

Council of Institutional Investors
First Annual Meeting
Atlanta, Georgia

Major Efforts and Issues at the SEC
John Shad

October 29, 1985

Ladies and Gentlemen:

I am delighted to be with you - and let me tell you why.

The Council of Institutional Investors may prove to be one of the most important developments in investor representation since the creation of the SEC - half a century ago. As fiduciaries of \$130 billion of securities, you are in a unique position to address major issues of concern to investors. The Council and the SEC have an identity of interests - fair and orderly markets.

Council Committee

I would like to cite a problem - and suggest a solution - for your consideration.

The problem is that when the SEC solicits comments on new concepts or proposed regulations, we receive extensive comments from the legal profession and representatives of the securities industry and corporate America, but seldom from investors - the principal constituency the Commission was created to serve.

The suggested solution is that the Council form a Committee:

- o to respond to SEC releases;
- o to communicate your views to the Commission and others;
- o and to meet once a year with the full Commission and senior staff in an open forum.

In order to implement this suggestion, the Committee will need the services of a competent individual, who is familiar with the securities laws and the needs and interests of the Council and the investing public. We want your substantive comments, and those of your money managers and securities analysts.

If you decide to pursue this suggestion, I would like to arrange the initial meeting of the Committee with the full Commission and senior staff before the end of the year.

Major Efforts and Issues

And now, after I have highlighted some of the major efforts and issues at the SEC, I would appreciate your comments and suggestions.

As you know, the SEC was created after the 1929 crash to help protect investors and maintain fair and orderly markets. America has today, by far the best securities markets the world has ever known - the broadest, the most active and efficient, and the fairest. The SEC's job is to help keep them that way.

Some of the Commission's programs have been opposed by various factions, but rarely by institutional and other investors or securities analysts, because the SEC has been increasing investor protections and reducing unnecessary paperwork and other expenses that are ultimately borne by investors - by over a billion dollars per annum.

Integration and Shelf Registrations

For example, the integration of corporations' registration and reporting requirements and the shelf registration rule, are saving corporations, for the benefit of their shareholders, over a billion dollars a year in paperwork, underwriting and interest costs - without compromising full disclosures to the investing public. Whether or not a publicly-owned company has filed a shelf registration statement, it must of course continue to make public disclosures of its subsequent interim and annual results and other material developments.

Institutional Book-Entry

Expansion of the institutional, electronic book-entry delivery system, in lieu of the physical delivery of securities by institutions, is saving over \$350 million per annum of expenses ultimately borne by investors.

Private Placements

Over \$45 billion per annum of securities are being offered to sophisticated institutional and accredited investors under new private placement and small business exemptions from SEC registration requirements at a savings of hundreds of millions of dollars per annum. The small business exemptions are in response to Congressional directives.

Clearinghouse Deposits and Net Capital

Updating the securities industry's clearinghouse deposit and net capital requirements has freed-up over a billion dollars of capital and helped investment bankers and brokers finance the record volume of trading and financings.

Prospectus Simplification

Simplification and improvement of prospectuses and proxy statements have reduced their cost and increased their utility to investors. More detailed information is publicly available in 10Ks, annual and other reports. While few individual investors carefully review prospectuses and proxies, most rely on investment advisory services, brokers and other professionals, who do carefully study and analyze such documents.

SEC/CFTC Accord

Resolution of the 7-year turf battle between the SEC and the Commodity Futures Trading Commission has permitted the authorization of trading in new options and futures, which enable institutional and other investors, banks and corporations, to hedge stock market, foreign currency and other risks, at a fraction of the costs of prior means of hedging or reducing such risks.

SEC/Swiss Accord

The SEC Accord with Switzerland has removed the haven of the Swiss secrecy laws from those who would trade on inside information prior to merger or takeover announcements. During this period of increasing internationalization of the securities markets, the Swiss Accord is an important precedent.

Insider Trading Sanctions Act

The SEC proposed the Insider Trading Sanctions Act which was passed last year. Most inside traders have only been compelled to disgorge their profits - which has not been much of a deterrent. Now they are subject to fines up to three times their profits, as well as criminal sanctions.

Intermarket Surveillance

At the Commission's initiative, intermarket stock and options surveillance systems and transaction audit trails, are facilitating the quick detection of market manipulators and inside traders - and also reducing transaction reconciliation costs, that are ultimately borne by investors.

SEC Budget

Since 1981, the SEC's budget has been increased by 33%, which is more than for most independent agencies. Many have been reduced. In any case, in each of the last three fiscal years, registration, transfer and other fees have exceeded the Commission's \$90 to \$106 million budget, which has only happened once before in the past 50 years. The three-year surplus totals over \$70 million - and the 1986 surplus is expected to exceed \$30 million. So, SEC fees are now making a net contribution to a reduction in the federal deficit. The Commission's budget and fees are set by Congress. The fees are remitted to the Treasury as they are received.

Automation and Paperwork Reduction

Since 1981, through automation, paperwork reduction and other staff improvements, each SEC division has achieved record results or the highest levels in years, with 2% to 5% less personnel.

Annual Volume Increases

Since 1981, the annual volume of:

- o enforcement actions has been increased by over 35%;
- o broker-dealer oversight examinations, by over 50%;
- o full disclosure filings reviewed, by over 60%;
- o and investment company and adviser inspections, by over 100%.

Also, tri-annual accounting firm peer reviews, under the SEC's oversight, have been increased by over 100%.

Enforcement Actions

During the last two fiscal years, the Commission has brought 568 enforcement actions of which 17% were financial reporting cases against corporations, executives and accountants. Many were products of the 1982 recession and the 1983 "hot new issue" market. It is during such periods that some companies and executives are tempted to "cook the books".

Insider trading cases have received wide publicity. The Commission has brought a record number of such cases in recent years, but they only amount to about 8% of the total - and this activity should be inhibited by the heavy sanctions of the new law.

A large number of enforcement actions are brought against broker-dealers and other regulated entities. The SEC, NASD and stock exchanges receive and follow-up on a large volume of complaints from investors. Most relate to delays or failures by brokers in delivering securities, funds, confirmations and prospectuses, transferring accounts, order executions, brokerage commissions, interest charges and the churning of accounts.

Private suits can be filed instantly. The SEC attempts to prove its allegations before it files enforcement actions.

Competitive Options Markets

Efforts to increase competition in the securities markets include three recent SEC decisions. First, to permit the stock exchanges and over-the-counter dealers to make competitive options markets. To date, five exchanges are trading options on 30 over-the-counter stocks. Under the SEC's oversight, the exchanges and the National Association of Securities Dealers are carefully surveilling these markets.

Side-By-Side Marketmaking

Second, the Commission has approved plans to test competitive side-by-side marketmaking in over-the-counter options and the underlying stocks, through a one-year pilot in the six most actively traded over-the-counter stocks. The pilot will begin in early 1986, subject to adequate surveillance systems.

Unlisted Trading Privileges

Third, last month the Commission approved the stock exchanges granting unlisted trading privileges in NASDAQ securities. Beginning in January, each stock exchange will be permitted to make competitive markets in up to 25 over-the-counter stocks.

Major Ongoing Efforts

Now I would like to mention three important ongoing efforts, concerning:

- o the internationalization of the securities markets;
- o the immobilization of securities certificates;
- o and the Commission's pilot electronic disclosure system;

And conclude with some brief comments on corporate takeovers.

Internationalization

For over two centuries, the United States has been a prime beneficiary of foreign investments.

Last year, \$18 billion of net direct foreign investment in the U.S. partly offset our \$101 billion current account trade deficit. During the first nine months of this year, U.S. corporations have raised a record \$24 billion in the Eurobond market. Foreign companies have only raised \$3 billion here.

The Commission has recently approved linkage of the Boston and Montreal stock exchanges and the American and Toronto stock exchanges. Other major exchanges are also discussing international linkages.

Approximately 10% of the transactions on the New York Stock Exchange are now originated abroad. Over 325 companies' shares are actively trading in more than one country - and it seems safe to predict that within five years, at least twice as many will be trading around the clock - and the world.

U.S. shareholders of foreign corporations are often at a disadvantage when such companies do rights or exchange offerings. For example, in the UK new equity offerings by listed companies have to be made through rights offerings to the existing shareholders. Since new issues are typically priced at discounts, the rights usually have significant value, but U.S. shareholders cannot receive the offering materials, unless they are filed with the SEC and comply with our requirements. This is also true of exchange offers. Thus, our regulations may preclude U.S. investors from benefits received by other investors in foreign securities.

With a view to addressing such problems, facilitating the international mobility of capital and the proper surveillance of these markets, the SEC recently issued two concept releases, which suggest approaches and solicit comments on ways to coordinate and improve international disclosure, distribution, surveillance and enforcement practices - particularly for multi-national securities offerings in the United States, the United Kingdom and Canada. In addition to our common language, these three countries' securities laws, disclosure requirements and accounting practices are more similar than those of other countries.

Immobilization of Securities Certificates

Another important initiative is to accelerate the immobilization and ultimate elimination of securities certificates through the use of central depositories and proven electronic book-entry systems.

This is another area in which the Council of Institutional Investors could be of help.

Over half of the securities listed on the New York Stock Exchange are immobilized in depositories, but the manual handling of the balance, as well as the mounting volume of municipal and agency bonds and new financial instruments, is costing investors hundreds of millions of dollars per annum. And even in the absence of such savings, the potential paperwork and other problems avoided more than justify simplifying the process.

Tons of certificates are engraved and delivered daily, often by armed guards, to investors throughout the world. They are physically counted and recounted, and held in vaults and safety deposit boxes. Millions of dollars of certificates are lost, stolen, mutilated and counterfeited annually. These expenses are ultimately borne by investors. Most can be eliminated.

At SEC forums, favorable reactions have been received from a broad cross section of investment, corporate and financial executives to the following voluntary evolutionary approach, which only involves new issues of debt securities. It does not involve stocks, and investors will not be required to turn-in any of their existing certificates.

Corporations, municipalities and other issuers should be encouraged to do their future public offerings of debt securities in the form of single "Global Certificates" - against which investors' interests are recorded by depositories on a book-entry basis.

Central depository book-entry facilities should be developed for mortgage-backed securities and the increasing array of new financial instruments.

And those remaining states that limit the use of central depositories by insurance companies 1/ or state and municipal pension funds 2/, and those that have not as yet adopted the 1977 Uniform Commercial Code amendments 3/ (which facilitate uncertificated securities interests) should be encouraged to update their statutes on a timely basis. Many of your funds are subject to such state statutes.

While outmoded state statutes do not prevent the use of global certificate book-entry systems, they do impose unnecessary costs and burdens on investors.

There are many favorable developments.

This summer, IBM Credit filed a shelf registration statement on a billion dollars of debt, all or a portion of which is expected to be sold in book-entry form. This is expected to be the first major public offering of corporate securities on a book-entry basis.

There have been several successful public offerings of book-entry money-market preferred and debt issues.

Twelve states and over 20 municipalities have done public offerings of over \$800 million of book-entry bond issues.

GNMA recently announced support for a depository to immobilize billions of dollars of pass-through mortgage certificates.

And the U.S. Treasury announced last February that next year, it will stop issuing note and bond certificates. All future Treasury securities will be issued on an electronic book-entry basis. Freddy Mac and Fannie Mae are also converting to the Treasury's book-entry system for their future offerings.

If the Council wishes to join with the Commission in the effort to accelerate the immobilization of securities certificates, I would like to arrange a meeting next month of your representatives with the senior members of the SEC staff, who are heading-up this effort.

1/ Ark., Calif., La., N.M., S.D., Ut., W.Va. and Wy.

2/ N.J., Ohio, Ok., Tex. and Wy.

3/ The states that have adopted the 1977 UCC amendments are: Calif., Col., Conn., Del., Mass., Minn., Mont., N.Y., Ohio, Ok., Tex., Va., W.Va. and Wy.

EDGAR

Another major project is the SEC's pilot electronic disclosure system - known as Edgar, which stands for Electronic Data Gathering Analysis and Retrieval. Edgar is intended to increase the efficiency and fairness of the securities markets by accelerating dramatically the filing, processing, dissemination and analysis of corporate information. As such information is filed electronically with the Commission, it will be instantly accessible to investors, securities analysts and others on personal computer screens throughout the country. Some industry observers have indicated that Edgar has the potential to revolutionize the manner in which investment decisions are made and executed. 4/ Through Edgar, detailed corporate information will be publicly available in a matter of minutes and hours - instead of days and weeks.

In the 13 months of the Edgar pilot, over 170 issuers have filed electronically or on diskettes over 1,600 documents. Participants in the pilot range from AT&T, Exxon, General Motors, IBM and other major corporations, to small companies and limited partnerships.

GMAC, one of the most frequent Edgar filers, has indicated that the system has enabled them to react quicker to changing market conditions and get to the market faster.

Next month, the Edgar pilot will be expanded to include 180 mutual funds and unit investment trusts. 5/

In mid-1986, subject to Congressional approvals, the Commission plans to select a contractor for the operational Edgar system, with a view to phasing-in the 11,000 publicly-owned companies over the next three years.

The fully operational system will accelerate the screening and processing of filings and facilitate enforcement reviews and investigations. It will also virtually eliminate the six million pages of paper that are filed with the SEC annually, and growing at the rate of a million pages a year.

Since software services will receive corporate filings faster, their data will be more up-to-date than at present. In a matter of minutes, through Edgar and auxiliary software services, investors, securities analysts, money managers and others will be able to display on personal computers, for example:

- o All of the listed stocks that closed yesterday at less than seven times earnings, and 75% of their book values, that yield over 6%;

4/ N.Y. Times, Sept. 25, 1984, at D-1; Time, Oct. 8, 1984, at 60. See also, Ipsen, "The Edgar Revolution," Institutional Investor, at 98, 100 (Sept. 1984).

5/ 107 mutual fund and 73 unit investment trust complexes with over 2,000 separate series of funds.

- o Screen the list by additional criteria, such as debt-equity ratios, return on equity and compound annual growth rates;
- o Sort the list by the size and nature of the businesses;
- o Review the latest financial and other reports filed with the SEC by those companies that are of interest;
- o Enter buy or sell orders with brokers;
- o Receive transaction confirmations;
- o Enter them in their memory banks;
- o Price their securities to market at any time;
- o Display their realized and unrealized gains and losses;
- o And decide whether to take profits or losses for tax or other purposes.

From the point of view of corporations, in addition to accelerating the dissemination of their filings and their access to the market, a single SEC filing will serve all 50 state securities commissions (three of which are participating in the pilot), other federal agencies, the securities exchanges, the National Association of Securities Dealers, and virtually all others to whom they routinely distribute their 10Ks and other reports.

Takeovers

I would like to conclude with some brief comments on corporate takeovers.

Some contend that rising institutional ownership and the threat of takeovers are forcing corporate managements to forego long-term growth programs, for short-term earnings results. Others contend that takeovers bring the disciplines of the marketplace to bear on corporate managements and accelerate the reallocation of assets, in response to changing economic conditions.

There is limited empirical support of these contentions, but there is evidence of the benefits to the shareholders of target and bidder corporations. A recent study by the SEC Office of the Chief Economist of tender offers from 1981 through June 1985, discloses that target companies' shareholders have received an average premium of 47% and that the bidders' shares have risen an average of 4% net-of-the-market. ^{6/} The 47% average premium paid to targets' shareholders amounts to about \$39 billion.

^{6/} SEC Office of the Chief Economist, "Any-or-all, Partial and Two-tier Tender Offers", 1985.

Corporate responses to the threat of takeovers include recapitalizations, antitakeover charter and by-law amendments, supermajority vote requirements, fair price amendments and "poison pills". Within the past two years, over 500 publicly-owned companies have proposed such measures. A survey by the Investor Responsibility Research Center indicates that 150 of the Fortune 500 have adopted such proposals.

Recapitalizations include the creation of two classes of common stock - one with greater voting rights than the other. Studies indicate that, all other things being equal, non-voting common stocks sell at about a 5% discount from voting common stocks. 7/

Supermajority proposals typically require that a takeover be approved by the holders of 80% of a target company's shares - which permits 21% to veto the desires of the other shareholders. Studies by the SEC Office of the Chief Economist of supermajority proposals from 1981 through June 1985, indicate that announcements of such proposals initially depressed the market prices of the companies' shares by an average of 3% net-of-the-market. This amounts to over \$300 million. 8/

There are signs that shareholders, particularly institutions, are reacting against such proposals. Since 1981, there has been a movement away from supermajority and classified board amendments toward fair price proposals - which require that the highest price paid for any of the shares, be paid for all of the shares. 9/ Unlike supermajority provisions, fair price amendments have had negligible effects on stock prices. 10/ Fair price amendments have increased from 23% in 1981 to 64% in 1985 of all antitakeover proposals. 11/

An Investor Responsibility Research Center study of the 1985 proxy season indicates increasing shareholder opposition to antitakeover proposals. 12/ A comparison of negative votes of surveyed proposals in the 1984 and 1985 proxy seasons discloses:

- o an increase from 16% to 20% against fair price proposals;

7/ Lease, McConnell, Mikkelson, "The Market Value of Control in Publicly Traded Corporations", Journal of Financial Economics, April 1983.

8/ SEC OCE, "Shark Repellents and Stock Prices", 1985.

9/ Kidder Peabody and Drexel Burnham studies: In 1979-82 Supermajorities outnumbered fair prices 54 to 38. SEC OCE: In 1985 fair prices outnumber supermajorities 95 to 24.

10/ SEC OCE: Based on 544 1979-85 antitakeover amendments, the net-of-the market reaction to supermajority, classified boards and "blank check" preferreds proposals were a 3% decline; the reaction to fair price proposals was an 0.73% decline.

11/ SEC OCE: "Shark Repellants and Stock Prices", 1985.

12/ IRRRC: "Voting of Institutional Investors on Corporate Governance Questions", Nov. 1985.

- o from 16% to 24% against classified boards;
- o and from 16% to 19% against so-called "blank check" preferreds, which can be used for "poison pills".

"Poison pills" may consist of preferred shares, warrants or rights, distributed as dividends to shareholders. They permit the holders to acquire certain of the company's assets, or the shares of an unwelcomed bidder, at very low prices, or they are exchangeable for debt securities. The purpose is to make target companies prohibitively expensive to acquire.

Institutional shareholders have gone beyond merely voting against antitakeover proposals. 82% of the Rorer Group's outstanding shares were represented at a shareholder meeting. As a result of large institutional participation and other blocks, 54% of the shares represented voted to rescind the company's poison pill. However, management did not abide by the vote, contending that it was not representative of the long term shareholders, and that it consisted of less than a majority of the outstanding shares.

Shareholder opposition to antitakeover proposals may be the reason more boards have unilaterally adopted poison pills, which circumvent shareholder participation in such decision. Only four companies adopted poison pills in 1983. Since then, 23 companies have adopted them, including Colgate Palmolive, Crown Zellerbach, Dart & Kraft, General Host, McDonald's, Owens-Illinois, RCA and Revlon.

The propriety of poison pills is a matter of state corporate law. The issue is pending before the Delaware Supreme Court in the Household International case. The Commission has submitted an amicus curiae brief, in opposition to Household's poison pill.

To date, reliance on shareholders to protect their own interests through their voting rights, has worked well. However, the absence of an effective judicial or market response to poison pills, may invite federal intervention. Crown Zellerbach's poison pill did not prevent Sir James Goldsmith's acquisition of control of CZ. Revlon's refined version of the pill is presently under attack by Pantry Pride.

In response to discriminatory tender offers, the SEC has released for comment an "all holders, fair price" proposal. The responses are presently being analyzed.

Shareholder disenfranchisement through charter and by-law amendments, recapitalizations and state statutes ^{13/} raises very serious questions. If shareholders' "bargaining positions" are diminished, will corporate managements become less responsive to their needs and interests? Will shareholders begin to shift out of corporate equities into investments which afford capital a stronger bargaining position - such as debt securities, real estate, limited partnerships and tangible assets?

Thank you for the opportunity to highlight some of the major efforts and issues at the SEC. I will be pleased to amplify any of the topics mentioned and I would appreciate your comments and suggestions.

^{13/} So-called "antitakeover statutes" have been enacted in Ohio, Pa., Md., Wis. and Minn.