NEWS
SECURITIES AND
EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 272-2650

REMARKS TO

WASHINGTON & LEE UNIVERSITY

LEXINGTON, VIRGINIA

MAY 5, 1983

THE SECURITIES AND EXCHANGE COMMISSION: SOME HISTORY AND FUTURE

JAMES C. TREADWAY, JR.

THE VIEWS EXPRESSED HEREIN ARE THOSE OF COMMISSIONER TREADWAY AND DO NOT NECESSARILY REPRESENT THOSE OF THE COMMISSION, OTHER COMMISSIONERS, OR THE STAFF.

I. SOME HISTORY

I. CURRENT SPECIFIC MAJOR ITEMS

1. Insider Trading Legislation

In terms of specific current topics of interest at the Commission, one of the most publicized has been insider trading. Trading securities on the basis of material, non-public information, commonly referred to as "inside information," is illegal and is a major enforcement emphasis. The Commission recently sent legislation to Congress seeking new, more severe sanctions on those who trade on inside information. Presently, someone who trades on the basis of inside information may be ordered by a court not to repeat such violative activities and may be required to disgorge the illegally gained profits. The new legislation would permit the imposition of a monetary penalty of up to 300% of the insider's profits as an added deterrent. Hearings on this legislation is now underway in the House.

Why all this attention to insider trading? In a sense, it's two fairly simple notions. The first is fairness. Should a Director of a public corporation, which is about to be acquired at a substantial premium, be allowed to secretly tip his son, who invests $3200 in call options and 48 hours later, when the takeover is publicly announced, sells the options at a profit of $427,000? That's an actual case. Shouldn't those who wrote the options, or sold the stock to him, be entitled to know the same inside information before they enter into the transaction? The second notion rises from the present result if you are caught. If you trade on inside information and don't get caught, you keep the illegal profits. If you get caught, you merely give the profits back. Heads I win, tails you lose.

2. <u>Tender Offer Study</u>

A second area of curent interest is that of contested take-overs, or tender offers. The past two years have seen a number of billion-dollar, hotly contested, bloody and destructive tender offers. The Allied-Bendix-Martin Marietta saga is perhaps the best-known example, leading the Chairman of Allied to describe it as one of the "sorriest spectacles in the history of American business." To respond to these developments, the Commission recently formed an Advisory Committee on Tender Offers, which is to examine tender offer practices and make recommendations for changes in current regulations by July, 1983. In particular, the Committee is considering whether additional protections are required for the shareholders of both target and bidder companies. The sixteen members of the Committee included businessmen who have been both bidders and targets in tender offers, investment bankers, lawyers, academicians, and a former Supreme Court Justice.

The initial position papers of the Committee members were revealing. On one hand, the two academicians, both from the University of Chicago, suggest that the best way to deal with tender offers is simply not to regulate them, other than through after-the-fact fraud prosecution. In effect, they would repeal the current regulatory scheme. The businessmen, even those generally on the bidder side, seem to prefer greater certainty, even if that means more regulation. The lawyer and investment bankers are generally somewhere in-between, prompting some cynics to observe that lawyers and investment bankers have no views, unless paid to have them.

One much debated issue on the agenda for the next Committee meeting originates in the British take-over regulations. Under the British approach, if a bidder acquires a given percentage of the issuer's securities, e.g., 20%-30%, the bidder is then required to make a non-discriminatory bid to acquire all remaining shares at the same price and for the same form of consideration. This approach would bar the so-called "two tier" or "front-end loaded" offers which we permit in the U.S.. In those offers, the bidder frequently bids to buy 40%-60% of the shares for cash, and then bids for the balance for a note or debt instrument which has a market value less than the per share cash offer. This technique has become quite popular, but also has been heavily criticized. Whether the Committee actually will advocate such a change will be hotly debated.

3. Stockholder Proposals

Another area of current interest involves the right of stockholders to have certain proposals included in management's proxy statement. Since 1942, the Commission has permitted the holders of even one share to have certain proposals presented in the proxy statement and to have proxies for such proposals solicited at little or no expense to the shareholder. The controversy over this process arises from the pointed nature of the proposals presented: stop doing business with companies that pollute the environment or do business with South Africa, or sell arms, or discriminate against minorities. Incumbent management frequently views these proposals as political statements, harassment, or disparagement of management. The stockholder proponents view them as a legitimate exercise of their corporate franchise.

Last October, the Commission published a series of proposals intended to reevaluate this process. Under one proposal, a company could adopt its own procedures governing the proposal process, as liberal or restrictive as shareholders are willing to approve.

A second proposal would call for relatively minor adjustments to the existing scheme, requiring a proponent to have a minimum stake to propose a vote on an issue -- ownership for one year of at least 1% or $1,000 in market value of the company's securities. The third proposal would throw the process open to stockholder proposals on a first-come, first-served basis, subject to an overall numerical limit.

The idea of giving corporations more control over shareholder proposals has, expectedly, upset some shareholders. Since October, the Commission has received hundreds of negative responses from individuals and "public interest" groups. But what you might find surprising is the fact that most corporations say they, too, prefer no less radical changes. Some companies have argued that without the certainty of the present system, they could become involved in litigation with shareholders who charge that the company is not properly administering its own plan. Companies have also voiced a fear of chaotic systems of rules unique to each corporation.

This makes for an interesting situation, for while most companies continue to criticize social activists who, they say, abuse the rules, most companies have exhibited a general reluctance to drastic changes.

4. Swiss Accord

The Commission's investigations of violations of the Federal securities laws - - particularly insider trading -- have sometimes been impeded by foreign secrecy laws or blocking statutes. We are all familiar with those mysterious things called "numbered Swiss bank accounts," which regularly appear in movies and novels. But those accounts in fact exist, and we frequently find that the suspicious securities trading has been conducted through a foreign bank account but that we are unable to obtain information about the persons behind the account or thė details of the transactions. Such trading frequently appears to involve inside information.

In August, 1982, Switzerland and the United States concluded long negotiations by signing a Memorandum of Understanding, which now permits Swiss banks to furnish certain information and evidence to the Commission, notwithstanding Swiss bank secrecy laws. This Accord removes a major barrier to investigations and prosecutions and may well set a precedent for similar agreements with other countries having bank secrecy laws and in other areas of law enforcement. Similar negotiations are underway with approximately a dozen other countries.

5. Securities Activities of Banks

A year ago no bank provided discount brokerage service; today over 600 do so. This rapid expansion of securities activities of banks is leading to substantial changes in the structure of the brokerage industry. In a sense, the Commission's involvement in this process has been peripheral, but we are becoming progressively more involved in the activities of depository institutions, an area traditionally reserved to Federal and State bank regulators. Historically, there has been a philosophical conflict between the approach of bank regulators and that of the Commission. The bank regulators generally focuses on protecting the enterprise and the depositors, even if that means concealing information about the bank and its affairs which clearly would be material under the securities laws. The Commission's approach focuses on protection of the investors, and that mandates full and prompt disclosure of all material information, even if it is adverse and may cause damage to the enterprise. The blurring of traditional barriers between banking and securities activities, and therefore the jurisdictional lines between of the various regulators, carries with it some interesting potential for conflict between the Commission and the bank regulatory authorities.

6. Proxy Contests

Several decades ago, proxy contests rather than cash tender offers were the principal means to acquire control of a target company on an unfriendly basis. Generally, the insurgents would propose a slate of directors in opposition to management's slate and attempt to influence stockholders to vote for their slate and oust incumbent management, who generally were depicted during the contest as lazy, arrogant, incompetent, or crooked. A complex body of rules and regulations grew up around proxy contests, with both sides subject to complicated filing, disclosure, and waiting requirements.

During the 1960's, proxy contests went into decline as the cash tender offer grew in popularity. But this past year, the proxy contest has suddenly re-emerged. In 1982, there were 68 proxy contests for the election of directors, compared to 66 in 1981 and 38 in 1980. And proxy fights are not always confined to the election of directors. Some minority stockholders of TWA recently conducted a proxy contest over a proposal to break TWA into five separate companies, claiming that the value of the five companies operating separately would exceed the value of TWA as presently structured. This group, which owned less than 1% of TWA's stock, obtained a 25% vote in favor of this break-up. While this was not sufficient to carry their motion, 25% is a large number, and it will be interesting to see how TWA responds to this pressure during the next year.

IV. FINANCIAL SERVICES INDUSTRY TASK FORCE

Looking beyond these specific current items, I would say that the broadest, most significant development on the Commission's agenda is the restructuring of the financial services industry. Brokerage firms have expanded into banking activities; banks have expanded into brokerage activities. There have been interindustry mergers between financial institutions -- Bache with Prudential Insurance, Dean Witter with Sears, and Shearson with American Express. 600 banks today provide discount brokerage services; a year ago none did. 400 savings and loan institutions are expected to participate in a jointly-owned discount brokerage operation.

Since December, 1982, banks and thrift institutions have deposit accounts intended to compete directly with money market mutual funds. Mutual fund managers, such as Dreyfus, have responded by acquiring banks but selling the bank's commercial loan portfolio in an effort to fall outside the definition of bank, which is an institution which accepts deposits and makes commercial loans. These are euphemistically referred to as "non-bank banks." When Dreyfus started this trend, Dreyfus obtained a ruling from the FDIC that Dreyfus' acquisition of a state bank would not cause Dreyfus to become a one bank holding company. The FDIC ruled that the sale of the commercial loan portfolio of the bank indeed changed the bank from a bank to a non-bank. The Federal Reserve Board wrote the FDIC and told them they didn't understand the law. The FDIC wrote the FRB and told them to mind their own business. Finally, the Comptroller of the Currency declared a moratorium on "non-bank" banks to preserve the status quo until Congress can review the situation. Mr. Isaacs of the FDIC again was outspoken, commenting caustically: "I don't see Congress doing much if we impose the moratorium - except extending the moratorium." Such is life in Washington.

But these changes, and undoubtedly there are more to come, are erasing the traditional separations between banking and commerce. In response, the Administration has established a Task Force led by Vice President Bush to re-examine our financial regulatory structure and possibly suggest a merger of some of the financial regulatory agencies. The specific proposals for merger or consolidation are numerous, but generally deal with ideas such as the following:

- Merge all the banking regulators -- the FRB, Comptroller, FDIC, FHLLB, and FSLIC.

- Merge the FRB, Comptroller, and FHLBB into one entity, and then merge the FDIC and FSLIC, the providers of deposit insurance, into another.

- Merge the SEC and the Commodities Futures Trading Commission.

- Transfer various functions from the bank regulators to the SEC in the area of securities activities of banks.

Most agree that it would be a good idea to streamline the regulatory process, assure uniform standards, and eliminate duplication. But there are some knotty issues.

In addition to substantive issues, human nature also plays. When the Task Force was first announced, Paul Volcker, head of the Federal Reserve Board, promptly paid a personal visit to Vice President Bush. Volcker supported consolidation of the other banking authorities, as long as the Fed remained independent because of its key role in setting monetary policy. The head of the Federal Home Loan Bank Board, which regulates savings and loan associations, said it was all right to merge the other bank regulators as long as the FHLBB was left independent because of the special role of S&L's in providing home mortgages. The head of the FDIC said the FDIC should remain independent because of its special role as an insurance provider. The Senate Agriculture Committee and the commodities industry are up in arms about the possibility of merging the Commodities Futures Trading Commission into the SEC. After all, they reason, what do a bunch of stuffy, pin-striped lawyers from Washington and Wall Street know about pork bellies and soybeans?

V. ENFORCEMENT PROGRAM

But now back to something very specific at the Commission. The Commission's role of in many of the structural or marco-economic issues -- such as the Bush Task Force -- is admittedly limited. But there is one area in which our jurisdiction is not limited or questioned -- and that is the investigation and prosecution of securities fraud cases. To return for a moment to one of my initial comments -- the Commission is primarily a law enforcement agency. Enforcement is the largest segment of our activities, accounting for approximately one-third of our budget and staff.

Our enforcement activities are far-ranging, and a few highlights might give some idea of the breadth of our activities.

1. One area involves the sales practices and conduct of broker-dealer employees. Broker-dealers occupy a unique

position, serving as the sole means of access to the securities markets for ordinary investors. Therefore, the Securities Exchange Act imposes on broker-dealers a responsibility to supervise the conduct of their employees. We bring enforcement actions against employees for violations of the securities laws and against the firms if they fail to adequately supervise the activities of their employees.

2. A second enforcement focus is financial statement fraud -- colorfully known as "cooked books" (the expression arose from the practice of "cooking the books" until they are done the way you want them) -- by public companies. These cases involve outright falsification of books and records through a variety of schemes, such as prerecognition of revenue, falsification of inventory records, and the fictitious invoicing of customers. It is surprising and disappointing to see the blue-chip companies where these activities have occurred -- Heinz, McCormick, Ronson, and just this week, AM International.

3. The third area is insider trading, which I mentioned earlier. Regardless of what happens with the legislation, the Commission will continue to be active in this area.

4. The fourth area is market integrity. In the past year the Commission brought 31 cases dealing with manipulative market activity.

5. A final area involves the con-games which seem to re-occur year after year. For example, we recently had a case in Utah where a promoter was selling interests in a machine that converted shale into oil. Unsuspecting investors were shown a machine that ground up shale and produced oil. The only problem was that the machine had a hidden reservoir filled with oil. Other cases involve ponzi's or chain letter schemes, non-existent mining property, non-existent oil wells, master-record licensing agreements, and phony domestic and foreign banking operations and schemes. The ingenuity of con-men is apparently endless. Generally, these are not sophisticated schemes. Instead, the promoters usually closely resemble the door-to-door con-men of the early 1900's, preying on those who are gullible or greedy. These activities occur throughout the United States, not just in major financial centers.

That's a quick indication of the diversity of our enforcement activities.

VI. SOME FINAL COMMENTS

As you see, the Commission is involved in a wide range of activities: processing corporate filings, investigating and prosecuting fraud, overseeing the securities exchanges and securities markets, negotiating international law enforcement agreements, and dealing with the restructuring of the financial services industries.

How does the Commission do all this? What are its resources? You might find a few statistics and comparisons interesting.

The Commission has an annual budget of $85 million, a total staff of 1800, including 700 lawyers, of which 400 are in the Enforcement Division. That's nationwide. In the main office in Washington, there are 110 attorneys in the Enforcement Division. That may sound like a lot.

But consider:

1. The dollar volume of trading on the New York Stock Exchange on an average day is $2 billion. The Commission is supposed to oversee all of that activity. On a heavy trading day, that may be $4-5 billion. The Commission's entire annual budget is .7% of that daily amount. On an annual basis, the percentage is almost too small to be calculated.

2. The dollar volume of over-the-counter securities trading on an average day is $332 million, or $87 billion Annually. The Commission likewise is supposed to oversee all of that activity.

3. The government securities market, which the Commission does not regulate directly, but are suppose to police to prevent fraud, is many times the size of exchange trading. The Average outstanding U.S. government debt, represented by treasuries

and agency debt, was $1.2 trillion, which includes $210 billion in new primary issues.

4. The investment companies we regulate have assets of approximately $200 billion. Those assets are invested and reinvested many, many times in a year. The Commission is supposed to oversee all of this activity.

5. The Commission receives processes and reviews some 65,000 principal corporate filings each year.

6. Any three good-sized law firms in New York, Chicago, Washington, or Los Angeles would have more attorneys than the entire Commission. Any one good-sized law firm in any of those cities has more attorneys than we have in our Enforcement Division in Washington. Any one of those firms can assign more attorneys to a given case than the Commission. And those are the firms that frequently represent the parties with whom the Commission litigates.

7. Last year, through various fees imposed on those who file documents with the Commission, the Commission collected and offset 94% of its budget of $85,000,000. The out-of-pocket total cost to U.S. taxpayers of operating the Commission was approximately $5,000,000.

* * * * * * *