not having taken action, the SEC threatened to begin rulemaking if the NASD board did not take a vote on whether to begin a process on rulemaking. The NASD Board voted to do so but rules were proposed only after Congress began hearings on analyst conflicts in the summer of 2001.

**Ended the Selective Disclosure of Inside Information.** In the summer of 2000, the SEC passed Regulation Fair Disclosure in the face of enormous opposition. In the year prior to its adoption, much of Wall Street and Corporate America fought to kill Reg FD, arguing that the rule would do more harm than good. The Commission was lobbied by every major firm on Wall Street and very heavily by its trade organization, the Securities Industry Association. Letters from various Members of Congress questioning the purpose of the rule arrived as the date to adoption moved forward. The rule required that if a company wishes to pass on market-moving information, it must share the news with everyone at the same time – not just a privileged few. In recent years, CEOs and their finance chiefs had learned that they could indirectly control their stock price by currying favor with research analysts. Some were trading important information about earnings and product development with selected analysts, who in return were writing glowing reports. Such selective disclosures got passed on to powerful institutional investors and to brokers who could be counted on to place a substantial number of shares in the accounts of individual investors. Nortel Networks Corp. shares, for example, fell 12 percent on September 29, 1998, after the company told some shareholders and analysts that revenue growth in Asia and Europe would be disappointing. When Nortel made the news public four hours later, its market value had dropped by $3.2 billion. (Bloomberg News, 12/24/2001) No longer will individual investors lose money because bigger investors got advance word.

Today, analysts can no longer rely on the gravy train of free, market-moving information from companies. And CFOs can no longer steer analysts to a preferred earnings figure, then message the numbers to come in just above that to pleasantly surprise the market – and get a boost in the share price as a reward. Despite Wall Street's claims that FD would chill the flow of information, nine out of ten companies reported disclosing more or the same amount of information. (PricewaterhouseCoopers Survey, October 2001).

*"Today, as Wall Street analysts play an increasingly visible role in recommending stocks, some in corporate management treat material information as a commodity -- a way to gain and maintain favor with particular analysts. What's more, as analysts become more and more dependent on the "inside word," the pressure to report favorably on a company has grown even greater…These practices defy the principles of integrity and fairness. In this country, we pride ourselves on having the purest form of meritocracy in the world. We teach our children that a person gets ahead through hard work and diligence. We ground ourselves in a trust that, through equal opportunity, everyone has a chance to succeed. America's marketplace should be no exception. Instead, it should serve as a beacon. No one should be excluded. Regulation FD would bring all investors, regardless of the size of their holdings, into the information loop -- where they belong. To all of America's investors, it's well past time to say, "Welcome to the neighborhood.""* – Arthur Levitt, August 10, 2000.

**Improved Transparency When Investors Buy and Sell Shares.** In November 2000, the SEC adopted rules that require markets and brokers to provide monthly information on how well they executed stock orders. They must reveal, on a stock-by-stock basis, how often they obtained better prices for customer orders, versus how often they simply executed orders by using the best quotes available at a competing market. In addition, market centers will have to reveal the average spread, the speed of matchups and the number of orders that go unfilled. Brokerages, on a quarterly basis, must make public which market they send customer orders to and whether they received any payment for doing so. Investors, for the first time, will so be able to judge if their broker is getting them the best execution of their trades

*America's investors deserve a national market system where every market is driven by footsteps: the fast approaching footsteps of competitors improving execution quality, the fading footsteps of customers leaving if it fails to measure up*. – Arthur Levitt, July 25, 2000

**Required Mutual Funds to Disclose After Tax Returns.** In January 2001, the Commission adopted rules requiring mutual funds to disclose standardized after-tax returns. Taxes are one of the most significant costs of investing in mutual funds. Recent estimates suggest that more than two and one-half percentage points of the average stock fund's total return is lost each year to taxes - significantly greater than the amount typically lost to fees. Despite the dollars at stake, many investors lack a clear understanding of the impact of taxes on their mutual fund investments, particularly the fact that differences in fund investment strategies can produce markedly different tax consequences. The fund industry resisted the specific nature of the disclosures ultimately adopted by the Commission.