U. S. Securities and Exchange Commission
Washington, D.C. 20549 (202) 272-2650

News Release

Address to the

Financial Executives Institute

(Edited from Notes)

New York City
November 5, 1991

REFLECTIONS

Edward H. Fleischman
Commissioner
Securities and Exchange Commission
Washington, DC 20549

For nearly six years now, I've had the privilege of sitting as a Commissioner of the SEC. How very much those six years have encompassed: the height of the mergers and acquisitions wave, the development of a wide variety of derivative and hybrid and even synthetic instruments, the market break, the acceptance of institutionalization and also of internationalization of the securities markets, and now a persistent (perhaps even a double-dip) recession straining the nation's economic fiber.

Three years ago, I had the temerity to come before you to speak of expectations -- yours and mine -- and to urge you on into the professional fray. Today, I've come, with a much softer tone, to reflect -- and to echo themes from your own reflections (published in the "Special Report: Should You Worry About the Future of the Profession" in the last issue of Financial Executive magazine) -- on what this one lame-duck Commissioner distills from six years of government service.

Let me start by telling you a one-liner from my tour as a GI some forty years ago. An old master sergeant told me one day: "Young fella, don't let anybody get you down with tall tales of how wonderful things used to be in the good old days. You'll soon learn, wherever you go, that the 'good old days' always ended just before you got there." In that spirit, I undertake these reflections without pining for the good old days like some oldster on the year-round beach; I'm still eager to help bring about the good new days that are yet to come -- but I am somewhat slower and more tired in that effort, and I know I have to take the remaining occasions like this one to seek to enlist the likes of you in the struggle. So.......

One of your most senior members evidenced a capacity for quite youthful insight and excitement with a comment to the following effect:

> Sixty years ago, the chief accounting officer of a business enterprise was primarily an experienced accountant who was expected to supervise the accounting employees in their detailed work without much regard for the overall and long-range objectives of the company. Today, the financial executive has broadened his or her interests to include the overall objectives of the company: financial health, personnel, government relations, and management development.

Yes you have, and you have affected the very fabric of American internal corporate structure by the expansion of your interests in that way.

I recently received a copy of the exposure draft study on Internal Control -- An Integrated Framework, prepared for COSO (the Committee of Sponsoring Organizations of the Treadway Commission). Reminiscent of SAS 55, the COSO definition of internal control is "the process by which an entity's board, management and other personnel obtain reasonable assurance as to achievement of specified objectives." While those objectives include the preparation of reliable financial reports as well as the entities' compliance with applicable laws and regulations, the first objective addresses the entity's general business operations and relates to "effective and efficient use of the entity's resources." Of course. How could it be otherwise? At bottom, that's the purpose for which a company is organized. I've no doubt that the company must be a law-abiding corporate citizen; I've no doubt that it must report reliably to its suppliers of capital and its regulators; but its reason for being is to conduct business operations as effectively and efficiently as possible.

Preparation of reliable financial reports is, among other things, a management tool to conduct business, as (in a sense, apart from the fact that the alternative is jail time) is law compliance. So it comes as no surprise that the chief financial and accounting officers of today's business enterprises have broadened their interests. You've had to do so, and the enterprises you serve are the better for the additional input and professional insight you bring. As always, along with those broadened interests come broadened responsibilities, but they are not qualitatively different from the responsibilities you've always borne. And, as I understand the business world swirling around you today, those additional responsibilities are not the most challenging or difficult ones you face.

For another of your members made a comment on what is to me a fascinating theme:

> Pushing back the frontiers of finance and financial management has inevitably disrupted old habits and created new pressures and challenges. But it has also shaken American business out of its industrial lethargy and professional complacency. In turn it has contributed to enhancing America's competitive position, by optimizing how we use our capital resources and our industrial capacity. As financial executives, we now have the opportunity to go beyond reporting what has happened -- and even beyond reporting what may happen. We now can make things happen.

Now there's a vista of challenge, of pro-active rather than re-active responsibility.

Just last week I was reading an article out of a recent issue of Institutional Investor magazine entitled "Indecent Exposure" and subtitled "That's how the FASB views cutting-edge hedging strategies that U.S. companies yearn to use to manage mounting foreign exchange risk. Luckily, it's reconsidering." Aside from describing forex risk and explaining some basic hedging strategies, the article put forex risk into the broader context where it belongs: the currency implications of where to site a plant, even when product and market are both domestic, "are every bit as important as the cost of local labor, the extent of the infrastructure and the strength of local markets." Foreign suppliers' charges, foreign customers' and consumers' prices, and foreign competitors' costs, all elicit greater or lesser attention to forex risk in an increasingly international commercial world -- and all are within the range of the financial executive's consideration. By your reaction to your company's exposure, you can make (or let) things happen to the company -- in a month, in a year, or in a decade.

The tiny sliver spotlighted in the Institutional Investor article gives but a glimpse into a variety of challenges and opportunities opened -- like Pandora's box, some among you may say -- by all the derivative and synthetic instruments created in recent years by the fertile brains on Wall Street and LaSalle Street. But the fact remains that, if used carefully, they can help your company compete, they can help you optimize your company's capital resources and industrial capacity, and they can help you make things happen. I think that's fine. I know that not all companies will pick and choose appropriately among the new instruments available; that's the human experience. But I also know well the incentive goading you to learn to use these instruments properly. As phrased at the conclusion of the Institutional Investor piece: "What's changed in an increasingly global marketplace is that the speed with which death by currency mismanagement comes is now stunningly fast." (The emphasis is mine.)

Speed of events, and of reporting of events, leads to my next reflection, this time adapted from a comment by one of your formerly-on-line and currently-academic members:

> I blame the analysts for much of our present short-term orientation. And going along with the boss has helped. I know many senior officers who wanted confirmations, not real opinions. Thus, my own law of corporate structure: An organization takes on the characteristics of its chief executive officer.

I'm going to split that in half.

First, as to short-term orientation, the analysts may have been the original driveshaft for short-term (which means quarterly) orientation -- I would have guessed that the president's letter accompanying the old quarterly dividend check was the real initiator -- but in any event the SEC now serves as the differential, transmitting that ongoing drive to the financial reporting wheels.

Most of the world is on a semi-annual reporting cycle. Four years ago, at an open meeting of the SEC, I suggested that the U.S. could abandon mandatory quarterly reports and move to semi-annual reporting (like the old Form 9-K) without doing fundamental damage to our corporate disclosure system. In my view, the major public companies would remain subject to the financial analysts' pressure -- and, more important, to their own stockholders' and debtholders' pressure -- to report quarterly, and I've no doubt that other companies that chose to report only semi-annually would suffer a price discount in the marketplace. But the role of government would be changed from mandating short-term orientation to insisting that whenever (not less often than semi-annually) a publicly-held enterprise does speak in public, it must speak fully of its trends, risks and prospects (the MD&A analysis with which you are all familiar). That latter is, in my estimation, a far more constructive role for government than the one the SEC quarterly-reporting rules now play in terms of imposing short-term orientation on business managers.

The second part of this particular comment strikes very close to home for me. We've all known CEOs who wanted confirmations, not real opinions, and we've all seen organizations take on the characteristics of their CEOs. Up close it's a fearsome thing, and there aren't very many of us possessed of the financial or structural independence to be able to give real opinions nevertheless. (I'm very fortunate in that respect.)

In the business context, this is a real problem to everyone involved: to the board members, who are deprived of honest professional input; to the CEO herself or himself, whose effectiveness is in fact diminished by the effects of her or his own demands; to the financial executive, whose professional growth and self-esteem are inhibited; to the enterprise as an entity, for which honest and integrated leadership and experienced succession are important ends in themselves; to the financial publics, be they present debtholders or present equityholders or prospective buyers, who cannot properly value the future cash flows of the enterprise; and to the general public, affected indirectly but affected nonetheless. It is the business patterns frequently evidencing the development of this syndrome for which we should all remain particularly alert: not merely the media-advertised dictatorial CEO, but also (1) the enterprise that has achieved a premium in its price/earnings ratio because of several consecutive years of better-than-peer-group results (Lord help the financial executive who first sees the warning signs that growth is continuing but only at the peer-group rate), and (2) the enterprise that is among the last in its industry to evidence the effects of an industry-wide externality (American GAAP does not allow for unallocated reserves or for their recovery to modify other results), and (3) the enterprise that is characterized by the hockey-stick pattern of earnings all at the end of each reporting period (confirmation that the blade of the stick has appeared on the charts is often the only acceptable report). I don't envy you the task of standing firm in your responses to insistent CEOs, but you and I both know -- and the SEC fully demonstrated in the <u>Oak Industries</u> orders that it well knows -- that there is no other tolerable way.

The confirmations and opinions you give must be truthful and professional. That doesn't mean they must always be bleak -- all contingency risk and no revenue reward. It means they must be made professionally and in good faith, and in accordance with GAAP as you professionally understand GAAP to apply. (There are times when the SEC says otherwise, but that "otherwise" simply can't be the law.)

In another vein, there are times when the SEC requirements don't elicit information that you might consider disclosing just the same. This happens to be one of my favorite hobby horses, so I hope you'll forgive my adapting a second quote from one of your members:

> Let me have the numbers and I'll find the industry-wide rates and make the adjustments myself. If the ordinary reader can't do this, he or she can't evaluate the numbers anyway.

So much insight, in my view, is embedded in that brief observation.

Of course I understand that no financial executive is going to volunteer proprietary internal information, but I have always been a proponent of whatever degree of non-mandated disaggregation can be done by public companies without inordinate expense and without self-damage. I usually articulate this theory as "show me the bricks so that I can put the house together in my own way." Its corollary should be: "with the individual bricks at my disposal, you have less of a responsibility for showing me which bricks are hollow or where the foundations are crumbling." I ought to have some obligation to look at the structure without a financial nanny; if you let me have the numbers, I should be bound to make my own adjustments myself. (The very articulation of that notion shows you how far into wonderland the opportunity for reflections can lead.)

While I'm in Oz, let me urge a partial change in the viewpoint evidenced in a comment from one of your members who couples healthy skepticism with open-eyed realism:

> Companies will interact with regulatory bodies much as they have in the past. If an issue affects a company, then that firm will get involved. I don't see any proactive initiative developing on the part of individual companies or their lobbying agencies.

I agree that, for the most part, you will go on interacting with regulatory bodies much as you have in the past, but there is one area where you have the obligation, and the opportunity, to do more.

F.E.I. comes to Washington to converse with senior staff of the SEC and with those Commissioners who are sufficiently interested and educated to attend. F.E.I. comments on SEC rule proposals and on FASB and AICPA exposure drafts. F.E.I. lobbies in the halls of Congress -- and sometimes effectively, as I read in the Washington Post concerning the Wyden Bill only a few weeks ago. It's time to raise your sights, in Washington as you have in Norwalk.

It's not only that you need input into SEC decisions affecting enterprise reporting; it's that the SEC needs the input that some of you could provide. The SEC has had one in-house corporate lawyer as a Commissioner in my memory. The SEC has never had a professional financial executive. (The SEC hasn't even had anyone with an accounting background for nearly twenty years.) It's a long pull, and it's a political pull, but the game is very much worth the candle. And since it won't be achieved quickly, I put it to you that the time to start is now. (Please don't think this is advice I limit to the F.E.I. I would say the same to each representative organization of participants in the financial markets -- and I mean it for all.)

Interaction with the regulators brings me to the single subject on which more of your members commented than any other. I'll adapt three quotes:

> Regulation will no doubt become more and more burdensome and expensive. It's a function of big government, and it would be very difficult for the system to change. Too many people have too much to lose, and these are the same people who are charged with orchestrating the changes.
>
> Our challenge is to ameliorate the excesses of recent years without reverting to counter extremes or regulatory strangulation. For example, the sensationalist media and demigods in Washington have condemned junk bonds. Nevertheless the basic premise of creating a new source of funding for smaller and less creditworthy companies promotes the growth of many new businesses, expands research, encourages innovation, increases employment, and improves the economy in general. Those who criminally abused this new instrument deserve to be just where they are, but the fundamental idea was good.
>
> My biggest worry about the future of corporate finance is the potential crush of regulation. It seems more and more energy and resources are being spent both conforming and reacting to regulatory intervention. That is not to say that all regulation is not needed, but rather that regulation should be intelligent, resourceful and not anti-competitive in a worldwide marketplace.

I have become somewhat notorious -- perhaps I owe my invitation to speak here today to the notoriety -- for agreeing with those sentiments.

Regulatory intrusion lays upon the regulated community a set of costs that are immediately borne by the regulated entites but that then ripple and spread out through the public generally. Those costs, if unrecognized, can be insidious, and, if unrestrained, can be suffocating. It is therefore essential for regulators to weigh and balance the benefits sought to be achieved against those costs (so far as they can be assayed), and to reassess that balance periodically as both benefits and costs become more tangible. The objective ought to be to make the regulated activity function as efficiently as possible with the least intrusive externally-mandated regulatory burden; the work of two successive Noble Laureates, applicable to the financial markets, should have taught us the value of that objective.

When it comes to financial disclosure imposed by rulemaking, the balancing analysis at the time of initial imposition of regulatory requirements all too often appears to be a process of articulating hoped-for benefits without real consideration of anticipatable costs, and it is a rare occasion indeed (despite the Regulatory Flexibility Act) when that balancing analysis is re-undertaken after regulatory requirements have been for some time in effect. As to financial disclosure imposed by prosecutory enforcement (normally by consent order deemed in practice to be applicable to every reporting entity simularly situated), hardly even a pretense of balancing analysis is observed. In my view, financial regulators who fail to analyze -- or who fail continually to re-analyze -- the regulatory costs as well as the regulatory benefits of their regulatory actions (whether by rulemaking or by enforcement) mis-perform their function and, by doing so, justify your members' criticism of the entire system of regulation as unduly burdensome, expensive, strangulating and anti-competitive in the worldwide market place.

Let me quote to you from a recent speech by Treasury Secretary Brady that puts it all together for me. With reference to the events that have roiled the government securities markets and have drawn banner headlines this summer and fall, Secretary Brady called for "swift and fair justice from balanced and consistent regulators." [The emphasis is mine.] He pointed up the choice, and the temptation, among enforcement alternatives quite clearly: "In the desire to seek out criminals and build our reputation as tough enforcers, let us not forget that there are many honorable people in our financial institutions [and, I would add, our non-financial business enterprises] who are as appalled as we are at recent events." And: "We in the regulatory community will have the laboring oar in creating new regulations [and, I would add, new enforcement policies]. If they are sensible, they will improve our chances to avoid this kind of fraud in the future. But ... if the system we create is too onerous, the money and the markets will work around it [or, I would add, work away from it] or not work at all."

I do believe that there is a further factor to be taken into consideration in all of this. In testimony before the Senate Securities Subcommittee, the SEC recently took a position that, when applied to reporting entities, may be paraphased this way: The laws and regulations applicable to financial disclosures are complex, and good faith problems may occur even in the very best firms. However, it is not an adequate ethical standard for a firm simply to seek to avoid prosecution by the SEC for violation of applicable rules. Rather, those in positions of leadership have as perhaps their very highest duty the establishment of an environment in which a strong code of ethics prevails in the firm's determination of what is to be disclosed, and how. Hopefully, a strong code of ethics will prevent a firm from knowingly even approaching the limits of unlawful conduct. Where problems do occur, however, it should be seen as the personal obligation of every executive to make an immediate and full investigation of the possible wrongdoing.

In the view of this <u>one</u> Commissioner, the discovery, investigation, correction and (if material) subsequent reporting of financial wrongdoing <u>within</u> your business enterprise is part and parcel of your professional responsibility and, when performed by you (with the supervision of your board of directors and the assistance of your internal and external auditors and your chosen counsel) rather than by the government's delegated investigatory forces, merits commendation <u>for the encouragement of law compliance</u> throughout the reporting system and in the financial markets generally. Not the media's and the public's acclaim for a broadsword-wielding, muscle-flexing regulator, but rather the effective spreading of the contagion of law compliance, creates the best and safest market system with the most genuine protection for investors.

Well, to conclude: I cannot reflect on six years' life as an SEC Commissioner, or upon the prior twenty-six years' life as a private lawyer, without coming back to the lodestone of which I spoke to you three years ago and which I've mentioned repeatedly today. I'm a firm believer in the internal incentive that carries each of us through the daily travails and over the extraordinary hurdles of business life: the insistence on fulfillment of personal standards of professionalism in the discharge of business responsibilities. In the performance of my own responsibilities I take comfort -- and I believe I am not alone -- in your continuing efforts to exercise professionalism in judgment, professionalism in resisting pressure, professionalism in analysis, professionalism in emphasizing the importance of your company's control environment. And I take <u>great</u> comfort -- and again I believe I am not alone -- that, in the face of the kaleidoscope of change in today's business world, the Financial Executives Institute remains dedicated -- in a sense as proxy for all your many directors, for the members of your audit committees, for your CEOs, for your shareholders, for the SEC, for the Congressional oversight committees, and for the public at large -- to the fulfillment of the personal standards of professionalism that, in my reflections, I am proud to say I share with you.