

ROUNDTABLE ON MAJOR ISSUES

September 5, 1985 and September 11, 1985

BACKGROUND MATERIALS

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

INTRODUCTION

Thank you for agreeing to participate in one of the SEC Roundtables on Major Issues. The purpose of the Roundtable discussions is to identify and ventilate public policy issues raised by recent developments in the securities industry and the financial markets. A full and candid discussion will better enable the members of the Securities and Exchange Commission to formulate policy positions on these issues. You therefore are encouraged to speak freely on any and all of the issues raised in these materials, as well as any other issues you wish to raise.

The Roundtables will be held on September 5 and September 11, 1985, and will be comprised of leading representatives of the business, legal, and financial communities. The agenda for the Roundtables will be:

9:30 a.m. - 9:45 a.m. Coffee

9:45 a.m. - 12:30 p.m. Discussion

12:30 p.m. - 2:00 p.m. Lunch Break

2:00 p.m. - 4:30 p.m. Discussion

4:30 p.m. - 5:00 p.m. Wrap-Up

The Roundtables will take place in the Commission's open meeting room (Room 1C30), located one floor below street level.

All of the members of the Commission (Chairman Shad and Commissioners Cox and Peters) will participate in the discussions. The other participants in the September 5 Roundtable will be:

Boris S. Berkovitch, Vice Chairman
Morgan Guaranty Trust Company

New York, New York

Douglas H. Ginsburg, Administrator
Assistant Attorney General
Antitrust Division
Department of Justice
Washington, D.C.

Harrison J. Goldin
Comptroller of the City of New York
(Co-Chairman, Council of Institutional Investors)
New York, New York

Roderick M. Hills
Latham, Watkins & Hills
Washington, D.C.

Dean LeBaron, President
Batterymarch Financial Management
Boston, Massachusetts

Martin Lipton
Wachtell, Lipton, Rosen & Katz
New York, New York

T. Boone Pickens, President and Chairman
Mesa Petroleum Co.
Amarillo, Texas

The other participants in the September 11 Roundtable will be:

Joseph H. Flom
Skadden, Arps, Slate, Meagher & Flom
New York, New York

Ray J. Groves, Chairman and Chief Executive
Ernst & Whinney
(Chairman, AICPA)
Cleveland, Ohio

Frederick H. Joseph
Vice Chairman of the Board and Chief
Executive Officer Drexel Burnham & Co., Inc.
New York, New York

Bevis Longstreth
Debevoise & Plimpton
New York, New York

John J. Phelan, Chairman
New York Stock Exchange
New York, New York

Andrew C. Sigler, Chairman
Champion International Corporation
(Chairman, Task Force on Corporate Responsibility, The Business Roundtable)
Stamford, Connecticut

A. A. Sommer, Jr.
Morgan, Lewis & Bockius
Washington, D.C.

Walter B. Wriston
Former Chairman of Citicorp
New York, New York

The following background materials do not represent an exhaustive discussion of the issues. Instead, the materials are intended to acquaint the participants with current issues and developments in the financial and securities markets and to serve as a springboard for a fuller discussion at the Roundtables.

LIST OF BACKGROUND MEMORANDA

- A. Government Bond Market
- B. Immobilization
- C. Tender Offer Regulation
- D. One Share-One Vote Initiatives
- E. Shareholders Renting Their Votes
- F. Emerging Disclosure Issues
- G. The Edgar Electronic Disclosure System
- H. Internationalization of the Securities Markets

I. Foreign Secrecy and Blocking Laws

J. Currency and Rate Swaps

K. New Products and Services

L. Liability and Insurability of Officers and Directors

M. Liability and Insurability of Accountants

A. GOVERNMENT BOND MARKET

The failures of a number of small dealers in government securities, resulting in losses to investors of about \$900 million since 1977 (before any recoveries), have raised questions about the need for additional oversight or regulation of the government securities market. In particular, the recent failures of two unregistered government securities dealers, ESM Government Securities ("ESM"), and Bevill Bresler Schulman Asset Management Corp. ("BBS") have brought these questions to the fore. ESM failed in March 1985 with alleged losses of over \$300 million to investors, including two savings and loan associations that subsequently failed. ESM allegedly was able to continue in business through the use of fraudulent financial statements. BBS failed in April 1985, with alleged customer losses of as much as \$235 million. BBS allegedly engaged in fraudulent repurchase transactions without proper collateralization.

A Treasury official has stated that the failures have not had a perceptible adverse impact on the cost of financing the national debt. The long range impact of these failures is less clear. Market participants have indicated that these failures have caused investors to leave the government securities market and that the long term effect of these failures could lead to a contraction in the dealer community, thus decreasing liquidity. Chairman Volcker of the Federal Reserve Board ("FRB") has testified that these developments "carried at least the seeds of more widespread systemic problems."

The market and various regulators already have responded to these failures in a variety of ways. Dealers and customers are taking greater care in assessing the creditworthiness of counterparties. Customers are obtaining possession or securing third party control of securities underlying repurchase agreements. Regulators of financial institutions, including federal and some state agencies, are requiring stricter credit procedures and collateral requirements for regulated entities. The Commission also has required disclosure of substantial repurchase positions that could affect performances

In addition to these efforts, the Commission, in response to a Congressional request, reviewed the operation of the government securities market and reported to Congress its recommendations for additional regulation of this market, if Congress concludes legislation is needed. The recommendations were developed in consultation with the Treasury Department and the FRB, with some differences emerging among these entities. The Commission recommended that:

- A. All currently unregulated dealers in Treasury or government-sponsored agency securities be registered with the SEC, and that information on these dealers be accessible to all relevant regulators.
- B. The SEC and, the bank regulators be granted the authority to impose sanctions against or to bar those who violate either the securities or the banking laws.
- C. The Treasury, in consultation with the FRB, be granted authority to adopt rules in respect to currently unregulated dealers in Treasury or government-sponsored agency securities as necessary on:
 - (1) capital,
 - (2) independent audit and recordkeeping.
- D. All others continue to be subject to SEC or banking agency capital and recordkeeping requirements.
- E. Inspection and rule enforcement of
 - (1) non-bank dealers be undertaken by existing self- regulatory organizations, under SEC oversight, including inspections;
 - (2) bank dealers be undertaken by banking agencies.
- F. FRB continue to exercise surveillance over primary dealers.

Several bills have been introduced in Congress to regulate the government securities markets. Of the principal bills, HR 2521, introduced by Rep. Fauntroy, gives rulemaking authority to the FRB with respect to government securities dealers. Areas of rulemaking authority include capital adequacy, recordkeeping, internal controls, and collateral segregation and delivery. The FRB would list dealers in compliance with its rules and have inspection and enforcement authority. S. 1416, introduced by Sen. D'Amato, gives the FRB authority to adopt rules regarding registration, financial responsibility, financial statements,

recordkeeping, and prevention of fraud regarding repurchase agreements. Dealers would be subject to registration with the Commission or, in the case of banks, the appropriate regulatory agencies and would be subject to enforcement by these agencies. H.R. 2032 as amended, introduced by Rep. Dingell, gives rulemaking authority to a new Government Securities Rulemaking Board, would require unregistered dealers to register with the Commission, and would give enforcement power to the FRB.

* To what extent have market and regulatory responses reduced the likelihood of problems in the government securities markets?

* If additional regulation is considered beneficial, what structure should this regulation take and what areas should it cover?

B. IMMOBILIZATION

Since 1975, the SEC has fostered the development of the National Clearance and Settlement System, which allows broker-dealers and banks to immobilize and safekeep securities certificates in centralized securities depositories and to settle securities transactions by computerized book-entry. This system has become highly automated, operating through a sophisticated set of interconnections among various processing entities. Without these efficient National System support services, financial institutions would not be able to handle today's heavy trading volume as safely or efficiently, and paperwork crises could recur.

Despite the growth of deposits in the National System since its inception, and the widespread availability of automated clearance and settlement services, nearly 50% of the dollar value of corporate securities certificates listed on the NYSE remain outside that system. Moreover, because new securities products continue to be issued and circulated in fully certificated form, a proliferation of paper continues to produce high costs and risks for issuers, the financial industry, and investors.

The SEC Division of Market Regulation hosted a series of workshops on immobilization in February and March, 1985. At the workshops, issuers, broker-dealers, banks, securities processors, and relevant state and federal regulators sought to identify practical ways to spur further depository immobilization of securities and carefully controlled issuer experiments with certificateless systems. The following action plan resulted from the workshops.

Immobilization Initiatives

* Encourage the use of global certificate issues for corporate and municipal debt offerings.

In a global certificate the issuer deposits at initial issuance one certificate in a depository representing the entire issue. All ownership records are maintained by the depository and no individual certificates are issued to investors.

Both municipal and corporate debt issuers have successfully marketed global securities at considerable cost savings. (An issuer can save an estimated \$400,000 on a \$100 million issue by eliminating certificate and transfer processing.) Unlike equities, the global certificate on debt issues does not entail shareholder communications problems or conversion of outstanding certificates to certificateless form. The SEC will be seeking commitments by year-end from both corporate and municipal issuers to use global certificates in their next debt offerings.

* Press for elimination of remaining state statutory restrictions on insurance company and pension fund use of depositories, ,

The SEC staff will be working with representatives of the National Association of Insurance Commissioners and state regulators to promote model legislation in those twelve states that continue to require insurance companies and public pension funds to keep a certain amount of their assets within that state, thereby precluding the use of centralized depositories,

Longer-term Initiatives

* Encourage experimentation with issuer-run book-entry (uncertificated) systems.

Issuer-run book-entry systems enable issuers to control securityholder records and maintain a direct relationship with securityholders. (The global certificate, in contrast, requires issuers to place their securities with an intermediary depository which masks the identity of investors.) A number of such systems, including dividend reinvestment and employee stock purchase programs, exist today on a limited basis.

Currently no connections exist between issuer-run book-entry systems and centralized depositories. Accordingly, the SEC has met with issuers and investment bankers to explore operational means to ensure smooth broker and bank processing of uncertificated securities transactions and to promote issuer book-entry experiments in the near future.

* Encourage adoption of the 1977 Amendments to the Uniform Commercial Code which provide for transfer and pledge of uncertificated securities.

Only fourteen states have commercial law provisions that recognize purely uncertificated (issuer-run book-entry) securities issues as investment securities. Without uniform state laws in this area certainty in multistate securities transactions cannot be assured. So that experiments with issuer-run book-entry systems can proceed safely, the SEC will be working with bar associations and other interested parties to promote legislative initiatives for passage of the 1977 Amendments to Article 8 of the U.C.C. in all states.

Points for Discussion:

1. What are the most effective means for encouraging the issuance of corporate and additional municipal debt offerings in global certificate form?
2. How can issuer experimentation with uncertificated book-entry systems be promoted? Are any SEC regulatory initiatives necessary?
3. What role can the financial industry play in furthering the goal of immobilization?
4. How can state legal impediments to immobilization and issuance of uncertificated securities be most expeditiously addressed?

C. TENDER OFFER REGULATION

* Since 1980, there has been a fivefold increase in the dollar volume of tender offers to over \$45 billion in 1984. The marked increase in the size of tender offers has been accompanied by an expanding array of novel market and corporate practices.

* In July 1983, the Commission's Tender Offer Advisory Committee (the "Committee") endorsed the Williams Act's premise that takeover regulation should not favor bidders or target companies. While the Committee did recommend changes in federal regulation of both bidders and targets, it essentially sought to preserve the basic foundations of the current regulatory scheme.

* In May 1984, the Commission submitted legislation seeking the authority to close the ten-day filing window under Section 13(d) of the Exchange Act, and to increase federal regulation with respect to "golden parachutes," defensive issuance or reacquisition of securities, and "greenmail." On May 20, 1985, the

Commission voted to endorse its 1984 recommendation to close the Section 13(d) ten-day filing window, but, in view of the evolution of tender offer practices, voted not to support the other 1984 recommendations.

* On July 1, 1985, the Commission proposed for comment proposed Rule 14d-10, which would codify the Commission's position that the Williams Act requires that a bidder's tender offer be open to all holders of the class of securities subject to the tender offer, and that all holders be paid the highest consideration offered to any holder.

* Set forth below are some developments of current concern relating to tender offer regulation.

1. Use of Defensive Tactics: The use of poison pills and other defensive tactics, including the so-called "lollipop" defense, has continued to attract controversy. For example, CBS adopted a series of measures, including by-law amendments and a stock repurchase program, in response to a tender offer by Turner Broadcasting System. A federal district court in Atlanta recently upheld the validity of these tactics. The Household International case, in which the Commission participated amicus curiae, is another recent example of litigation involving the validity of poison pills. Among the concerns raised by some commentators about the effect of defensive tactics have been their effect on share prices, and their potential to disenfranchise shareholders. Other commentators have contended that defensive measures enable management to operate a corporation more effectively in the long-range interests of all shareholders.

2. Evolving Nature of Tender Offer Practices: The recent evolution in tender offer practices is illustrated by such developments as the number of issuers adopting or proposing anti-greenmail charter amendments and the formation of the Council of Institutional Investors in response to the proliferation of anti-takeover charter amendments. Some commentators have argued that such developments illustrate the market's ability to develop appropriate responses to changing practices in hostile battles for corporate control and that additional regulation is therefore unnecessary.

3. Economic Issues: A number of views have been advanced in the debate over the effects of takeovers on the U.S. economy. Some commentators assert that takeovers are generally beneficial and require little or no regulation; others state that takeovers disrupt long-range corporate planning and have other adverse effects on the economy. Various researchers, including the Commission's Office of the Chief Economist, have begun to develop an empirical base from which to better evaluate these arguments.

4. Effect of Takeovers on Management Planning: In the debate over takeovers, commentators frequently discuss the effects of takeovers, or threatened takeovers, on the planning of incumbent corporate management. Some contend that takeovers have a disciplining effect on incumbent management, while others argue that fear of a takeover causes management to reduce long-range research and development, and to focus too extensively on short-range planning.

5. Impact of Other Major Participants in Takeover Battles: Major participants in takeover battles typically include investment bankers, institutional investors (including pension funds), and arbitrageurs. For example, there has been increased interest in examining the role played by institutional investors when anti-takeover charter amendments are presented to shareholders for their consideration. Some commentators have stated that it is the increasing role of both institutions and arbitrageurs that causes management to become more oriented to short-term goals.

6. Desirability of Additional Federal Regulation: A variety of measures have been introduced in Congress that would make major changes in takeover practices with respect to both bidders and targets. Opponents of such measures have questioned the need for additional regulation, and contended that such proposals represent an undue infringement on state law. Opponents have also contended that the evolution of takeover practices (as noted in topic 2) makes such legislation unnecessary.

7. State Law Developments: Since MITE, several state legislatures have amended their takeover statutes. One example of this is the proposed revision of the New York takeover statute, which Governor Cuomo recently vetoed. Another significant development in state law has been the series of recent cases, including Household International, involving application of the state “business judgment rule” in the change of control area.

8. Financing Techniques: The use of certain financing techniques has raised public policy concerns, both inside and outside the change of control context. For example, the use of leveraged buyouts, in both mergers and tender offers, has been the subject of attention during recent congressional hearings. In addition to concerns over the use of leveraged buyouts as a takeover tactic, concerns have been expressed that the large-scale borrowing often used to fund leveraged buyouts may adversely affect the financial soundness of individual companies. However, the Federal Reserve Board has testified that leveraged buyouts do not appear to have significant long-term effects on credit markets. The use of so-called “junk bond” financing is another area of recent interest, as some have questioned the long-term economic effects of the growing use of less than investment grade financing.

D. ONE SHARE-ONE VOTE INITIATIVES

I. Background

In July 1984, the New York Stock Exchange (“NYSE”) imposed an informal moratorium on delisting companies for violations of its shareholder participation requirements. The NYSE then created a Subcommittee on Shareholder Participation and Qualitative Listing Standards (“Subcommittee”) to review its voting and shareholder approval requirements. On January 3, 1985, the Subcommittee issued a report to the NYSE’s Public Policy Committee recommending that the NYSE revise its listing standards to permit listed companies to create dual class capitalization under certain enumerated conditions. The NYSE has indicated that the NYSE Board of Directors has discussed the recommendations but has not voted on them.

The NYSE Subcommittee proposed that the NYSE list companies having multiple common stock classes so long as the additional stock class had been approved by at least two-thirds of the shares entitled to vote on the proposal and by a majority of the outside directors of the issuer’s Board if the Board consisted of a majority of such directors; if the issuer had less than a majority of independent directors, approval of such directors must be unanimous. Further, the voting differential per share can be no more than one to ten, and the rights of the holders of the two classes of common stock must be substantially the same except for voting power per share.

II. The Senate and House Bills

In June 1985, legislation was introduced in both the Senate and the House that would prohibit exchange or NASDAQ-listed companies from departing from a one share-one vote standard. The legislation would prohibit issuers from registering for purposes of exchange or NASDAQ trading non-voting stock or securities carrying disproportionate voting rights. Common stock intended to be registered would be deemed to have “disproportionate” voting rights if the shares of any class of a company’s stock carry voting rights either greater or less than one vote per share. The legislation would amend Sections 12 and 15A of the Securities Exchange Act of 1934 (“Act”) providing registration requirements for securities as conditions for listing on a national securities exchange and a national securities association (i.e., the NASD), respectively. The proposed legislation would grant grandfather status to companies with dual class capitalizations established prior to June 18, 1985.

III. Recent NASD Initiatives

In July 1985, the NASD, which currently will quote on NASDAQ issues with dual class capitalization, issued alternative listing proposals for membership comment, including a one share-one vote requirement for NMS Securities. The first of two NASD proposals would establish a one share-one vote standard for all NMS Securities. Existing issues of NMS companies would be granted grandfather status under the proposal.

The second proposal would permit an issuer to adopt dual class capitalization if the initiative were approved by two-thirds of the issuer's shares. Further, the voting differential between the high and low vote stock could not exceed ten to one. In addition, the issuer's dual class capital structure would be subject to a "sunset" provision requiring reauthorization every ten years by a similar two-thirds vote.

In addition, at its July meeting, the NASD Board approved a series of additional corporate governance requirements applicable to its 2,050 NMS Securities, including requirements regarding annual and interim reports, audit committees, annual shareholder meetings, soliciting proxies and distributing proxy statements and conflicts of interest.

IV. Discussion Points

1. Is an absolute ban on stock classes with different voting rights appropriate, or is shareholder ratification of different stock classes acceptable?
2. Assuming some shareholder participation rules are appropriate, should they be rules of the SROs, or should Congress adopt legislation?
3. What, if any, role should the Commission play regarding shareholder Participation?
4. Are uniform rules in this area necessary, or should different SROs or different types of companies (e.g., small vs. large) have different rules?

E. SHAREHOLDERS RENTING THEIR VOTES

It has been proposed that in order to redress the shift of corporate power from owners to managers, legislation should be enacted to allow a public market in shareholder voting rights. Generally, the proposal would work as follows:

- * Allow shareholders to detach the voting rights from their shares and offer them for sale.

- Sales would be for a limited period (e.g. three months) after which the votes would revert to the shareholder, who could resell them.
- Prices would depend upon the level of interest in corporate governance -- rights would be worth more at annual meeting time or during a proxy contest.
- * A market would develop for voting rights. Such rights could be acquired either permanently by buying the stock or temporarily by renting those rights.
- Shareholders holding their shares for investment may lack the time or the interest to become involved in issues of corporate governance. Under the proposal shareholders would earn capital gains on their stock and ordinary income from renting their voting rights.
- Votes could be cast by investors with the time, resources and ability to be fully informed on the issues.
- * The proposal raises many questions, including:
 - What are the self regulatory, state and federal law barriers to the sale of votes?
 - What is the potential for abuse? Would this create an area ripe for insider trading (e.g., buying votes before announcing a proxy contest)? If so, would this be a securities fraud? A common law fraud?
 - What, if any, legislation would be needed to implement such a proposal and limit the potential for abuse?
 - Would the proposal effectively disenfranchise shareholders? How could it be ensured that shareholders receive adequate disclosure (i.e., that they be advised of the Potentially conflicting objectives of those to whom they rent votes)? Would other adjustments in the disclosure system be necessary?
 - What are the long-term implications for the structure and governance of corporations?
 - What are the long-term implications for the securities markets?
 - What is the relationship between this proposal and the two classes of stock/one share-one vote controversy?
- * Is this proposal an indication of a trend toward unbundling securities? See Americus Trust.

F. EMERGING DISCLOSURE ISSUES

The development of new disclosure issues closely follows the creation of new types of financings or financial instruments as well as new types of securities.

I. New Types of Financings

A. Securitization of Debt

One recent example is the expansion of the more traditional securitization of debt, which typically involves pools of first and occasionally second mortgages, to create pools backed by consumer debt. In several financings, the collateral involved installment obligations secured by new and used automobiles. In addition, discussions have been held regarding the possibility of regular consumer trade obligations.

These financings have raised disclosure concerns with respect to the ability of purchasers to assess the timing of cash flow, the risk of default, the availability of guarantees and the (impact of such guarantees on the purchaser in the event of the bankruptcy of the sponsoring issuers.)

B. Off Balance Sheet Activities

A further development in the area of new financing methods involves an increase in activities which are not fully reflected in the financial statements of the participants. These include credit enhancements, the use of guarantors to increase the credit worthiness of certain borrowers, interest rate swaps, and hedge transactions.

Where these activities are material, the disclosure areas of concern relate to the ability of the public to assess with respect to each of the parties to these transactions (including any intermediaries): (a) the dependence on such transactions for the maintenance of reported income and/or growth trends, (b) the exposure from either shifts in monetary conditions or default by the contra party to these agreements.

II. New Securities Being Issued

An increasing number of new securities are being publicly offered. These include:

- * Securities with a transferable put option;

- * Units consisting of common stock and rights that, upon exercise, are payable at the option of the company in common stock, cash or notes;
- * Floating rate debt securities;
- * Debt securities whose interest may be payable in cash or securities of the issuer at the option of the issuer;
- * Variable rate preferred stock, with rates being fixed as a result of periodic "Dutch auctions";
- * Novel securities with varying priorities which are permitted by the newly adopted Delaware Partnership statute;
- * "A/B" capitalizations, in which one class of common stock has superior voting rights to another class of common stock.

The areas of disclosure concerns include:

- * The ability of the issuer to provide sufficient information to allow purchasers to assess inherent risks in such instruments, particularly where the instruments involve hybrid forms of securities with novel rights and priorities;
- * The ability of the issuer to provide sufficient information to the market place regarding the effect of such securities on the overall capitalization of the issuer;
- * The status of such securities under the various state laws, and the effect of the issuance of such securities on the continued listing of such securities on various national securities exchanges;
- * The proper accounting for such novel securities, in order to assure that securities more in the nature of debt obligations are not reflected as equity;
- * The tax implications of such novel features, both to the issuer and to the purchaser.

G. THE EDGAR ELECTRONIC DISCLOSURE SYSTEM

The Commission has embarked upon a project to establish an electronic filing, processing and dissemination system, known as Edgar. Edgar has the potential to revolutionize the manner in which investment decisions are made and executed by:

- * increasing the efficiency and fairness of the securities markets by affording investors, securities analysts and others instant access to corporate information;
- * accelerating corporations' access to the capital markets and the dissemination of their information to investors; and
- * enhancing the Commission's ability to protect investors and maintain fair and orderly markets.

In September 1984, the first electronic filings were received at the Commission, and, since that time, over 1300 live electronic filings have been received and processed. Filings are accepted in three different electronic media: (1) transmissions over telephone lines using a number of different communication protocols; (2) diskettes prepared on over eighty-five different types of word processors and personal computers; and (3) magnetic tapes. The filings received are processed by the Division of Corporation Finance and the Office of Public Utility Regulation. Soon to be added are filings processed by other offices in the Division of Investment Management.

Based upon staff experience, on-going Pilot evaluation and the comments of volunteer filers, the Commission believes that the Pilot has been highly successful. The next step is the operational system. It will include electronic filing (direct transmission, diskette or magnetic tape) by most, if not all, of the entities filing with the Commission. In this regard, it is anticipated that all registrants filing documents processed by the Divisions of Corporation Finance and Investment Management will be filing electronically by September 1988.

Recently, the Commission issued a Pre-Solicitation Document seeking comments regarding the proposed operational Edgar system from potential bidders, persons who make filings with the Commission and potential users of the system. It described a cost-sharing arrangement pursuant to which the Commission will contribute its investment in Pilot hardware and software and an annual dollar amount. The contractor will assume an investment of approximately \$63 million over the seven years of the contract to support the Commission's functional requirements, including the receipt, internal processing and dissemination of filings. In exchange, the contractor will be permitted to sell the electronic public filing data base and earn a reasonable rate of return.

The Pre-Solicitation Document requested commentators to respond to a series of questions, including:

1. What is your view of the cost-sharing approach to financing the system?

2. Do you think it would be appropriate, desirable or practical for the Commission to finance more of the system?
3. How should annual reports to shareholders, which often contain significant information that is incorporated by reference into Commission filings, be handled?
4. In the Pilot, signatures for direct transmission filings are made by means of a personal identification number ("PIN"). Are there alternative technical or legal approaches that the Commission should consider?
5. Has the Commission taken sufficient steps to ensure the confidentiality of non-public information and avoid conflicts of interest? If not, can or should the Commission prohibit certain firms from bidding on the contract?

H. INTERNATIONALIZATION OF THE SECURITIES MARKETS

Capital markets are becoming increasingly internationalized. More and more, both debt and equity securities are being traded and distributed in more than one country. Direct linkages have been developed or currently are proposed between several foreign and United States securities exchanges.

These developments create opportunities to enhance international economic cooperation. They also pose problems for national government agencies with responsibility for capital formation and securities regulation.

The SEC has issued three major releases in less than a year seeking comment on internationalization of the world's securities markets. [Footnote: Securities Exchange Act Release No. 21958 (Apr. 18, 1985), 50 Fed. Reg. 16302 (1985) (Global Trading release); Securities Act Release No. 6568 (Feb. 28, 1985), 50 Fed. Reg. 9281 (1985) (Multinational Offerings release); Securities Exchange Act Release No. 21186 (July 30, 1984), 49 Fed. Reg. 31300 (1984) (Transnational Enforcement release). The Transnational Enforcement release, which discussed foreign secrecy and blocking laws, is covered in a separate memorandum.] In addition, a June 1985 report of the Committee on Energy and Commerce of the U.S. House of Representatives directed the Commission to conduct a study of "the accelerating internationalization of the securities and currency markets and [its] implications." The results of the study are to be reported to Congress on or before September 1, 1986.

Among the questions the Commission is considering in the area of internationalization are the following:

1. What are the interests of the Commission in facilitating multinational securities offerings? The Multinational Offerings release solicited comment on two conceptual approaches to facilitate multinational securities offerings in the United States, the United Kingdom, and Canada -- the reciprocal approach and the common prospectus approach. In addition, the release requested responses to a series of specific questions dealing with these approaches, their impact in other areas, and the Commission's role in facilitating multinational offerings.

Some of the principal points made by the approximately 60 persons who have commented on the release are:

- * The common prospectus approach, although ideal, may not be practical or realistic at this time.
- * Consideration should be given to starting with a reciprocal approach and moving toward a common prospectus approach.
- * If a reciprocal approach is adopted, certain minimum standards or supplemental disclosures such as appropriate cautionary legends, management's discussion and analysis and financial statement reconciliations should be required.
- * The reciprocal approach should be made available only to world class issuers.
- * The reciprocal approach should be adopted initially only for rights offerings and exchange offers.
- * Any experimental approach should include other countries such as Australia, Japan, and the Netherlands.
- * Either approach could have an adverse impact on domestic disclosure and financial statement requirements.

Other issues related to this area include:

- * The role of the states in facilitating multinational securities offerings.
- * The policy implications of the trend towards increased investment of the assets of U.S. pension funds in foreign securities.

2. What is the extent of the demand for international trading opportunities; in what ways will such demands shape international market structure, clearance and settlement arrangements, and broker-dealer access to foreign markets? The Global Trading release solicited comment on a broad range of issues concerning

the increasing internationalization of the world's securities markets. The release requested comment on what conditions and structures should characterize international trading markets, possibly including international consolidated reporting, consolidated quotations, and intermarket linkages. Other issues were access to securities markets, clearance and settlement of international transactions, the effect of Exchange Act rules such as Rule 10b-6 on multinational distributions of securities, and international enforcement problems.

Although the comment period on this release runs through September, to date there have been 19 comment letters. The exchanges that have commented were particularly optimistic about prospects for the internationalization of the world's securities markets. They maintained that transnational trading would become commonplace and that the future structure of the international markets would be a network of exchanges trading world class securities around-the-clock. In contrast, one corporation stated that, while its stock is listed on 12 exchanges around the globe, trading occurs outside the United States only in special situations, it opined that, if true international trading markets were to develop, the market structure more likely would be around-the-clock in-house trading by United States-based firms than a worldwide network of exchanges.

In light of the issues presented in the Global Trading release and the comments received to date, a number of questions present themselves for discussion: Is the future structure of the international securities market likely to be a network of exchanges trading world class securities around-the-clock, or around-the-clock in-house trading by United States firms? What kinds of trading linkages and market information systems, if any, would be necessary to ensure that global trading is fair and efficient? What kinds of expanded international clearance and settlement arrangements would be required to facilitate trading through linkages? How can proper surveillance be exercised over global trading? What role, if any, should the SEC or the United States play in attempting to lower barriers to securities market entry in foreign nations?

3. Do the interests of the United States and other countries in protecting international commerce, maintaining fair and honest international markets, and protecting investors indicated the need for an international scheme of securities regulation? Does the level of sophistication of participants in the international securities market justify the same level of protection as is found in the U.S. domestic market? If an international securities regulatory scheme is advisable, what regulatory model should be adopted? Is an international self-regulatory organization feasible? How should the Commission deal with perceptions that some of its efforts in the area of internationalization are attempts to unilaterally extend its jurisdiction?

4. What should be the Commission's priorities in the area of internationalization?

I. FOREIGN SECRECY AND BLOCKING LAWS

[Footnote: For a more in depth analysis of the problem, see the Commission's July 1984 Release seeking comment on the "waiver by conduct" concept (Rel. No. 34-21186).]

The Commission often confronts secrecy and blocking statutes when investigating conduct abroad. Blocking statutes, in force in approximately sixteen countries, generally embody national interests in prohibiting the disclosure, copying, inspection, or removal of documents located in the territory of the enacting state in compliance with orders of foreign authorities. They cannot be waived by private parties because they protect national rather than private interests.

Secrecy laws, in force in over twenty-five countries, protect private interests in such documents as bank records or records held by a fiduciary, thus protecting such information as the identity of a client or details concerning a client's business. Secrecy laws generally may be waived by the customer.

When applicable, foreign secrecy and blocking laws of statutes can frustrate a Commission investigation. The impact of such laws on Commission investigations is illustrated by the following two examples:

Secrecy Law Example:

A person opens an account with the foreign office of a U.S. brokerage firm in a country with a secrecy law and immediately places an order to purchase extremely large quantities of securities of Company X, which is traded on the New York Stock Exchange. Within several hours of the order, a tender offer for the securities of Company X is announced and the stock rises by twenty dollars a share.

Based upon the circumstances and timing of the purchase, the SEC begins an investigation in the U.S. to determine whether the purchases were made while the purchaser was in possession of material nonpublic information in violation of U.S. securities laws. The SEC learns from Company X that the critical negotiations were conducted in the city from which the customer's order was placed during the two weeks prior to the announcement. The SEC wishes to obtain relevant customer documents maintained by the foreign office of the brokerage firm. It also wishes to depose: a) the broker, to determine what the customer said at the time the account was opened and the order was placed; and (b) representatives of banks and credit card companies in that foreign country to determine the financial dealings of the customer at the time of his

purchases. The customer will not consent to allow this testimony. All of the Commission's requests are denied on the basis that such disclosures would violate the foreign secrecy law.

Blocking Statute Example:

The subsidiary of a U.S. corporation has a significant operation in a foreign country ("Country X") which has a blocking statute. Allegations are made that certain officers of the corporation, some based in the U.S. and some in Country X, intentionally overstated the earnings of the foreign subsidiary in the annual reports of the parent which were filed in the U.S. as required by the U.S. securities laws. These false statements were made in an effort to conceal the foreign subsidiary's operating losses, which were material to the overall financial results of the parent. Prior to the time those allegations were made, accountants located in Country X evaluated the books of the subsidiary and gave an unqualified opinion on the financial statements.

The SEC begins an investigation to determine whether the allegations are true. Its staff deposes the officers of the corporation who are based in the U.S. as well as the corporation's U.S. based accountants. As a result, the staff determines that there is reason to believe that the earnings have been falsified. The SEC now needs to obtain similar documents and testimony from the foreign officers and accountants to determine whether this suspicion can be confirmed, and if so, who is liable. All foreigners decline to testify on the grounds that their cooperation would violate a blocking statute.

In both of the cases described above, without a treaty or other agreement, secrecy and blocking laws will in all likelihood prevent the SEC from obtaining the evidence sought. If a mutual assistance treaty is available, assistance may be sought for the evidence. However, such treaties do not always apply to Commission investigations and few nations have such treaties with the U.S.

The only other option available to the Commission to obtain the evidence is to initiate litigation. Thereafter the Commission could seek assistance through the Hague Convention on Evidence Gathering or Letters Rogatory, or could compel the production of the evidence by parties over whom the court could exercise jurisdiction. While the Commission has successfully used all of these devices, they have proven to be cumbersome and have provided only limited results.

ISSUES FOR CONSIDERATION

As the markets increasingly become internationalized, the Commission has begun to address such issues as:

- a. Should the Commission seek to negotiate international agreements to resolve its evidence gathering problems?
- b. If so, what type of agreements, multilateral or bilateral?
- c. With whom should the Commission begin negotiating?
- d. What types of information should be covered by any new agreement?
- e. In what time frame should the Commission strive to reach agreements?
- f. If agreements cannot be reached in a reasonable period of time, should the Commission consider unilateral measures?
- g. What types of unilateral measures should be considered?

J. CURRENCY AND RATE SWAPS

* Currency swaps are agreements to exchange payment or receipt of principal and interest in one currency for payment or receipt of principal and interest in another currency.

* A newer concept is interest rate swaps, which constitute the greatest percentage of the total swap market. Most interest rate swaps are fixed-rate to floating-rate swaps. Parties agree to exchange interest payments, generally on a net basis, on a notional (principal) amount for a set time period. No exchange of principal takes place. Less creditworthy parties with floating-rate obligations that are unable to obtain fixed-rate funds at an acceptable cost enter into swaps with more creditworthy parties with fixed-rate obligations. The less creditworthy party thus effectively obtains fixed-rate funds. The arbitrage among different quality borrowers is created by the contrast between the narrow interest rate differential in the floating-rate market between high and low-rated borrowers and the broad spread in the fixed-rate market. Swaps may be asset, rather than liability, based and effectively convert fixed income flows to floating and vice versa. In addition, parties may combine an interest rate swap and a currency swap in one transaction.

* The first swap was made public in 1981. Volume has grown exponentially. The 1984 interest rate swap market has been estimated at \$85 billion, 1983 volume at \$40 billion. [Footnote: See American Banker, 2/12/85 and Forbes, 7/18/83.] For example, J.P. Morgan indicated in its 1984 annual report that the notional amount of its outstanding contracts approximated 11.2 billion and 4.4 billion dollars at December 31, 1984 and 1983 respectively.

- * Rate swaps are no longer heavily negotiated transactions. They can now be bought and sold on a continuing basis in a secondary market, enabling participants whose needs change to get out of a swap.
- * Parties to swaps, both end users and intermediaries, are subject to various risks. The risks raise disclosure issues, accounting issues and regulatory concerns. The Commission has requested comment on the accounting and disclosure issues. (Release No. 33-6590, June 27, 1985).
- * There are no specific accounting rules for swaps. The FASB's Emerging Issues Task Force has reached consensus positions on certain issues relating to accounting for swaps and swap termination. The FASB is considering how to define a broad project on financial assets and transactions that likely will encompass swaps.
- * Treatment of swaps in the event of bankruptcy or insolvency is not certain, subjecting parties to litigation risks.
- * Contract documentation is another problem; it is being addressed by the International Swap Dealers Association ("ISDA") whose membership includes the major participants in the market. ISDA has recently released a set of definitions and standard contract provisions which are aimed at standardization of contracts for rate swaps.
- * Swaps are flexible and very useful. They have been used to:
 - obtain a fixed borrowing rate when rolling over commercial paper
 - hedge and close maturity gaps between existing assets and liabilities in balance sheet management; "create" assets with very specific or odd maturities
 - take advantage of export or other credits available in one currency when the funding need is in another currency.

Discussion Points

- * Are swaps a function of a broader economic phenomenon? If so, how can the SEC best address the issues presented?
- * What is the market perception of risks posed by swaps both for end users and intermediaries? Is it accurate? Are there parallels to early risk perceptions in the repurchase agreement market?

- * What methods do participants use to quantify risks? Can these risks be quantified?
- * Is there a growing use of collateral in transactions? What are the bankruptcy or insolvency risks posed by use of collateral?
- * Do swaps present greater risks than other contingent liabilities? How should regulators evaluate contingent liabilities? What accounting treatment is appropriate? What disclosure of risk is appropriate?
- * Are participants disclosing the effect of swap transactions? What disclosure is appropriate?
- * What secondary market developments should be anticipated? Will they pose additional risk? - Could a different interest rate environment impact liquidity?
- * Will a standardized contract be developed? If so, how will it affect the market? Intermediaries? End users? Will standardized swaps be less effective for end users? Will they lessen the risks for intermediaries?
- * Are swaps serving needs similar to those served by futures transactions? Other transactions? Will growing use of swaps impact futures markets?

K. NEW PRODUCTS AND SERVICES

Options

Foremost among new products and services introduced or proposed this year by the self-regulatory organizations (“SROs”) were options on individual over-the-counter (“OTC”) stocks and stock indexes. There are now 26 classes of OTC stock options traded on five exchanges, with 7 traded on two or more exchanges. Average daily trading volume in these contracts has ranged from 50 contracts to approximately 6,000. The NASD also has received approval in principle to trade options on individual OTC stocks.

The Philadelphia Stock Exchange (“Phlx”) commenced trading options on an index of 100 OTC stocks (“National OTC Index”). Trading volume has averaged around 500 contracts per day. The NASD has received approval to trade two 100 stock OTC index options (the “NASDAQ 100” and “NASDAQ Financial” Indexes), and expects to commence trading in September. In addition, the CBOE has proposed to trade options on an index of 250 OTC stocks, whose value, unlike the Phlx and NASD indexes, would be based upon bid and ask quotations rather than last sale prices. The Chicago Board of Trade and the Chicago Mercantile

Exchange have proposed to trade futures contracts patterned on the NASDAQ 100 Index and the CBOE OTC Index, respectively.

There were several new options product developments in addition to OTC options. The Phlx introduced an option on the Value Line Stock Index Average, which has traded on average 10,000 contracts a day. In addition, the Phlx has proposed to trade options on European Currency Units ("ECU"), a composite currency whose value is based upon the weighted exchange value of 10 European currencies. In addition, the CBOE has proposed to trade "European-style" options, or options that can only be exercised on the last trading date prior to expiration. The Commission has approved one such proposal, and another is pending.

New Twists on Common Stock

The Americus Shareholder Services Corporation ("Americus") recently began to offer a unit investment trust which permits shareholders of Exxon Corporation to exchange common shares for trust units with two component parts. One part represents the right to receive dividends and to vote (the "PRIME"), the other represents the right to capital appreciation over a predetermined value upon termination of the trust (the "SCORE"). The American Stock Exchange expects to list and trade units and component parts. Americus has expressed its intention to offer similar trusts based on other common stocks.

It remains to be seen whether this product will have an impact on shareholder voting patterns or corporate management. If a significant portion of the voters were to have a stake only in dividends, i.e. hold just the PRIME component, will management be forced to strive for short-term results at the expense of long-range planning?

General Motors Corp. has successfully issued a new type of common stock, whose dividend is linked to the performance of one GM subsidiary. In October, 1984, GM issued Class E common stock, on which dividends are based upon the net income of Electronic Data Systems, a high-technology business acquired by GM at that time. Class E shares have 1/2 the vote and liquidation rights of GM common stock. The NYSE listed the GM Class E, feeding the controversy over the continuing need for the "one share, one vote" rule waived in this case. The market has been enthusiastic thus far. GM now proposes to issue Class H common stock, with similar features, in the acquisition of Hughes Aircraft Corporation.

Flexible Premium Variable Life

The life insurance industry is bringing to market a new variable life insurance product known as “flexible premium variable life insurance” or “variable universal life insurance” (“Flexible Life”). Flexible Life will provide a death benefit and cash surrender value which vary based on the investment performance of the separate account funding the policy, and will allow the policyholder to change the amount and timing of premium payments and increase or decrease the amount of insurance coverage. The separate account is like a mutual fund and a cash management account out of which term insurance premiums are paid. Many types of separate accounts are expected to be offered, including common stock, bond, and money market funds, as well as more exotic funds like zero coupon bond funds, high yield (or “junk”) bond funds, and growth funds.

Securitized Credit Instruments

The proliferation of securitized credit instruments continued this year. The basic principle is that the issuer collects a pool of money to invest in secured debt instruments, such as home mortgages, car loans, equipment loans, etc. The more established of such products are collateralized mortgage obligation bonds (“CMOs”), proceeds of which are invested in certificates guaranteed by Ginnie Mae (the Government National Mortgage Association), Fannie Mae (the Federal National Mortgage Associations), or Freddie Mac (the Federal Home Loan Mortgage Corporation). The market for privately-insured mortgage pools has also burgeoned, and creative financiers have been assembling other types of consumer debt for similar marketing. For example, Collateralized Automobile Receipts are marketed to investors who want to Participate in secured lending on cars.

This trend clearly operates to stretch the distance between the borrower and the lender. As home mortgage foreclosures have reached record high levels, Kaufman of Salomon Brothers, and Trautman of Donaldson, Lufkin, are advising the public to exercise caution.

Investment Company Products

An investment company product which re-emerged this year is the “fund of funds”, a mutual fund which invests in other mutual funds. The FundTrust funds, with only \$8 million after seven months, and Vanguard’s STAR Fund, are the first to come to market. Perhaps the market’s lukewarm response reflects skepticism about the potential for high returns after payment of two layers of management fees. Forbes has dubbed the concept “the dumbest idea in years.”

L. LIABILITY AND INSURABILITY OF OFFICERS AND DIRECTORS

Directors' and officers' liability, and the insurance to cover it ("D&O policies"), have received a lot of attention lately. Litigation is pending against the directors or officers of Union Carbide, Continental Illinois, Penn Square Bank, Walt Disney, ESM Government Securities, Home State Savings Bank, American Savings and Loan, and Baldwin-United Corporation. With the exception of the Penn Square litigation (brought by the Federal Deposit Insurance Corporation as receiver), all of these lawsuits involve alleged violations of the federal securities laws. Several of the suits, including Penn Square, also allege breaches of fiduciary duty. In addition to these actions, two commercial banks (Chase Manhattan and Bank of America) have taken the unusual step of suing former employees in the hope of collecting damages from their own D&O policies.

In the public offering context, the Commission has traditionally taken the position that indemnification of a director or an officer against his statutory liability under the Securities Act for deficiencies in the registration statement is against public policy and unenforceable because it tends to frustrate the purpose of individual liability under Section 11 of the Act. When there is a provision for indemnification, the Commission has refused to accelerate the effectiveness of the registration statement unless the registration statement includes a statement of the Commission's position and an undertaking to the effect that no claim for indemnification will be honored unless the issuer has first obtained a judicial ruling that indemnification is not against public policy. Despite the Commission's policy, directors and officers continue to seek insurance coverage against Securities Act liabilities.

In light of the damages paid or possibly payable under D&O policies (estimated at 3-4 times last year's premiums), insurers are trying to protect themselves in several ways, including raising rates on renewals, refusing new coverage, canceling coverage, changing standard terms to include legal fees in the insurance coverage limit and to cover only those claims made while policies are in force, and setting up single-line mutual companies to offer D&O policies.

In response to these actions by insurers, companies or directors are paying higher premiums, buying less coverage, self-insuring (or mutually insuring), suing insurers that cancel coverage, seeking legal advice on the responsibilities of directors and possible defenses to litigation, and resigning from boards.

Some of the questions raised by these circumstances are:

- * Will public companies have difficulty recruiting qualified outside directors?
- * Should the role and responsibility of outside directors be reconsidered?

- * Should the liability of outside directors be more closely connected to the scope of their responsibilities?

M. LIABILITY AND INSURABILITY OF ACCOUNTANTS

RECENT DEVELOPMENTS

- * In information gathered for Congress, the staff found that the Big 8 firms paid out at least \$189 million in damages and settlements in the last five years.
- * Alexander Grant reportedly has been named as defendant in suits claiming over \$500 million in connection with the collapse of ESM Government Securities; Arthur Andersen has been sued by the British government for \$270 million in connection with its audit of DeLorean; the FDIC sued Peat Marwick for \$130 million in connection with the Penn Square collapse.
- * Firms are finding that liability insurance coverage is harder to find at an economical cost. The result is: significantly higher premiums (reportedly increasing 200 to 400% this year); increased deductibles; reduced coverage. Some firms fear that, in the near future, adequate coverage may not be available, or the cost will be so great they may be forced to forego coverage.
- * The U.S. Supreme Court in the Arthur Young case concluded that auditors “assume a public responsibility transcending any employment relationship with the client This “public watchdog” function demands that the accountant maintain total independence and requires complete fidelity to the public trust.”
- * Federal RICO statutes have recently been used by plaintiffs to add treble damage claims, court costs and attorney fees to plaintiff’s actions against accountants. The Supreme Court in Sedima, S.P.R.L. v. Imrex Company, Inc. (July 1, 1985) found that no showing of an earlier criminal conviction is required to establish a RICO claim. A Bill (H.R. 2943) was introduced in the House on July 10, 1985, however, which would add a prior criminal conviction to the elements of a RICO claim. A different Bill (S. 1521) was introduced in the Senate which would remove securities and mail fraud from the definition of racketeering activity and require proof of another injury caused by racketeering activity. Either amendment may make proceeding against accounting firms under this statute more difficult.
- * State court decisions vary in the scope of accountant’s liability for negligence. The New York Court of Appeals recently held under New York law that an accountant may not be held liable to third parties for professional negligence absent privity of contract or an equally close relationship. New Jersey courts have extended liability to persons the auditor should reasonably foresee will be

given, and rely on, the audited information, and New Hampshire courts have cited the auditor's "deep pocket" in finding liability.

* In the UK, the possibility of limiting accountant's liability is being explored. Possible directions include: incorporation of partnerships; statutory limits based on a multiple of fees; a jointly-owned captive insurance company; and even a system to apportion liability among auditors, management and others.

DISCUSSION POINTS

-- What impact, if any, has the Arthur Young case had on the profession? Does it differ in any way from the general perceptions of the independent auditor's role?

-- Will the difficulty in obtaining adequate insurance and the potential dilution of profits affect the ability of accounting firms to attract and retain quality personnel?

-- Payments of damages and settlements by accounting firms may be increasing over time, which would indicate a trend; alternatively, they may be cyclical due to business failure cycles which follow periods such as the economic downturn in 1980-1981. Should there be an upper limit on auditor liability? On what theory or model should such a limit be based? What form should it take?

-- How would limited liability affect auditors' willingness to find and report fraud and other illegal acts to law enforcement or regulatory agencies?

-- Does the threat of litigation serve to instill a discipline in auditors when performing their duties? If so, would any limitation on liability affect this discipline?

-- Has there been confusion between management's and auditor's responsibilities for the preparation of accurate financial statements? Has this had an impact on auditors' liability?

-- Should the RICO Act be amended to avoid impacting persons it was not intended to cover? If so, how?

-- Should auditors be liable to all reasonably foreseeable plaintiffs for negligence in the performance of their audits? Should the "deep pocket" theory of liability often found in products liability cases apply to accountants?