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United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

WASHINGTON, DC 20510-6075

June 1, 1987

CHAIRMAN'S OFFICE
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SEC. & EXCH. COMM.

The Honorable John Shad
Chairman
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Dear John:

Due to the crush of business on the Senate Floor, I was unable to remain at the May 13, 1987 hearing for the entirety of your testimony. Enclosed you will find those questions that I would have asked had I been in attendance. I have also enclosed the questions that Senator Garn would have posed had he been able to remain for the entirety of the hearing.

Your response to these questions by July 1, 1987, would be greatly appreciated.

Sincerely,

Alfonse M. D'Amato

Enclosures

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Questions for SEC Chairman Shad from Senator D'Amato

May 13, 1987

Insider Trading

Q. 1. In 1984, the Insider Trading Sanctions Act, which I sponsored, was enacted. The legislation was designed to provide an effective deterrent to insider trading by increasing the penalties from disgorgement alone to disgorgement plus a civil penalty of up to three times the amount of the profits gained or losses avoided. Although the Insider Trading Sanctions Act was intended to be a deterrent, some of the largest and most egregious insider trading cases have been prosecuted since that time.

(a) In light of the recent prosecutions, do you believe that the civil sanctions imposed by the Insider Trading Sanctions Act need to be increased?

(b) Do we really need more severe civil and criminal penalties (5 years and $250,000 fine for each criminal securities law violation) or do we need more cops on the beat to provide a more effective deterrent?

(c) As you know, I have introduced legislation attempting to define insider trading. Pursuant to my attempts, Senator Riegle has asked a panel of securities law experts, including two of this Committee's counsels, to formulate a definition of insider trading. Do you believe that a carefully crafted definition of insider trading could facilitate your enforcement efforts - especially with regard to your ability to bring close cases such as the Foster Winans case? Could you briefly explain your theory of the case and why Winans' alleged violations constitute insider trading?

(d) What specific additional steps would you recommend to crackdown of insider trading?

Q. 2. Some commentators have suggested that illegal trading activity will not be stymied until really harsh criminal penalties are imposed on inside traders. How do you respond to those who claim that the civil and criminal penalties imposed upon Levine, Boesky and Siegel et.al. were too lenient? How do you determine (i.e. what factors) the adequacy of the jail sentences which were imposed in these cases since none of these men ever stood trial? If you find during subsequent investigations that any of the individuals involved in the cases which have settled have failed to tell the whole truth, what recourse do you have against them?

Q. 3. An SEC Office of Chief Economist Study entitled Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation concludes that the increase stock prices and trading volumes of target shares before a takeover announcement due to a number of factors that have nothing to do with illegal insider trading. Do you agree with the findings of this report or do you believe that insider trading is the dominant source of information that spurs a runup in a stock's price before the announcement of a takeover bid?

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Q. 4. Do you believe that lowering the Schedule 13D reporting .cquisition threshold from 5% to 3% or lower could have any impact on the incidence of insider trading?

Q. 5. The first line of defense against insider trading should be the in-house policies and procedures of firms that regularly engage in securities transactions. My perception of these in-house, self-policing mechanisms is that they are illusory and these firms are paying lip service to their commitment to eradicate insider trading. I have introduced legislation that would, under certain circumstances, impose civil penalties upon firms for an employee's violations of the federal securities laws. Do you believe that these firms would have a greater incentive to formulate and implement self-policing mechanisms if the firm was civilly liable for the actions of their employees if they knew or should have known that their employees were trading on inside information? What, if any, provisions of the law permit the SEC to prosecute firms for the actions of their employees? What are the limitations of these laws regarding your ability to prosecute a firm?

A. 6. Since 1981, what percentage of the insider trading cases which have been successfully brought or settled by the SEC have involved market professionals such as investment bankers, investment professionals and broker dealers and what percentage have been brought against corporate officers and directors and their friends and relatives?

Q. 7. As a result of the increasing internationalization of the securities markets, shouldn't we be focusing on the real threat to our system posed by insider trading which occurs when transactions are executed in our securities on overseas markets? Do foreign bank secrecy laws complicate your task to such a degree that they impede the successful prosecution of insider trading cases? What enforcement mechanisms exist to detect and prosecute insider trading conducted offshore? What role can Congress play to increase cooperation between U.S. and foreign authorities in the fight against insider trading? Would the prosecution of these cases be facilitated if the SEC had the power to freeze assets (before they are sent abroad) without first obtaining a court order?

Q. 8. Published reports regarding the Boesky case imply that the SEC miscalculated the illegal profits that Boesky earned. These reports state that Boesky illegally earned $203 million, not the $50 million figure claimed by the SEC. To the extent you can discuss the case, could you please explain how the SEC calculated Boesky's profits and arrived at the $50 million figure?

<u>Takeover Reform - Amendments to the Williams Act</u>

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Q. 1. a) In light of the U.S. Supreme Court's decision in CTS v. Dynamics Corporation upholding an Indiana anti-takeover statute, what specific amendments to the Williams Act would you recommend?

b) What was the SEC's position regarding the Indiana anti-takeover statues? Do you think that the Court's decision challenges the principle that the regulation of takeovers should be the exclusive domain of federal securities laws?

Q. 2. Do arbitrageurs play any useful role in the marketplace?

Q. 3. If a firm has been retained as an investment adviser or banker in a particular takeover contest, should it be prohibited from engaging in any arbitrage activity in the securities of the company involved in the takeover?

Q. 4. Do Chinese Walls really work? Should additional incentives such as civil penalties be imposed on firms to ensure that they really work?

Funding the SEC

Q. 1. One of the greatest problems of the SEC is retaining qualified professional staff due to the gross salary discrepancies between the Commission and private practice.

a) Should the Commission be relieved of the salary constraints traditionally imposed by the civil service laws in order to allow it the flexibility already afforded to the FED?

b) Should the Commission be put on a self-sustaining basis (i.e., the Commission would pay for itself through filing fees, civil damages it has won and other sources of revenue)?

Corporate Democracy - One Share/One Vote

Q. 1. When will the SEC finally rule on the pending applications of the NYSE and the AMEX regarding changes in their listing standards? Are there any obstacles confronting the Commission which are precluding a decision in the near future?

Program Trading

Q. 1. In testimony the Committee received earlier this year from Robert Rittereiser, he stated that the development of derivative products such as options and futures when combined with program trading creates a problem of extraordinary market volatility during those 4 Fridays of the year with "triple witching hours."

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a) Is this volatility only limited to 4 triple witching hours each year? (The 114 point swing in the market on January 23, 1987 was not on a triple witching hour Friday; the 120 point drop on September 11 and 12 was not on a triple witching hour Friday.)

b) NYSE Chairman John Phelan recently expressed his concern that a failure to curtail the volatility of a program trade driven stock market could lead to a 1929-style market crash. Do you agree with Phelan's assessment and how could such a crash be triggered by program trading? How likely is the occurrence of such a market calamity?

c) What specific regulation of program trading activity is required?

S. 1175

Q. 1. Last Friday, I introduced a bill, S. 1175, which amends the Securities Exchange Act of 1934. This amendment to the Exchange Act, which is supported by the SEC, would require banks when performing certain brokerage activities to register with the SEC. This legislation essentially codifies SEC Rule 3b-9 - a rule the SEC promulgated in 1985 and which was invalidated by the District of Columbia Court of Appeals in 1986.

a) Rule 3b-9 was in effect from its promulgation by the SEC until the 1986 court decision. Did any banks register as broker dealers while the Rule was in effect? Are these banks still registered with the SEC? What has been the SEC's experience with these banks to date?

b) In your opinion, why did the banks so vehemently oppose the promulgation of Rule 3b-9? What are the additional operating expenses that a bank will incur when it is required to register with the Commission?

c) How will the enactment of S. 1175 improve the safety and soundness of the banking system and ensure more investor protection?

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Questions to SEC Chairman John Shad from Senator Garn

MAY 13, 1987

Q. 1. As part of the FSLIC recapitalization legislation, Congress has ordered the Bank Board to require for regulatory purposes asset writedowns no more stringent than under GAAP. How does the Commission's Accounting Release FRR-28 apply to credit losses on loans secured by real estate?

How active does the real estate market have to be for reliance to be placed on potentially "fire sale prices" rather than derived values?

Q. 2. Does the Commission intend to await guidance from the Financial Accounting Standards Board in terms of appropriate reflection of financial instrument positions in an entity's financial statements?

Will the Commission move quickly on any further interim disclosure requirements?

Does the Commission propose to take a more active role in determining investment vs. trading portfolios and historical cost vs. mark-to-market carrying values?

Q. 3. Does the Commission have any concerns about investor disclosures for exotic new mortgage-backed securities?

Does the Commission feel that further disclosures should be made especially for instruments targeted towards individuals' investments?

Does the Commission propose to make any changes in its Capital Rule 415 shelf registration requirements for mortgage-backed securities especially REMICs?

Q. 4. Does the Commission plan to adopt last December's proposal on mutual fund rate of return disclosures?

Does the Commission propose to require the amortization of premiums on debt securities into the disclosed rate of return symmetrically along with discounts?

Does the Commission propose to adopt the market value amortization method discussed in last year's proposal?

Q. 5. I have been following an issue with special interest and concern for some two years that in my judgement has not yet been satisfactorily resolved. That issue is the process by which banks, security firms and

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savings institutions guarantee signatures on stock certificates and related documents. Banks and brokers routinely provide this service to their customers, but savings institutions, for reasons that escape me, are frequently not allowed by stock transfer agents to provide this necessary service to their customers. I know that this matter was brought to the attention of Commission staff several years ago, but to date the problem still has not been satisfactorily resolved. Would you please explain why a matter of this nature can't be more promptly resolved so that savings institutions and others will not continue to be at a competitive disadvantage with regard to this service?