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Challenge & Opportunity for the SEC

A Conversation with Former SEC Chair Harvey Pitt

Harvey L. Pitt served as the twenty-sixth Chairman of the United States Securities and Exchange Commission from 2001 until 2003. In that role, Mr. Pitt was responsible, among other things, for overseeing the SEC's response to the market disruptions resulting from the terrorist attacks of 9/11, for creating the SEC's "real time enforcement" program, and for leading the Commission's adoption of dozens of rules in response to the corporate and accounting crises generated by the excesses of the 1990s. For nearly a quarter of a century before becoming the SEC's Chairman, he was a senior corporate partner in the international law firm Fried, Frank, Harris, Shriver & Jacobson. A founding trustee and the first President of the SEC Historical Society, Mr. Pitt is a leading expert and frequent commentator on the U.S. securities markets and regulatory environment. He participates in a wide variety of bar and continuing legal education activities to further public consideration of significant corporate and securities law issues.

Mr. Pitt is the Chief Executive Officer of the global business consulting firm Kalorama Partners, LLC and its law firm affiliate, Kalorama Legal Services, PLLC.

BLB&G Partner Mark Lebovitch recently had the opportunity to interview Chairman Pitt about his time as head of the agency, and about the SEC's role in today's regulatory landscape.

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Q *Mark Lebovitch: Thank you for your time, Mr. Chairman. For starters, how did you begin with the SEC?*

Chairman Harvey Pitt: My professional career began in 1968 as an entry-level attorney in the SEC's Office of General Counsel. We counseled, litigated, drafted legislation and rules, helped develop SEC policies, and guided the Agency's performance of its substantive mandates. After starting in the GC's Office, I was Legal Assistant to Commissioner Francis M. Wheat, an Editor of the SEC's Institutional Investor Study, Chief Counsel of the Division of Market Regulation (now Trading & Markets) and, after seven years, I became the first career SEC General Counsel, serving three years.

Q *What were your best and worst experiences as an SEC attorney?*

Working as an attorney at the SEC was enormously gratifying. One highly positive aspect was receiving immediate and broad responsibility for significant matters. That was also one of the most frightening aspects—I wasn't necessarily always ready for the responsibility I received! Perhaps my "best" experience was serving as Chairman Ray Garrett's Chief of Staff. Ray was brilliant and a fabulous mentor, both professionally and personally; I tried to embrace the wisdom he constantly dispensed.

My worst experience was arguing *SEC v. Sloan*, 436 U.S. 103 (1978), in the Supreme Court. In the absence of adequate information about publicly traded securities, the SEC could suspend trading "for a period not exceeding ten days." From its creation, the SEC interpreted those seven words as if there were ten — that is, "for a period not exceeding ten days at a time." Samuel Sloan was defrocked as a securities broker for insufficient net capital, caused by holding shares of a security the SEC suspended, ten days at a time, for over a year! Sloan challenged his expulsion, arguing the Commission unlawfully nullified the value of the suspended security by suspending trading beyond the initial ten days. When the case reached the Supreme Court, the Solicitor General wouldn't argue the case, so I did, and lost 9-0 to a non-lawyer who didn't even have his own lawyer! I argued several other cases in the Supreme Court as SEC GC, with better results, leading Harold Williams—the third Chairman I served as GC—to remark at my farewell reception that I had never lost a Supreme Court case I argued myself, where the other side was represented by counsel!

Q *What was your biggest surprise during your tenure as Chairman ?*

My biggest surprise was how political, vitriolic and ill-informed Congressional and journalistic criticism of the SEC (and especially its Chairman) was. I naively believed that, if we did the right things substantively, our efforts would be credited. In the face of one crisis after another, starting with 9/11 (where there was praise, not criticism), followed by Enron, Arthur Andersen, faulty analyst research, etc., most politicians and journalists weren't interested in helping us solve problems, but only in capitalizing on, and blaming others for, them.

Q *What would you say are the SEC's top strengths and weaknesses?*

The SEC's real strengths are its role, history, and the high quality of the people it attracts. The Commission's mandate is to protect investors and facilitate capital formation. When performing those functions at its historically high levels, it becomes an important instrument for economic growth. Our freedoms are a direct result of an economic system that facilitates private enterprise and concomitantly ensures that those who commit funds to our capital markets are protected from sharp practices and fraud. The SEC has always successfully attracted the highest quality professionals to carry out its important mission.

Conversely, the SEC is plagued by continually expanding mandates without concomitant resource increases, efforts of many Congressmen to treat the Commission as if it were an institutional piñata, and its deserved reputation as "over-lawyered." Since 2002, Congress passed Sarbanes-Oxley, Dodd-Frank and JOBS, each exponentially increasing Agency burdens, without providing means to fulfill them. The Commission is substantially behind in adopting required rules, despite herculean efforts. Simultaneously, the Commission is constantly attacked, both by Congress and the press. No agency is perfect, but the SEC gets most things right, yet receives little or no recognition. Its few missteps result in excessive attacks. Finally, the Agency must wean itself from its over-dependence on legal analysis, and start looking at things from an economic point of view.

Q *What do you see as the most significant opportunities and threats the SEC faces today?*

The SEC can modernize the way we regulate financial services, and make regulation relevant to current market realities. The statutory framework it administers — especially after recent legislative efforts—

reflects a quilt-patch system, designed and developed nearly eighty years ago. That system based regulation on what enterprises did at birth, rather than the functional services and products enterprises currently offer. Functional regulation — where comparable services are regulated comparably — is crucial. While it will require creativity, the SEC needs to embrace functional regulation and mold the statutes it administers to the realities of today's markets.

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One threat the SEC faces is industry's increasing reliance on technology. We've seen repeated technological snafus create capital markets havoc. Neither the Commission, self-regulators, nor the financial services industry effectively anticipate how current technology creates problems;

Chairman Pitt talks with the Senate Banking Committee Chair Paul Sarbanes during a Capitol Hill hearing about accounting and investor protection issues. (Getty Images)

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all lack early warning systems for technological problems, and all lack viable methodologies for responding to problems that do arise. Another threat is the SEC's lack of resources. In an era of financial restraint, the only viable solution is to give the SEC the same ability to fund its own operations that a number of the banking agencies have. The SEC polices increasingly complex markets; it will never effectively oversee markets it does not understand. Because SEC self-funding is unlikely, it must rely on self-regulation for industries it oversees.

Q ***What would you say is the most significant corporate governance problem you see today?***

Many directors — while intending to perform at the highest level — don't understand how to do their jobs. This is exacerbated by Sarbanes-Oxley, which seems to have substituted a "check-the-box" mentality for serious rigor. Outside advisors contribute when they deem themselves beholden to those who hire them, rather than to the community of interests reflected by the corporation. Frequently, this lack of true rigor manifests itself in two extremes—when things seem to being going well, these board members are compliant and unquestioning; when trouble strikes, they adopt adversarial postures. Neither extreme is conducive to good governance. Boards should try to maximize a collaborative approach with management, but always maintain healthy skepticism, to protect crucial shareholder interests.

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Q ***How would you change how corporations are managed?***

I have a number of thoughts on that:

- There's too much emphasis today on form and process, over substance, vis-à-vis governance. Independent board members should organize themselves to be responsive to management initiatives while also setting their own agendas.
- Many companies have unduly large boards, making it impossible for those boards to function effectively. Smaller boards can be far more effective.
- Too much burden is placed on audit committees; separate committees — for governance, legal compliance and risk management — should be the norm.

- In many instances, management treats board members as if they were "rubber stamps," presenting them with conclusions, rather than explicating the process that produced a particular recommendation.

- At some companies, board meetings are like "show-and-tell" sessions, where management asserts everything is fine, and doesn't provide meaningful insights into the reasoning that led management to the positions they are recommending their boards embrace.

Q ***You have taken a public stance against mandatory auditor rotation. What do you recommend instead?***

Those promoting mandatory rotation have a valid concern—ensuring auditor independence. Unfortunately, any rote obligation to change auditors after X years won't ensure greater independence, will substitute less knowledgeable auditors for audit firms steeped in a company's business, and may do more harm than good. Studies indicate serious frauds often occur in the first 2-3 years of an audit firm's retention. I believe audit committees must ensure the independence and high performance of their outside auditors. By giving audit committees the tools to fulfill that obligation, true independence will result—audit committees should be obligated to perform a *de novo* review of existing auditors every 5-7 years. This consideration should be searching and extensive, not cursory. Audit Committees should have access to PCAOB quality review data, to assess how exacting their outside accounting firm has been. This regime would permit replacement of outside auditors more frequently than a rote service term limit, but would require affirmative evidence that the outside auditors are performing at the highest professional level. It would produce meaningful rotation of audit firms based on quality and independence, rather than a rote system that would prevent audit committees from exercising their independent judgment about the quality and independence of audits their company receives from its outside audit firm.

Q ***What do you see as the most significant obstacle to restoring investor confidence today?***

Investor confidence is a function of many variables, only some of which are within the control of regulators and the private sector. Among the hurdles we face are:

- A lack of real and immediate transparency on the part of public companies, market venues, self-regulators and regulators;

- "Reverse laissez faire" by the business community — inertia that causes businesses to wait for government to opine whether what they're doing is wrong, why it's wrong, and how to fix it;

- A sense businesses don't really care about their customers and clients (after they've parted with their money); and

- An overarching concern regulators are almost always a day late, a dollar short, and devoid of creativity.

These are all things that can be fixed, if the will to do so exists. ◆

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