Misc.

VI. MISCELLANEOUS

A. THE SEC AND CAPITAL FORMATION BY DR. ROGER SPENCER

The language of the Securities Act of 1933 and Securities Exchange Act of 1934 does not contain direct references to capital formation issues. That does not mean that in passing the Acts, which are typically interpreted as "investor protection Acts", Congress was unconcerned about the role the SEC might play with regard to encouraging growth of the capital stock. The letter of transmittal which accompanied a recent submission to Congress of the SEC's annual report states:

> "Congress's fundamental objective in enacting the federal securities laws was to promote public confidence in the securities markets in order to foster the vital process by which capital is marshalled from the public and channelled into growth of our economy. Accordingly, while the Commission's primary responsibility is to protect investors, the discharge of that responsibility results, in a broad sense, in stimulation of investor's willingness to provide the capital necessary to fuel our private enterprise system." 1/

SEC and Securities Demand

It has been said that full disclosure is both the lynchpin of investor protection and the heart of the capital formation process. 2/ Disclosure is obtained both by the anti-fraud provisions of Rule 10b-5 and by mandate; that is, information which is provided by firms must be accurate and certain types of information must be provided. The clear trade-off faced by the regulator is how much disclosure (and associated enforcement) for purposes of stimulating

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1/ 1977 SEC Annual Report.

2/ 1979 SEC Annual Report.

investor confidence should be encouraged vs. how much cost should be incurred by firms which must supply the required information. Apart from any impact on capital formation, mandated disclosure can (and has) been defended on the economic grounds of positive externalities. That is, governmental authority to require information should be exercised because of the benefits which accrue to third parties in information production. In this context, information is a quasi-public good, like education or national parks, with indivisible benefits and inherent difficulties in excluding free riders. Beyond this, disclosure is advocated on equity--or fairness--grounds and because it is thought that the incentives to produce positive information exceed those which firms have when the data about firm operations is not good.

Presuming that valid arguments can be made for disclosure, the question remains whether investors find the information which is mandated to be useful and whether production of that information engenders investor confidence. An affirmative answer to the question translates into increased securities demand (beyond that which would exist in the absence of SEC disclosure), and concomitantly, an impact on capital formation.

In the absence of market-oriented disclosure, it is difficult to say just what informational items would be regularly produced by firms and which would not. Suffice it to say that, prior to the 1933 and 1934 Acts, much less information on firm operations was produced than after

and considerably less disclosure is forthcoming in countries without an SEC-equivalent than in the United States. Because it is difficult to hold constant the Depression of the 1930's and the institutional differences between the U.S. and other nations, one cannot easily test which system is most conducive to enhancement of the capital stock. 3/

A former Commission bf the SEC, A. A. Sommer, has suggested that no reliable empirical test examining the relation between disclosure and investor confidence can be conducted.

> "I do not believe that investor confidence can be measured empirically. It is a matter of subtle psychology. Investors should be assured that they are receiving the information necessary to make informed decisions."4/

Although aggregative tests of disclosure and investor confidence generally are indeed hard to come by, specific disclosure provisions are somewhat more testable. Professor

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3/ Analysts have tried to conduct various types of comparison, however. Professor George Benston of the University of Rochester attempted such assessments and concluded that the U.S. system of mandatory disclosure suffers by comparison. Benston's examination of stock prices of NYSE securities pre-and post 1934 uncovered no positive effects on risk or return caused by the introduction of mandatory disclosure. Also, since NYSE stock prices followed a random walk pattern both before and after 1934, Benston concluded that "fairness" to investors was not enhanced by mandatory disclosure. On the other side of the fence, both Irwin Friend and Morris Mendelsohn of Wharton University dispute Benston's findings.

4/ A. A. Sommer, from speech cited in Kripke, pp. 28-29.

Dan Dhaliwal of the University of Iowa examined the relation between line-of-business reporting, first proposed by the SEC in 1968, and the cost of equity capital, finding the additional information appeared to reduce uncertainty about firm stocks, thereby reducing (in some cases) firms' costs of capital. Professor Paul Griffin, of Stanford University, conducted a somewhat different test on another controversial element of SEC disclosure, reporting of foreign bribes. Griffin's evidence suggested that despite the costs incurred, the new information obtained had little effect on investor's views of firms' market value.

Perhaps even more difficult to quantify than the effect of disclosure on investor confidence is the influence of the enforcement of Commission rules and regulations on confidence. It is well known that the Commission maintains a vigorous enforcement presence, one which is reflected regularly in news reports, in papers and periodicals and on radio and television. Certain other regulators, such as those with commercial bank oversight responsibility, seem to prefer less publicity associated with rule violations which they uncover. These opposing approaches may be justified on the grounds that the regulators are attempting to achieve different goals. Bank regulators wish to prevent a "run" on banks by depositors which might be set off by public disclosure of bank problems, and the securities regulators wish to demonstrate to the investor that he is protected

from those who would take advantage of him. The question remains, however, that if investors feel more secure in the knowledge that their interests are being protected by a regulator which often calls attention to violations of securities law, why does not the depositor feel the same way about violations of bank law? Of course, the question could be posed observely. From the viewpoint of the investor, the issue boils down to whether he gains more confience in securities markets from learning about many violations of securities laws than if he were to learn very little about such problems.

Virtually all activities of the Commission have as their basic intent the protection of investors and stimulation of investor confidence. This includes imposition of rules in the securities marketplace to assure equitable treatment of investors by brokers/dealers, actions taken, in conjunction with the Financial Accounting Standards Board, with regard to accounting principles and practices, and the registration of mutual funds and municipal securities dealers. The demand for securities, however, is a function of more than the degree of confidence investors have in the capacity of regulators to protect them. Another variable of interest is transactions cost.

High costs of purchasing and selling securities would negatively affect capital formation. Not a great deal of work has been done in analysis of the elasticity of securities demand with respect to transactions cost.

Perhaps the study which best relates brokerage costs, which are influenced to some extent by SEC policy decisions, to a measure of stock market activity is that of Thomas Epps. Epps determined that a 10% increase in total transaction costs leads to a decline in trading volume of about 2-1/2%. Because brokerage commissions accounted for about 2/3 of the transactions costs in his sample of stocks, he concluded that "a 10% increase in broker fees alone would be expected to reduce trading volume by about 2%. 5/

A major responsibility of the SEC regarding securities trading is its mandate recorded in the 1975 Amendments to the Securities Acts to promote the development of a National Market System. No person or body, such as the Congress, the SEC or the NYSE, knows just what the markets of the 21st Century will look like, but the intent of the legislation was to instill a greater degree of efficiency in the trading markets of tomorrow. The role of traders, specialists, and exchanges is continually evolving as the national market takes shape. Several market experiments are currently being conducted. One lings exchange floors with a price information network and another, permits orders to be matched automatically through a computer-based "black box." Whether these or [illegible] another system eventually evolve as the trading market of the future, it is likely that continued efforts to enhance

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5/ Thomas W. Epps, "The Demand for Brokers' Services: the Relation Between Security Trading Volume and Transaction Cost", Bell Journal of Economics, Spring 1976, p. 192.

trading efficiency will lead to lower transaction costs and a positive impact on capital formation.

It should not be forgotten that another facet of the 1975 Securities Act amendments strongly affecting securities trading was the unfixing of commission rates. Generally, commission rate deregulation has been deemed a success, largely because of transaction cost savings.

The Commission also has oversight responsibility in the stock options area. Only recently did the SEC, which had halted the expansion of put and call options because of a host of fraudulent practices, permit additional stock options to be traded. The options security demand relation is a complex one. To the extent that put and call options assist investors to develop and employ hedge strategies, risk is reduced and the trading characteristics of stocks are enhanced. However, there is concern that if investors lose their money through speculation in options or if potential investors are frightened away by negative publicity about options market practices, the attractiveness of the securities market may be diminished. Moreoever, if investors use options in <u>substitution</u> for stock purchases (and there is no convincing evidence that they do) the demand for securities declines.

Many SEC rules pertaining to brokerage operations indirectly affect securities demand. For example, the Commission's net capital rule, which requires brokerage firms to maintain certain capital standards in the interests of firm safety could be altered to encourage or discourage firm activities.

One effect of a relatively stringent net capital rule would be the tying up of funds which could be used for enhancement of the firm's trading position. There is, in fact, a proposal before the Commission, submitted by the Securities Industry Association, drafted to cut net capital requirements about in half. The Commission must balance its desire to permit broker-dealers to expand firm operations against its need to encourage firms to maintain a safe capital level during times of volatile markets.

The SEC and Accounting Effects

There would be little reason to discuss accounting at all in regard to capital formation were it not for the possibility that accounting affects both the investor's perception of firm value and expectations of its future performance, and the behavior of firm officials whose investment policy decisions may be influenced by accounting numbers. Can it be presumed that the Foreign Corrupt Parctices Act of 1977, which imposed, by way of accounting provisions, significant changes in managerial relationships within corporations, has affected investment policy decisions? Or that investors perceive firms differently somehow because of the changes? Do the pressures toward greater independence of internal audit committees and board of directors influence investment behavior or investor perceptions? If so, how? The effect on capital formation could be substantial.

Among the few pieces of evidence regarding accounting and firm behavior is a soon-to-be published paper entitled, "The Economic Effects of Involuntary Uniformity in the Financial Reporting of R & D Expenditures" by Professor Bertrand Horowitz and Richard Kolodny. Their paper examines the effect of FASB and SEC actions (1974-1975) regarding the decision to require all research and development costs to be charged to expense when incurred rather than capitalized. The authors concluded that "The expense-only rule caused a relative decline in the R & E outlays for small, high-technology firms which had previously used the deferral method of measurement." 6/ The authors do not attempt to evaluate the possible effects of reduced R & D outlays by small, high-technology firms on investment by those firms or on investment generally.

The attractiveness of the assets of other firms may also be influenced by Commission actions. In particular, the recent decisions regarding takeover bids and the time period for bid announcements may make the merger route a more or less attractive avenue for expansion. If the Commission's actions are perceived as slowing down merger activities, one must presume that expansion by purchase of new plant/equipment rather than the purchase of old, can positively influence capital formation.

The SEC and Securities Supply

In the aggregate, a firm experiences different types of costs in dealing with the SEC. The less obvious potential

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6/ Horowitz-Kolodny, p. 38.

costs, those of altering the firm's methods of doing business, has already been cited. These costs, which may be associated with different input mixes, or foregone opportunities, are particularly difficult to measure. Compliance costs, which include such SEC-induced costs as legal fees, accounting fees and printing fees are more quantifiable, but still difficult to interpret, given that in the absence of an SEC, some of these costs would be incurred anyway.

There should be no presumption that all such costs directly influence the supply of securities. Registration costs for new securities constitute one subset of compliance costs, which reached several hundred thousand dollars. A survey conducted a few years ago by the SEC's Advisory Committee on Corporate Disclosure found a wide range of compliance costs, but determined that the costs per dollar of assets were much higher for small firms than large firms. This evidence was consistent with the Commission's decision to consider more closely the special problems of small businesses, particularly in their efforts to raise capital.

The Commission recently has taken numerous actions to cut the costs for small firms of supplying capital. These actions have likely contributed to the large jump in initial offerings of stock to thepublic, reported to be up in First Quarter 1980 more than 100% over first quarter 1979. 7/

7/ "Going Public."

The ceiling on securities issued under Regulation A, permitting certain issuers to raise capital from a public offering without full scale registration, was lifted from $500,000 to $1,500,000. Rule 242, which permits small firms to issue stock to a class of investors not requiring large amounts of information about the firm, was adopted only recently.

The Commission created a new Form S-18, permitting firms to issue up to $5 million of securities with substantially less information required than for the standard S-1 registration document. In addition, Rule 144, which limits the amount of unregistered securities to be re-sold during a particular time frame was substantially relaxed, enhancing stock liquidity and encouraging the issuance of unregistered securities.

Regulatory Uncertainty

As a final link between the Commission and capital formation, consider not only the direction of Commission actions affecting securities demand or supply, but the certainty of such actions. Firm investment decisions are made on the basis of expectations over a substantial period of time. Firms would like to have "certainty of regulation" over the relevant time frame to offset (certainly not add to) uncertainties which arise from other sources. It has been conjectured 8/ that a principal explanation for the weakness in capital formation over the past decade has been a rise

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8/ By Burton Malkiel, "The Capital Formation Problems in the United States," Journal of Finance, May 1979.

in risk premiums, partially associated with regualtory phenomena. Major sources of risk have been energy and agricultural shocks, destabilizing monetary and fiscal policies, and such considerable regulatory forces as environmental protection policies.

The certainty of SEC regulation ranks well below these factors as a source of investment concern to most firms. However, with inflation and the increasing "homogenization" of financial institutions, the Commission's role could become an expanding one. Inflation has led to the proliferation of such securities as options, forwards, and futures, all of which are of current interest to the SEC. Its actions could influence the extent to which these "derivative" securities are employed to facilitate or detract from capital formation. Moreover, as savings and loans become more like banks, and banks become more like brokerage houses, the potential for regulatory overlap among the financial oversight bodies increases in the same way as it does with the rise in use of derivative securities. The overlap will not likely prove a major investment concern, either to issuers or purchasers of securities, but the potential for confusion and uncertainty remains.

Of more direct impact are the SEC's decisions on questions influencing the health and vitality of securities firms, particularly those which affect the underwriting function of such firms. Some actions, such as those pertaining to the deregulation of commission rates and the national market

system, are years in the making, may be difficult to predict and have an uncertain effect on the composition of the securities industry. Others, such as the presentation of evidence to Congress showing the potential adverse impact on investment bankers and securities firms generally if banks are permitted to underwrite muncipal revenue bonds, are not so long in the making and have a more clearly predictable implication for the securities industry.

Summary

Regulatory uncertainty is a factor with which those who demand securities and supply securities must contend. As with the other routes by which the Commission affects capital formation, including investor confidence, accounting decisions, and issuer costs, it is a matter of concern to many participants in the market.

It must be emphasized that those SEC actions which affect securities supply and demand are certainly of interest, but hardly compare with the impact of say, major changes in monetary and fiscal policies. Neverthe less, at a time when the economy faces another bout with prolonged stagflation and weak capital growth, any prudent measures which can be taken to encourage expanded-investment opportunities should be welcomed.

B. FEDERAL-STATE RELATIONSHIPS IN SECURITY REGULATIONS

It is recommended that the following suggestions be considered as a way of improving the relationship between the SEC and state security regulators. It is felt that enhancement of the State authority is a desirable goal and could permit some phasing down of the Federal role at some future time.

An SEC Commissioner should be considered for appointment from among present Blue Sky administrators. Not since the term of Commissioner Hugh Owen, a former state administrator from Oklahoma, has a former state administrator served on the Commission. Emerging state securities activity coupled with federal deregulation makes helpful a full appreciation and understanding of the relationship of state securities laws to the federal Acts.

The President should encourage the SEC to coordinate and cooperate with state securities regulatory authorities. To this end all prospective candidates for appointment to the Commission should be examined prior to nomination on their views of "Blue Sky" laws. Preference should be given those candidates for nomination who evidence a desire to work with state administrators. In addition, in an attempt to foster understanding and to encourage the free flow of information between state and fedreal securities regulators, the President should encourage the Commission to meet quarterly with NSAA officers and Directors.

The Chairman should direct that the Director of each Division of the SEC designate one upper level Division manager to establish and maintain liaison with state securities administrators. This liaison person should be responsible for soliciting state comments for all Division requested rules prior to the submission of those rules to the Commission and prior to publication of those rules for public comment. In addition, it should be the responsibility of this liaison person to counsel and advise state employees during their tenure with the Commission pursuant to the Intergovernmental Personnel Exchange Act. The Division liaison person shall be accountable to the Division Director for the division direction for the Division's successful state liaison program. The Division Director shall be accountable to the Chairman, or designated state liaison commissioner for implementing and maintaining a successful state securities law cooperative program.

The SEC should expand its participation in the Intergovernmental Personnel Exchange Program, IPA. This exchange of state and federal employees would serve to generate a better understanding and appreciation for the respective roles played by federal and state securities regulatory personnel. The personal contacts made by those employees in the program should promote mutual trust and respect in both sectors of a two-tiered securities regulatory scheme. Mutual

trust and respect cuts through red tape and short cuts procedures. Mutual trust and respect can form the foundation for more efficient regulation of securities markets.

In order to insure that the Commission's cooperative program indeed works, one commissioner should be assigned the duty of establishing and maintaining a close working relationship with state administrators. He shall supervise and report on the progress of the state liaison program within each Division of the Commission. The Commissioner shall annually report to the President and Congress on its state liaison program.

Increasingly, the principal focus of state securities enforcement is on multi-jurisdictional crimes. Complex economic crimes are rarely, if ever, confined within the boundaries of a single state. The securities violators now investigated by state agencies are highly sophisticated in the manipulation regulatory and enforcement loopholes. They are also very mobile, and regularly use the ordinary lack of communication between state jurisdictions to their advantage. To overcome these problems, state and local law enforcement has begun to recognize the value of structured multi-state enforcement projects. The Leviticus Project, which was partly initiated by state securities administrators, serves as an example of such a project.

The Leviticus Project is a cooperative multi-state investigation of crimes affecting the Appalachian coal industry. The Project consists of fourteen law enforcement agencies from Alabama, Georgia, Indiana, Kentucky, New York, Pennsylvania and Virginia. The member states joined as a structured group in 1978 after working together on a case-by-case basis since 1976. In the Autumn of 1978, the Leviticus Project Association was formed to seek funding assistance from L.E.A.A. An initial grant of $1 million was approved in February, 1980, followed in June, 1980, by a supplementary grant of $250,000 for a computerized management and information system.

The Project is directed by its Executive Committee which is composed of one member from each state. Robert M. Morgenthau, District Attorney of New York County, is Permanent Chairman of the Committee, and Thomas L. Krebs, Director of the Alabama Securities Commission, is Vice-Chairman. All member agencies are represented on the Board of Directors, whose chairmanship rotates from one meeting to the next.

The purpose of the Leviticus Project is the investigation and prosecution of a variety of crimes related to the coal industry, particularly in the Appalachian region. Project members coordinate their work on cases ranging from murder to theft of heavy coal mining equipment to complex organized frauds against financial institutions and investors. One

principal focus of the Project is the widespread fraudulent syndication of tax shelter investment schemes in coal mining ventures. It was the discovery by state securities agencies of a complex pattern of such schemes that eventually lead to the creation of the Leviticus Project.

Typically, a coal mining tax shelter is structured as a limited partnership. Syndication of the offering generally takes place in affluent, investor-rich areas such as New York, Philadelphia and Atlanta. Investors buy units as partial units in the limited partnership for an investment of cash and promissory notes. The entire investment is characterizeo as the advanced minimum royalty and, therefore, can be deducted by the taxpayer-investor in the tax year in which it is made. This deduction provision of the Internal Revenue Code, which makes the tax shelter so attractive, has created investment averages which now average about four to one, i.e. for each dollar of cash invested, four dollars may be deducted.

The Code permits such advantageous investments in an effort to stimulate the injection of private capital into the coal industry and thus increase coal production. When a limited partnership coal mining venture is fraudulent, and no coal is mined, a substantial amount of tax revenue is lost and the market for legitimate investment is tainted. Ordinarily, the fraudulent aspect of these limited partnership relates to the coal-bearing land in an Appalachian state, as to the subleased mineral rights to mine the coal. For example, the

property which is the subject of a fraudulent limited partnership coal mining venture might have already been mined, or might be under water, or might be owned by the Federal government.

Leviticus Project investigators have seen evidence indicating that several hundred to a few thousand such fraudulent schemes have been syndicated in recent years. Estimates of the resulting loss of tax revenue generally run from $5 to $6 billion to over $10 billion. A major portion of the schemes occurred in the few years immediately following the Arab oil embargo, a period in which there were widespread calls for increased coal production. The Leviticus Project has recently begun to see a sharp rise in the patterns of activity characteristic of fraudulent coal mining ventures, a development that the Project attributes to the current interest is increasing, perhaps were doubling, coal production in the next decade.

The Leviticus Project approaches cases of fraudulent limited partnership coal mining ventures from various angles. Because there are hundreds of such cases, and the Project's resources are limited, the Project tries to identify and focus on individuals who are repeat offenders as the subjects for criminal prosecution. Member states in which the partnership's coal-bearing property is located investigate the veracity of all representations in the partnership's offering which concern the land, the leases, and the coal. Member states in which the

offerings are syndicated investigate all of the circumstances surrounding their promotion and sale. All limited partnership coal mining ventures found to be fraudulent, including those not prosecuted criminally, are referred by the Project to the Audit Division of the Internal Revenue Service for recovery of tax dollars through the retroactive disallowance of deductions. The Leviticus Project expects to refer about $50 million worth of such cases in the next few months. The frequency and volume of referrals to the IRS by the Project should increase when the Project computerized information system, an index of all information in Project files, becomes fully functional in early 1981.

The SEC Division of Enforcement should promote and participate in multi-state enforcement efforts like the Leviticus Project. The success of any multi-state project involving complex criminal schemes depends upon the volume and quality of investigative information available to the participants. The SEC is well situated to share valuable information with state and local investigators, both on a case-by-case basis and in a more regular, structured fashion. Presently, however, the SEC's sharing of investigative information is inhibited by its internal regulations and guidelines. For example, following a formal order of investigation, the Division of Enforcement can share information on a case only when it has obtained the explicit consent of the entire Commission. And the issuance of a formal

order cloaks the case in confidentiality making it difficult, if not impossible, for a state agency to discover that an investigation exists. Without that knowledge, a stage agency will not make a request that the SEC share information on a case.

The Division of Enforcement should anticipate that a principal focus of state enforcement in the next several years will be on multi-state projects. The Division should be required to encourage such projects and to devise effective methods for sharing information with them. One possibility that should be explored is that of establishing regular cooperation with the six existing multi-state regional intelligence systems. They are: the Western States Information Network (WSIN) in Sacramento, California; the Rocky Mountain Information Network (RMIN) in Tucson, Arizona; the Mid-States Organized Crime Information Center (MOCIC) in Kansas City, Missouri; the Regional Organized Crime Information Center (ROCIC) in Memphis, Tennessee; the Mid-Atlantic Great Lakes Organized Crime Law Enforcement Network (MAGLOCLEN) in Philadelphia, Pennsylvania; and the New England State Police Administrators Conference (NESPAC) in Boston, Massachusetts. In addition, the Division should be required to cooperate fully and freely with the Leviticus Project in an effort to combat the expected increase in securities-related crimes affecting the coal industry.

The Division of Enforcement has at its disposal a computerized index of its public and enforcement. The information contained in the index has often proved invaluable to state enforcement agencies on those occasions when access to the index has been made available. However, state access to the index has been spotly and irregular, at best. Consequently, the Division should be encouraged to develop a method to permit state and local enforcement agencies, including non-securities law enforcement agencies, prompt and easy access to its computerized index.

The Commission should be encouraged to participate and contribute to the maintenance of the NASAA/NASD Central Registration Depository, (CRD). An estimated twenty to thirty million dollars per year cost savings to the securities industry is anticipated as a result of the CRD system. One step computer filing of Broker-Dealer and salesmen applications will reduce a vast amount of state paperwork and result in an enormous reduction of duplicitous mailings by firms involved in interstate marketing of investments. The state's resource savings occasioned by computer access to registration data can be invested in enforcement and other more vital regulatory services.

The capabilities of the CRD system would be significantly enhanced if the SEC were to load its public Dealer registration information into the system. This sharing of valuable SEC

public data with the CRD system would permit states to make rapid and better informed responses to requests for registration.

In addition, as the CRD system is expanded, other information of a public character may be included. For example, staff comment letters on applications for registration of securities may be included in the system. As objections are cleared by amendment, states in the CRD system can access the amendments and thereby avoid delays in effectiveness occasioned by the untimely deliveries of mail. Ultimately briefs, jury instructions and perhaps non-public enforcement data may be accessed by the states in the CRD system.

The SEC could input the following type information into the system: (i) registration review data; (ii) SEC regulations and opinions; (iii) registered company information; (iv) such other information such as legal memoranda, briefs, etc. as may be useful to more efficient government and regulation.

State securities administrators are active in the criminal prosecution of securities violators. State criminal enforcement cases have increased throughout the 1970's. Securities prosecutions comprise a substantial percentage of the total national white-collar crime prosecutions. State securities administrators should be represented on both the President-elect's Criminal Justice Task Force and the Law Enforcement Administration Task Force.

From the standpoint of the state agencies, the SEC should, in the absence of a state securities law impact study, reconsider its position on the ALI codification of the SEC code. Future SEC policy positions, if any, relating to the proposed federal securities code should be adopted only after consideration of the impact such position may have on state securities laws. For example, the Commission has reserved for future exposition the Loss Code treatment of industrial revenue development bonds. Most state legislatures look with favor upon such bonds and consider them to be valuable industry acquisition and expansion tools. These state policies are bound up in "Blue Sky" law provisions. A Federal policy which impacts these state-bound programs should only be adopted after notice of and an opportunity given the states to comment on the Commission proposals.

The North American Securities Administrators Association in 1977 endorsed the concepts of the Code. One of those concepts dealt with an expanded and relaxed version of Rule 147, and the 33 Act intrastate exemption. At the time NASAA approved the Code, the leakage provisions for out-of-state sales was large enough to accomodate a relaxation of rather strict standards and permit, nearly, the regional registration concept. This represented a healthy and welcomed reduction of federal regulation. In their hard negotiations with Professor Loss, the SEC substantially reduced the percentage of securities which could be sold out of state pursuant to the

exemption. This, in effect, negated the exemption and again laid the heavy hand of federal registration on companies which could not meet the now severe requirements of the exemption. This also altered substantially the state's view of the proposed code. Whether, as a result of these SEC mandated alterations to the Hoss proposals, the states can still support the Code remains at this writing in issue.

In the absnece of a specific Congressional mandate, NASAA is opposed to preemption of "Blue Sky" laws by SEC Rule.

Efforts to reduce the impact of federal securities regulation to truly be effective must take into consideration the collateral impact on the effectiveness of the administration and enforcement of state securities law.

Where appropriate statements regarding deregulation of Federal regulations should emphasize responsibility of state authority in those areas so affected.

The SEC, after consultation with the State administrators through NASAA, should submit an annual report to Congress on the effectiveness of securities regulation and enforcement.

C. ADMINISTRATIVE LAW JUDGES (ALJ'S)

There is an area of interest and concern to all federal regulatory programs which merits consideration with respect to the SEC. This issue of assuring adequate independence and accountability of administrative law judges (ALJ's).

At the present time the Senate has under consideration a recommendation to ransfer to the ALJ's asisgned to the various federal agencies to become part of the federal judiciary. Under the present system ALJ's are SES employees who are assigned to a particular federal agency. This system is founded upon the notion that former employees of the agency's active operating divisions become ALJ's. These individuals have been criticized as having a vested institutional interest in favorable resolution of disputes involving the agency which employs them. The recommendation under consideration is designed to insure the ALJ's independence and impartiality in consideration of administrative law issues which may arise. This proposal would tend to silence the current criticism that ALJ's have an institutional bias favoring the agency to which they are assigned.

Legislation presently being supported by Senator Howell Heflin (D. Ala.) and others is expected to come before the Senate Judiciary Committee for consideration in the near future. The primary intent of this legislation is to create an independent core of administrative law judges to resolve those contested issues of administrative law which

will doubtless arise. Under this plan each ALJ would be evaluated independently on the basis of their qualities as a jurist, rather than being subject to the evaluation of the agency for which they assist as decisionmaker.

Oil and Gas Advisory Committee

The whole issue of disclosure, accounting practices and enforcement needs study. An advisory committee should be created to review these items.

Summary

AND

EXECUTIVE SUMMARY

I. AGENCY OVERVIEW

The Securities and Exchange Commission with an authorized budget of $77 million and an authorized staffing of 2,100 persons, is responsible for three major program areas: disclosure, suppression of fraud and to a limited extent, regulation of the securities market activities. This report demonstrates how the staff and budget of the Securities and Exchange Commission can be reduced by approximately thirty (30) percent over a three year period without any compromise in the mission of the Agency.

The Report sets forth steps to be taken by the incoming administration in order to insure that the economic and deregulatory policy objectives of the Reagan Administration will be carried out promptly.

II. POLICY AND PROGRAM

A. Eliminating Regulatory Barriers To Capital Formation

Regulation of the financial activities of corporations and financial institutions should be limited to insuring that capital formation is facilitated and encouraged in an orderly process and with appropriate investor safeguards.

One of the principal objectives to be encouraged by the Reagan Administration is the elimination of unnecessary regulatory impediments to capital formation. It is only with effective capital formation that the goals of the Reagan

administration for economic growth and greater productivity can be fully achieved. While the Securities and Exchange Commission by no means has a major role to play in capital formation, the SEC can and does raise artificial barriers in certain circumstances to the free accumulation and formation of capital. This is done through regulations requiring excessive, unnecessary and costly initial registration and contiruing disclosure requirements. In addition, decisions which the SEC makes may impair the grcwth and continuing development of the secondary securities markets thereby adversely affecting capital formation in the primary markets.

Therefore, the policy of the incoming SEC leadership should be to eliminate promptly those impediments to capital formation which are not essential to the mission of the agency.

B. Disclosure

The Securities and Exchange Commission is now engaged in a modest program of reducing some disclosure requirements. This report recommends that the incoming Reagan administration immediately establish as a priority the elimination of a great deal of the disclosure which is presently required, and is unnecessary for investor protection. Significant policy judgments should be made in the disclosure area early.

The incoming administration should eliminate all but the very essential registration and continuing disclosure requirements. The continuing review of filings in certain areas should

also be eliminated unless there is a demonstrated need for such review.

C. Fraud Suppression

If one assumes that a proper and sound program for disclosure exists which is simple, but yet contains the appropriate minimum information necessary for informed investor decision making, then an improtant ingredient to an effective regulatory program is a strong unit devoted to the suppression of fraud. However, in the present form, there appears to be a proliferation of meaningless enforcement activity directed at minor infractions while in areas where serious enforcement pursuit would be highly desirable, lighter penalties are accepted than those which seem appropriate. Additionally, this function has become centralized in the Washington, D.C. headquarters office without apparent justification.

Therefore, it is recommended that changes be made in this program to correct these imbalances.

D. Regulation of the Markets

The policy unit in the Commission which deals with the regulation of the marketplace is more than three times the size that it was seven years ago without apparent justification. This report recommends a reduction of force in this unit, as well as certain directional changes. This division has not dealt effectively with certain policy issues which have been pending for some time. It appears that in the past, there has been too aggressive an approach towards regulating an area which

can be and is corrected by market forces. At the same time, the Agency has created apparently unjustified monopolies in certain facets of the securities industry, such as options activity in underlying securities.

Therefore, the incoming administration should make policy decisions which will result in less government intervention in the free market activities of the securities industry. There should also be significant deregulation in the financial, operational, and reporting requirements imposed upon brokers and dealers by the Commission and at the Commission's request by the self-regulatory roganizations. Also, the private sector self-regulatory organizations should be encouraged to play a stronger role in the process.

III. BUDGET

The fiscal year 1981 authorized and approved budget for the Securities and Exchange Commission is $85.5 million; $98 million for FY 82; and $108 million for FY 83.

This report justifies a reduced budget level of $71 million for FY 81; $60 million for FY 82; and $53 million for FY 83. Presently scheduled and budgeted items such as the development of a MOSS computer system, the purchase of a new building, a samll business conference and a number of significant extraordinary budget expenses are foregone in this recommendation. In addition, a staff reduction to a level of 1,252 over a three year period is recommended with equivalent reductions in budget more carefully detailed in Part III of this Report. The Team

wants to emphasize that this budget is not a "bare bones" proposal. The reduction will allow the mission of the agency to be fully implemented.

IV. PERSONNEL

A. The Leadership

As has been previously presented in supplemental reports to the Transition Team, the Chairman of the Securities and Exchange Commission is going to resign as a Commissioner, if he is not permitted to serve as Chairman in the Reagan administration.

It is the recommendation of the Transition Team that Chairman Harold Williams be replaced on or before March 1, 1981 by a Chairman of the SEC, appointed by President Reagan. Recommendations have been made separately by the team concerning the characteristics of and individuals who might serve in this post. In addition, it is recommended that in June of 1981 when the seat of Commissioner Steven Friedman becomes available, that appointment be used by the Reagan administration to insure voting control by the Chairman appointed by this administration.

At the present time, it is possible that voting control can be achieved by a new Chairman with the assistance of presently sitting Commissioners Loomis, Evans and Thomas. However, the seat presently occupied by Commissioner Friedman is essential to insuring broader control over policy as well as personnel decisions.

B. The Staff

At the present time, the leadership of the staff of the Securities and Exchange Commission has been appointed by Chairman Williams or has remained from previous Democratic administrations. In virtually every area the leadership of the various divisions is unsatisfactory either because of philosophic incompatabilities or competence. The individuals occupying the leading staff positions have almost to a person been placed in noncareer senior executive staff positions.

Therefore, the new Chairman should make sweeping changes in senior staff promptly.

V. OTHER MATTERS

While legislative issues exist and other matters of some importance are treated in this report, these issues do not warrant early attention or treatment in this summary.