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News
Release

Remarks of

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CORPORATE ISSUES

The views expressed herein are those of Chairman Ruder and do not necessarily reflect those of the Commission, other Commissioners, or the staff.

CORPORATE ISSUES

The American Society of Corporate Secretaries occupies a unique position among those organizations which focus on the regulation of corporations. Not only does the society follow a broad range of legislative, administrative, and judicial developments, but its large and broadly based membership offers a unique cross section of corporate America. It is appropriate therefore, that I offer some comments regarding the relationship of the Securities and Exchange Commission to the United States corporate world.

Corporate Disclosure

The Commission probably has its greatest influence on corporate policy through its disclosure requirements. Federal securities law disclosure obligations are imposed on corporate issuers primarily under the Commission's rules and regulations governing required filings and reports. These regulations are not static. To the contrary, they are almost always in flux as the Commission works to cull out regulations that impose greater burdens than benefits, generates new regulations to meet new problems, and modifies existing regulations to respond to the changing securities environment.

(a) Removal of Unnecessary Regulations

In recent years the Commission has taken a number of steps to remove what it believes to be unnecessary regulatory impediments to capital formation and corporate growth. In November, 1986, the Commission adopted amendments to its proxy rules to apply the integrated disclosure system to proxy disclosure. 1/ The amended rules allow "company-specific" information required in connection with mergers and acquisitions 2/ to be incorporated by reference under a system similar to that in Form S-4, the registration form for business combinations. Where securities are being authorized, issued or exchanged, 3/ the principles of integrated disclosure have been adapted in order to bring the benefits of the system to these transactions without unintentionally increasing the information required.

The Commission has also changed its rules to limit the need to file pricing amendments before going to market. 4/ The Commission has recognized that pricing information can be provided to investors without the formality of a pricing amendment, but also without decreasing the protections provided by the liability provisions of the 1933 Act. 5/

1/ Rel. No. 34-23789 (November 10, 1986). See also, Rel. No. 34-24515 (May 27, 1987).

2/ Item 14 of Schedule 14A.

3/ Items 11, 12 and 13 of Schedule 14A.

4/ Rule 430A. Rel. No. 33-6714 (May 27, 1987).

5/ See Rel. No. 33-6714 at 3.

In other areas, the Commission recently adopted amendments to Rule 174 to reduce the prospectus delivery period to 25 days in initial public offerings of securities that either are listed on an exchange or authorized for quotation on NASDAQ. 6/ The Commission has also recently adopted amendments to Regulation D broadening the definition of accredited investor in circumstances where it is plain that risk-bearing ability and bargaining power will allow the investor to obtain necessary information without the compulsion of federal law. 7/

(b) Additional Regulations, Responding to Investor Protection Concerns

Efforts by the Commission to eliminate or reduce regulations that are unnecessarily restrictive should not be perceived as an abdication by the Commission of its responsibility to investors. The Commission is also actively involved in strengthening regulation in areas where it appears that investors are not being adequately informed. Many of these new regulations will increase corporate costs and compliance burdens.

In October 1987 the National Commission on Fraudulent Financial Reporting, better known as the Treadway Commission, released the final report of a study containing extensive recommendations for improvements in financial reporting in the

6/ Release No. 33-6763 (April 11, 1988).

7/ Release No. 33-6758 (March 3, 1988). Amended Rule 501 effectively "expand[s] the definition [of accredited investors] to include virtually all classes of institutional investors." At 3.

United States. The Commission has endorsed many of the Treadway Commission's recommendations and is actively beginning to implement them.

In particular, the Commission will probably propose a rule for comment that would require annual reports 8/ to include a report by management assessing the company's internal financial controls. The report would encompass the company's system of internal controls directly related to financial reporting, not merely its internal accounting controls. Coupled with new auditors' responsibilities 9/ this new management report will result in closer scrutiny of internal controls as part of the annual independent audit.

The Commission has recently amended Regulation S-K, Form 8-K, and Schedule 14-A regarding disclosure by companies of changes in accountants in potential opinion shopping situations. These amendments will require any public company changing its auditor to disclose certain issues discussed with

8/ Both annual reports to security holders and annual reports on Form 10-K.

9/ The Auditing Standards Board has recently adopted nine new auditing standards: (1) The Auditor's Responsibility to Detect and Report Errors and Irregularities; (2) Illegal Acts by Clients; (3) The Auditor's Consideration of an Entity's Ability to Continue as Going Concern; (4) Consideration of the Internal Control Structure in a Financial Statement Audit; (5) Analytical Procedures; (6) Communication of Internal Control Structure Related Matters Noted in an Audit; (7) Communication with Audit Committees; (8) Reports on Audited Financial Statements; and (9) Auditing Accounting Estimates.

the newly engaged auditor within the two years preceding the change. 10/

The Commission plans to issue a concept release seeking comments on the costs and benefits of the Treadway Commission's recommendation that the SEC require independent public accountants to review quarterly financial data of all public companies before the data is released to the public.

The Commission is also supporting the Treadway recommendation that Congress take action to authorize the SEC to seek civil money penalties for securities law violations and to authorize courts to suspend or bar corporate officers and directors involved in fraudulent financial reporting from future service as officers or directors in a public company. These provisions are controversial, particularly with regard to the possibility that a prohibition from serving as a corporate officer or director may be imposed because of a securities law violation.

(c) Adapting the Commission's Disclosure requirements to a Changing Environment

The Commission's efforts to adapt the existing disclosure mechanisms to the changing securities markets are typified by the Commission's continuing drive towards the establishment of an operational Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system. When it becomes operational, EDGAR will increase the efficiency and fairness of the markets for

the benefit of investors, issuers, and other market participants by reducing from days and weeks to minutes and hours the public dissemination of time sensitive corporate information. The utility and feasibility of EDGAR has been demonstrated by the success of the EDGAR pilot, now in its fourth year of operation. The EDGAR pilot has successfully logged over 30,000 electronic filings. 11/ Over 1,200 companies now are submitting some or all of their filings electronically.

Another important initiative is continuing to be developed by the staff in its "Rule 144A" project. To date, institutional holders wishing to resell securities privately have relied upon lawyers' opinions that sales and resales to institutional investors do not constitute distributions and are therefore exempt from registration. The concept of Rule 144A would be to provide a safe harbor for the resale of unregistered securities between institutional purchasers. Such a clear exemption for institutional resales could contribute to the market's liquidity and efficiency. The staff is developing the scope of the rule, particularly with respect to the issuers it would cover and the range of permissible institutional purchasers.

11/ This total includes filings made under the 1933 and 1934 Acts, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, and the Investment Company of 1940.

In a related matter, the Commission is now considering a rule proposal submitted by the American Stock Exchange to establish a marketplace, known as SITUS (System for Institutional Trading of Unregistered Securities), for the secondary trading of foreign securities by and among Exchange members and institutional investors. The National Association of Securities Dealers has submitted a similar proposal, which it calls PORTAL (Private Offerings, Resale and Trading Through Automated Linkages.)

The Commission is also seeking appropriate responses to the accelerating development of new instruments and financing techniques. Companies are no longer content to merely issue common stock, debentures, or notes. New instruments include complicated new securities such as PERLS, SPINS, CARS, and Zero Coupon Notes. Asset-backed securities offerings are burgeoning. Structured financings and leveraged buyouts give rise to extremely complex debt instruments. Developing credit enhancement techniques add further complexity to the picture. The Commission's problem is to see that the disclosures concerning these new products and financing strategies adequately enable investors to evaluate risks. As you may know, we have also encouraged the Financial Accounting Standards Board to initiate a project on corporate disclosure regarding financial instruments. This project is creating great interest and substantial concern in some segments of the corporate community.

Contests for Corporate Control

Although the Commission's disclosure program provides the heart of its corporate regulation, a far more controversial area involves takeovers. Little doubt exists that the Commission has substantial influence on corporations through its regulation of contests for corporate control. The takeover area does not seem to have many neutral participants. Many corporate managers apparently believe that it is unfair that market participants with no long term interest in a corporation can buy a corporation, force a massive restructuring, or cause it to become private. Others contend that the takeover phenomenon is a good method of redressing inefficient management, stimulates beneficial reallocation of assets, and rewards target company shareholders.

The Commission's position is one of neutrality between bidders and targets in contests for corporate control. It believes that under clear current federal policy shareholders of the target corporation must be protected from undue pressure and must be adequately informed of the facts and circumstances of attempts to change corporate control.

(a) Legislative Proposals for Tender Offer Reform

In the current debate over tender offer reform the Commission has supported only a few limited reform proposals. It has supported a measure to require more timely disclosure of substantial acquisitions under Section 13(d) of the Securities Exchange Act by recommending legislation requiring purchasers

of more than five percent of a class of an issuer's equity securities to disclose that fact within five business days of making the acquisition, and prohibiting that purchaser from making additional acquisitions until the disclosure is made. 12/

The Commission has also supported clarification of the circumstances under which two or more persons will be treated as a single "person" or "group" for purposes of the disclosure obligation. 13/ It has supported proposals to enhance the remedies available to the Commission in its efforts to enforce this disclosure obligation, including the imposition of monetary penalties. 14/

The Commission has not supported proposals that would substantially alter the present system for regulating tender offers either by limiting the activities of bidders or by limiting the ability of target companies to implement defensive tactics. Some proposals, such as those that would require all substantial acquisitions to be made by tender offer, are regarded as interfering unduly with the ability to purchase control in private or exchange transactions. Other proposals, such as those regarding "greenmail," "golden parachutes," and

12/ Statement of David S. Ruder, SEC Chairman, Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce (September 17, 1987) pp. 11-15.

13/ Id. at 20-22.

14/ Id. at 22-23.

"poison pills" involve issues of corporate governance which the Commission believes should be left to state law.

(b) Relationship Between State and Federal Law

The Commission's concern for preserving the existing balance between state and federal law does not, however, mean that it will endorse actions by individual states which interfere with a free national market for the sale of shares. In the aftermath of the Supreme Court's decision in CTS Corp. v. Dynamics Corp. of America, 15/ more than a dozen states 16/ have adopted statutes whose clear design is to provide for state control over the takeover process. Changes in control that occur through the vehicle of the nation's securities markets are matters of both state and federal interest. Each state has certain interests in the corporations it charters, especially those located within its boundaries. When a state's legislation primarily affects the transfer of shares in companies which are locally based and locally owned, the state clearly has a legitimate interest in regulating changes of control. On the other hand, Congress has determined that "transactions in securities . . . are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions . . . in order to

15/ 107 S.Ct. 1637 (1987).

16/ These states include: Arizona, Florida, Hawaii, Louisiana, Massachusetts, Minnesota, Missouri, Nevada, North Carolina, Oklahoma, Oregon, Washington, and Wisconsin.

protect interstate commerce, . . . and to ensure the maintenance of fair and honest markets in securities." 17/ This statement sets forth a federal securities law policy that favors preservation of viable markets for the sale of securities. The existence of liquid secondary securities markets is extremely important for capital formation in our country, and Congress clearly supports this proposition.

Limitations on the free transferability of securities of corporations that are owned by shareholders nationwide diminish the efficiency, depth, and liquidity of the nation's securities markets. Accordingly, federal law should control in this area by preempting state statutes that unduly interfere with the free transferability of securities. 18/

Recently the Commission has filed briefs in Salant Acquisition Corp. v. Manhattan Industries, Inc. and RP Acquisition Corp. v. Staley Continental, Inc. arguing that the New York and Delaware state antitakeover statutes are unconstitutional. Despite my deeply held conviction that the federal government should avoid interfering with corporate internal affairs I voted for the filing of these briefs because

17/ Section 2 of the Securities Exchange Act, 15 U.S.C. 78b.

18/ In a speech this past September, Chairman Dingell of the House Energy and Commerce Committee expressed concerns that, "state statutes enacted recently may exceed traditional state corporate governance * * *." He cautioned against "balkanizing the economy." See Remarks of the Honorable John D. Dingell before the Garn Institute Conference on Restructuring of Corporate America (Sept. 21, 1987).

I believe the states should not regulate the interstate market for corporate control.

Insider Trading

In another area affecting corporations, the Commission continues to be active in strengthening and enforcing the federal prohibition against insider trading. Strong, effective prohibitions against insider trading are in the best interests of shareholders, and they are also in the best interests of corporations. If investors believe that secondary markets are fair and honest, it will be much easier for corporations to raise needed capital.

"Insider trading" is illegal under the antifraud provisions of the federal securities laws. The term refers generally to the act of purchasing or selling securities, in breach of a duty, by persons who possess material, non-public information about the issuer or its securities.

Insider trading prohibitions are extremely important because investors should have confidence in the fairness and integrity of our securities markets. The investing public has a legitimate expectation that the prices of actively traded securities reflect publicly available information about corporate financial condition and that persons with access to material, non-public information will not abuse their trust by trading before such information is publicly disclosed. As you know, the law prohibits such trading by corporate officers and directors and other persons having a relationship of trust and

confidence with the issuer or its shareholders. 19/ Under a theory developed in the Second Circuit Court of Appeals, such trading by persons who misappropriate material non-public information from sources other than the issuer also is prohibited. 20/ Tipping -- the wrongful communication of material, non-public information -- by such persons is also prohibited, and tippees are also prohibited from trading. 21/

The Commission aggressively pursues insider trading violations within this legal framework. We have brought insider trading cases not only against traditional insiders, but also against professionals, such as investment bankers, risk arbitrageurs, brokers, attorneys, accountants, and bank officers. We have also actively pursued cases involving tipping of associates, relatives, and friends. In the case of

19/ The Commission first articulated the prohibition against such insider trading in Cady, Roberts & Co., 40 SEC 907 (1961), stating that corporate insiders have an obligation to abstain from trading in the shares of their corporation unless they have first disclosed to the shareholders any material nonpublic information known to them. The Cady, Roberts "abstain or disclose" doctrine was subsequently endorsed by the Second Circuit of Appeals in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

20/ United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), aff'd on securities law counts by an equally divided court, 108 S.Ct. 316 (1987); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985); United States v. Newman, 664 F.2d 12 (2d Cir. 1981), aff'd after remand, 722 F.2d 729 (2d Cir.), cert. denied, 464 U.S. 863 (1983). The "misappropriation" theory was previously discussed in the concurring and dissenting opinions in Chiarella v. United States, 445 U.S. 222 (1980).

21/ See Dirks v. SEC, 463 U.S. 646 (1983); SEC v. Texas Gulf Sulphur Co., 401 F2d at 852.

corporate officials we hope that our activities will have an in terrorem effect, so that corporate insiders will actively avoid misuse of inside information.

In the wake of publicity about the Commission's enforcement efforts in the insider trading area, interest has developed in codifying and strengthening the law concerning insider trading. On November 18, 1987 the Commission submitted proposed legislation on insider trading to the Senate Banking Committee. This legislation would statutorily define and prohibit insider trading, utilizing concepts of breach of duty and misappropriation embodied in existing law. The legislation also would: (1) provide an institutional trading defense for institutions that have adopted certain reasonable procedures to detect and prevent violations; (2) address the issue of derivative liability for controlling persons and employees; (3) provide express private rights of action for certain persons; (4) and amend and clarify the Insider Trading Sanctions Act. In drafting this legislation, the Commission was particularly concerned about the activities of analysts, and took pains to include exemptive power so that it could deal with the thorny issue of analysts' relationships with corporations on a detailed basis.

Institutional Investors in the Market

A fourth area in which the concerns of the Commission overlap those of the corporate world is the changing role of institutions in the securities markets. Today, institutional

investors are an extremely powerful and growing force in the market. During the last ten years, institutional investors have held an increasingly large percentage of all outstanding equities. The 1980's have seen not only a substantial growth in the market value of institutional holdings, but also a surge in the percentage of the total trading volume accounted for by institutional investors.

In the first instance institutional investors are increasingly able to determine the outcome of important corporate matters. All of us recently watched with great interest to see whether Texaco management or Carl Icahn would win the proxy battle at Texaco. That contest certainly indicated the importance of institutional investors in today's corporate world.

Of course institutions also vote by their decisions to sell or hold securities. In the present market, a great deal of concern exists over the influence of institutions in takeovers. Some argue that institutional investors are actively involved in facilitating takeovers and that they are driven by short term goals rather than by long term investments in a company's future. Others contend that institutions are playing an important economic function by voting in favor of takeovers, with resulting benefits to all target shareholders.

For the most part, the Commission does not regulate institutional investors directly. Of course we do require disclosures from publicly held institutions such as bank

holding companies. 22/ We also require institutional reports of large securities holdings, 23/ and, of course, we regulate investment companies. 24/ However, for the most part, when we have concerns about activities of institutional investors, we are remitted to hortatory activities (known to some as jawboning).

Currently, serious concerns also exist regarding the impact of institutional investors on the markets themselves. The types of institutional transactions that occur and the investment decisions made by money managers are changing as a result of evolving investment and trading strategies, which in turn result in part from the extremely large size of some institutional portfolios.

The institutional use of new strategies during the October market break raised a number of serious questions. The Commission's staff analysis of trading on October 19 suggests that while the initial decline that immediately preceded the market break was triggered by changes in investor perceptions of investment fundamentals and economic conditions, institutional stock selling was an important factor in the market decline. Rapid and large stock and futures sales by institutions, while not the "sole cause" of the market break,

22/ Section 12, 13(a), 13(b), Securities Exchange Act of 1934.

23/ Section 13(d), Securities Exchange Act of 1934, and Rule 13d-1 thereunder.

24/ Investment Company Act of 1940.

were a significant factor in accelerating and exacerbating the declines. According to our staff, index arbitrage and substitution program sales comprised 14.7% of total NYSE volume and 21% of the total volume in S&P 500 stocks on the nineteenth of October. During certain critical trading periods on that day portfolio sales accounted for between 30 and 65 percent of total NYSE volume in S&P 500 stocks.

Stock index futures supplement and at times replace the stock market as the primary price discovery mechanism for stock price levels. Indeed, due to the links between the two markets, the futures market has become the market of choice for many institutions. The availability of the futures market has spawned institutional trading strategies that have greatly increased the velocity and concentration of stock trading. These strategies have increased the risks incurred by stock specialists and have strained their ability to provide liquidity to the stock market.

The result of these trends has been to increase the probability of abrupt market price swings. Although the derivative index markets provide valuable hedging and market timing benefits to institutions, nevertheless I believe that we should explore means of damping the effect of institutional trading on the combined stock and futures markets.

Members of the corporate community should have an intense interest in our securities markets. No corporation wants to have the market value of its shares dramatically and suddenly

reduced for reasons that seem unrelated to underlying values. In my remarks thus far, I have identified the growth of portfolio and index trading by institutional investors as a dramatic and changing element of our securities markets. You rightfully should be asking what steps are or can be taken to reduce the impact of such trading.

First, it is important to acknowledge that market volatility is a phenomenon which is likely to remain. Institutional trading and related arbitrage activity will continue, and we must all recognize that daily movements in the Dow Jones Industrial Average of 50 to 100 points will not be unusual.

Second, the Commission, the stock exchanges, and the National Association of Securities Dealers are actively involved in efforts to improve automated order routing, execution, and reporting systems. Broker-dealers are improving their telephone communications and their back office systems. The exchanges are evaluating specialist performance and taking steps to increase required specialist capital.

Third, at the intermarket level, the Commission, the Commodity Futures Trading Commission, the Federal Reserve Board and the Treasury, through the President's Working Group on the financial markets, have cooperated to recommend changes in the clearing, settlement, and payment systems on both a near term and a long term basis. The group has also recommended

coordinated trading halts across all markets when the Dow Jones Industrial Average declines by 250 points and 400 points.

Fourth, the futures markets have examined their margin requirements, and have increased initial margins on index products from five percent to fifteen percent, in recognition of the fact that our markets have become more volatile. The futures markets also have imposed price limits and delayed opening procedures designed to deal with unusual market conditions, and the Chicago Mercantile Exchange is now reviewing the possibility that block trading procedures can be introduced in the derivative index area, again as a means of dealing with volatility.

Fifth, banks, clearing corporations and market participants are reviewing credit lines so that confusion regarding the availability of borrowing power can be reduced if another dramatic decline begins.

Sixth, several stock exchanges, including the New York Stock Exchange, are reviewing the possibility of creating a special market for trading portfolios or market baskets of securities. The creation of market basket trading has been supported by the Commission, and we are hopeful that the economics of the marketplace will cause the creation of these markets, which hopefully will provide greater liquidity and reduce the impact of institutional portfolio transactions on individual shares.

Finally, speaking personally, I have urged institutions to review their investment strategies and refrain from trying to out race the market. The Economist recently sounded this theme in a survey article on America's capital markets, 25/ as follows.

Certainly anyone who thought his money was safer for being invested in a pension fund, mutual fund, unit trust or insurance company had a rude shock last October. Most of these "safe havens" dropped by a similar percentage to the market or by more.

The problem is that money managers do not care. They are measured by comparative performance and not by absolute performance. The issue is whether a money manager outperforms more than 50% of his competitors in a three-month period, not how he has performed absolutely. The money manager is therefore happy if his fund loses only 20% of its value when most of the competition loses 30%. Equally he is unhappy if he makes 10% and his competitors make 20%. This is silly. What matters to the individual investor is absolute not comparative performance - and, most important, the preservation of capital.

25/ America's Capital Markets, The Economist, June 11, 1988, at 22.

I believe that institutional investors should also concentrate on long term values and abandon attempts to beat the market on a short term basis. That attitude would be good for the market and good for long term corporate growth.

Conclusion

The few areas I have been able to discuss today only begin to touch on the many issues of mutual concern to the Commission and to members of the corporate community. I appreciate the opportunity to discuss these issues and others with you. A continuing dialogue between the corporate community and Commission will assist us in reaching our joint goal -- an efficient and fair capital market.