Response to Questions from Senate Banking Committee

in Connection with

Confirmation Proceedings

for

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as a Commissioner of the

Securities and Exchange Commission

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I. Questions from Senator Donald W. Riegle, Jr.

1. Philosophy

> You have witnessed first-hand the consequences of lax regulation of the thrift industry and the results of excessive risk-taking to the public and the taxpayer. What lessons have you learned from this experience and how, if at all, has the thrift debacle (together with the October 1987 crash break and all the indictments that have been handed down recently in both the securities and commodities markets) affected your views on securities regulation and your overall regulatory philosophy?

Among the lessons that I have learned as a consequence of the disaster in the thrift industry are the following:

- Accounting principles play a vital role in providing information necessary for regulators, policymakers and others to judge the condition of a financial institution. Distorted accounting principles adopted for "regulatory" purposes other than full disclosure can cause deteriorating trends to remain unnoticed.

- Capital plays an essential role in providing discipline for financial institutions and serves to deter against unwarranted risk-taking, especially by institutions with federal deposit insurance. Capital standards set by supervisors are essential to establish a minimum benchmark for prudent operations.

- Disclosure policies for insured institutions and their securities should be established by an agency other than the primary bank or thrift supervisory agency to insure that risks tolerated by supervisory authorities are publicly disclosed.

- Supervisory authorities must be allowed to take appropriate enforcement action free of political pressures -- from Congress or an Administration. Institutions engaged in serious fraud or other wrongdoing must not think that they can obtain political relief from enforcement action.

- Delay in addressing cases of deteriorating financial condition and violation of regulatory standards often results in much larger ultimate losses than would result from swift enforcement action.

The thrift experience has largely confirmed my prior views rather than changing them. I have always believed in strict enforcement of safety and soundness standards. Government regulation of financial institutions should seek to establish and to enforce minimum standards and rules of conduct, including capital, accounting, disclosure and other regulations necessary to prevent fraud, manipulation or similar abusive practices. At the same time, market entry and exit, product offerings, pricing, locations for doing business, affiliations and other aspects of economic competition should be left to market forces as much as possible.

If anything, the thrift crisis has demonstrated the need for elimination of the "regulatory" exceptions to the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"), including the bank and thrift exemptions in Sections 3(a)(2) and 3(a)(5) of the Securities Act and the bank and thrift reporting provisions of Section 12(i) of the Exchange Act.

2. <u>Special Study</u>

> As the markets have become increasingly automated, institutionalized and complex, more and more securities experts are recognizing the need for, and are suggesting, the creation of another independent Special Study along the lines of that conducted by the Commission and Milton Cohen in the early 1960s.
>
> Are you familiar with that Special Study and what is your reaction to taking a fresh look at a number of the new trends that have taken place since then?

In 1961, Congress directed the Commission to study the adequacy of the system of self-regulation in the securities industry and to recommend any necessary legislation. The result was the Special Study of the Securities Markets, prepared at the direction of Milton Cohen and submitted to Congress in 1963. The Special Study's recommendations formed the basis for the Securities Act Amendments of 1964.

In 1988, as part of the Insider Trading and Securities Fraud Enforcement Act of 1988, Congress directed the Commission to conduct a comprehensive study of the securities laws, but made the Commission's obligation contingent upon receiving a $5 million appropriation. Such an appropriation was not included in the Commission's FY 1989 budget, and the Commission did not request this money in its appropriations request for FY 1990.

The Commission has not taken any position on the need for a new Special Study.

If confirmed, I intend to lead the Commission in considering the implications of many of the trends that have affected our capital markets in recent years. Numerous studies and other relevant information already exist in the literature regarding financial services that can form the basis for sound policymaking. Another study might delay the process of modernizing our statutory programs without developing significant new information or perspectives. I believe the Commission should, on an ongoing basis, provide Congress with analysis of market trends and reevaluation of existing statutes and regulatory programs. Toward that end it would be more desirable to increase permanently the Commission's analytic capabilities rather than to perform a single study on a temporary basis.

3. Insider Trading

> Support for clarifying the laws on insider trading ranges from industry groups such as the Securities Industry Association to former prosecutors and government officials such as Judge Stanley Sporkin, the former head of the SEC Division of Enforcement, former Treasury Secretary Don Regan, and former U.S. Attorney Rudolph Giuliani. Last Congress Senator D'Amato and I introduced legislation, S. 1380, which in plain English clarifies the law in this area. This bill was drafted with the assistance of an Ad Hoc Committee consisting of some of the top securities lawyers in the country who represented a cross-section of interests.
>
> What is your position on whether the law on insider trading should be clarified by statute?
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> If confirmed would you support S. 1380, the insider trading bill I introduced together with Senator D'Amato last year? If not, why not? What changes, if any, would you make to it?

S. 1380 was the product of months of intensive effort by the Ad Hoc Committee, the Commission and its staff. Issues that arose in drafting the bill were complex and controversial, as reflected by the fact that the Commission's support for legislation was neither unanimous nor unqualified.

Since introduction of S. 1380, several important developments have occurred. First, the courts have had further opportunity to address insider trading issues and to provide further clarity to the law. Most notable in this regard was the Supreme Court's decision in United States v. Carpenter, which did not disavow the use of the misappropriation theory of insider trading liability by the Second Circuit. Second, like the courts, the Commission has added to the body of insider trading law through its enforcement actions. Finally, Congress has further addressed insider trading through enactment of the Insider Trading and Securities Fraud Enforcement Act of 1988. As a result of these and other factors, it is my current understanding that the lack of a codified definition has not impaired the Commission's enforcement actions to date.

Given the further development of the law of insider trading by the courts, Congress and the Commission since S. 1380's introduction, the circumstances that originally appeared to call for a definition of insider trading may have changed. Indeed, there may be advantages in the enforcement area to be gained from further administrative and judicial development of the concept. If confirmed, I will work carefully with the staff of the Enforcement Division and other Commission staff, as well as the other Commissioners, in reviewing the need for a legislative definition.

In reviewing this issue I would seek an appropriate balance of two somewhat inconsistent objectives. First, clarifying the scope of wrongful behavior -- especially in the criminal area -- would be desirable so that market participants can effectuate transactions expeditiously and with certainty as to their legality. On the other hand, too much rigidity in the elaboration of prohibited conduct could hamper the legitimate exercise of enforcement discretion in responding to new types of fraudulent conduct.

4. Insider Trading

> To what extent do you believe that front-running and trading on advance information between the securities and commodities markets has been a problem?
>
> How about securities firms buying and selling for their own accounts ahead of their individual customers?

In its broadest terms, "front-running" generally is defined as trading on the basis of nonpublic market information regarding impending market transactions. Prior to the advent of derivative securities markets (i.e., stock options), such practices generally were limited to brokers trading in the same security prior to the execution of a customer order. These practices, known as "trading ahead" or "scalping," always have been viewed by the Commission as serious violations of a broker's fiduciary duty to the customer. They also have been prohibited by federal securities law and exchange rules.

In the securities markets, the term "front-running" has been defined as the specific practice of trading in the derivative securities market and the underlying market for the security to take advantage of material, nonpublic market information regarding an impending transaction.[1] It has become evident over the last few years that opportunities now exist for similar trading practices involving trades with stock index futures contracts and the securities markets (a practice described as "index front-running").

As with other types of front-running, many if not all of the securities regulatory organizations ("SROs") have prohibited their members from engaging in intermarket index futures front-running. Several of the SROs have tried to adopt common definitions of violations. For example, the New York Stock Exchange ("NYSE"), Chicago Mercantile Exchange ("CME") and the New York Futures Exchange ("NYFE") have agreed on common definitions of intermarket index futures front-running violations, as well as formal procedures for sharing surveillance and investigative information to curb commonly defined abuses.

Because of the regulatory division between stock index futures -- regulated by the Commodities Futures Trading Commission ("CFTC") -- and securities, the detection and prosecution of intermarket index futures front-running requires effective sharing of data and information and the coordination of investigative and prosecutorial functions. If confirmed, I will evaluate the adequacy of current cooperative efforts, as well as the prevalence of abuse detected by current surveillance.

5. <u>Leveraged Buyouts</u>

> How do you respond to criticism that management has an inherent conflict of interest in a number of leveraged buyout deals because they have inside information

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[1]The term "customer front-running" is used to describe a practice where a securities broker trades a derivative security for its own account to take advantage of nonpublic information concerning the execution of a customer's order for the underlying security. In contrast, "self front-running" describes a practice involving trades in a derivative security to take advantage of nonpublic information concerning the execution of an order for the firm's own account rather than for a customer account.

> that is not readily available to all shareholders and, in taking a company private, they act upon it?
>
> Do you think long-term bondholders are treated fairly in these deals where often they see the value of their bonds drop dramatically overnight?

Under state law, corporate directors owe duties of care and loyalty to the company and its equity shareholders. Where a transaction involves the potential for self-dealing, courts have required directors to demonstrate good faith and the inherent fairness of the bargain, including, under recent case law, demonstrating that the transaction offers the highest price currently obtainable.

As a practical matter, it is difficult to eliminate entirely management's inherent informational advantage. However, procedures can be designed to isolate interested directors from consideration of a transaction. Disclosure of management's interest in the transaction and a description of the procedures and analyses followed to evaluate a transaction, as specifically required under Commission Rule 13e-3, permits shareholders to evaluate the impact of the conflict on the transaction and to pursue remedies in the state courts. For example, the Commission already requires disclosure regarding many of the following items, and may consider proposing further disclosure concerning:

- potential conflicts of interest when management is involved in a transaction;

- disclosures to shareholders about the intrinsic value of their corporation;

- management efforts to obtain the highest price for shareholders;

- providing shareholders with the same information considered by the board of directors in evaluating a management buyout proposal;

- recapitalizations that affect control of a corporation in favor of management and other insiders; and

- providing shareholders of a target company with non-public information and reports provided by the target to potential acquirors.

To date, it has been fairly clear under the law of most states that a fiduciary relationship does <u>not</u> exist between a bondholder and the company and its directors. Rather, a bondholder's rights are purely a matter of contract. The contract or indenture underlying the bond establishes the rights and responsibilities of the two contracting parties. Thus, a bondholder is treated "fairly" if he or she receives what was bargained for, including all the protective covenants contained in the bond indenture.

Accordingly, the best method to protect bondholders lies in the rules assuring adequate disclosure. The staff of the Division of Corporation Finance is reviewing and evaluating the status of the current disclosure in the offering materials distributed to prospective bondholders. The staff should consider whether to propose changes in the appropriate rules and schedules to ensure that the risks of going-private or other leveraged transactions are fully disclosed.

In addition, the market may respond to the risk of a significant change in the capital structure of an issuer by requiring more protective covenants for bondholders. Such provisions (usually negotiated by the underwriter) generally allow the bondholder to exercise an option to sell the debt instrument back to the issuer upon the occurrence of a certain specified event, such as a change of control resulting in a downgrading of the issuer's bond rating.

6. <u>International Issues</u>

> There is increasing concern with the internationalization of the capital markets. Do you believe the SEC should be doing more in response to this phenomenon? If so, what specific measures should the Commission initiate or support to facilitate international trading and appropriate regulation of such trading?

Yes. While the Commission has made important progress in a number of areas, I believe it should respond even more actively to the internationalization of our capital markets. Among the most important objectives should be improved clearance and settlement systems, common capital adequacy requirements, harmonization of accounting standards and conscious efforts to avoid any unnecessary impediment to the international competitiveness of U.S. markets or U.S. financial services firms.

Improved systems to disseminate market information, continuing improvements in mutual enforcement assistance and enhanced cooperation in defining and preventing abusive and fraudulent practices are also important. Finally, the Commission's efforts to achieve greater mutual recognition of securities offerings and other disclosure materials, as well as to simplify procedures for mutual recognition of oversight of market participants such as broker-dealers, should be continued and enhanced.

7. International Issues

> As financial markets become even more global, how can we, as a practical matter, avoid the tendency for all common nations to compete for expanding influence by offering the least regulation regardless of merit?

The Commission has worked to develop common understandings among countries regarding minimum standards for the emerging global securities markets. These efforts have resulted in significant steps toward harmonized standards for investor protection (e.g., the emerging consensus that insider trading is an unacceptable practice in modern securities markets, the development of minimum capital adequacy standards, and work on multi-jurisdictional disclosure documents). Especially with committed American leadership, cooperation among the world's securities regulators can help avoid a "race to the bottom" in regulatory standards. Moreover, the reality, as well as the perception, of fair and orderly markets can contribute to the competitiveness of U.S. markets, so long as regulation does not become excessive or stifle innovation.

8. International Issues

> Should there be uniform international standards for registering and selling securities?

It is highly unlikely that uniform global standards will be developed in the near future due to the traditional differences in national practices. Indeed, a "uniform" rule could be highly adverse if it did not meet the needs of U.S. markets. In some specific areas, it may be possible to develop uniform or closely similar standards. It is more likely, however, that increased regulatory coordination and mutual recognition of home country requirements provide the best opportunities for increasing the efficiency of the global capital markets while assuring investor protection.

This approach was followed by the Commission in its recent decision to propose that specified types of Canadian issuers could use Canadian disclosure documents to satisfy registration and reporting requirements for offerings in the U.S. This system could be utilized as a prototype for additional jurisdictions that have disclosure systems designed to assure that investors are given information adequate to permit them to make an informed investment decision. By permitting use of Canadian offering materials, U.S. investors may have greater investment opportunities due to the reduced time and cost for a Canadian issuer to extend its offer to the U.S.

Coordination and accommodation of legitimate, ordinary course foreign market practices may also be a more practical and timely means of addressing differences in stabilization and other distribution regulations among jurisdictions than seeking uniform rules.

9. <u>International Issues</u>

> Should the Securities and Exchange Commission accept, for sale in the United States, foreign registered securities that meet the standards for countries with a developed, sophisticated system for registering and selling securities and reporting financial results?

A primary challenge facing the Commission is removing unnecessary impediments to transnational capital formation. Therefore, in appropriate circumstances the U.S. should be prepared to allow the sale of foreign-registered securities, using foreign disclosure documents, where this action would be consistent with maintaining minimum U.S. standards. However, this objective must be accomplished in a manner that does not unduly disadvantage U.S. issuers in the U.S. markets, and that provides investors with the essential protections mandated by the federal securities laws.

10. <u>International Issues</u>

> Should the Securities and Exchange Commission be prepared to accept financial statements prepared on the basis of accounting principles other than generally accepted accounting principles as promulgated by the Financial Accounting Standards Board ("FASB")?

In some circumstances, the Commission currently accepts financial statements of foreign issuers prepared in accordance with home country accounting standards. This practice is an appropriate recognition of the fact that the entire world is not prepared to follow the pronouncements of the FASB. The Commission does require, however, reconciliation of income and equity to U.S. accounting standards. The Commission should be prepared to expand this practice as a means of reducing the cost of capital, while maintaining adequate disclosure standards.

11. International Issues

> At the present time efforts are being made to develop a body of international accounting standards, some of which may not be as stringent as those prevailing in the United States. Would you, in the interests of facilitating international trading of securities, favor adopting the proposed international standards in preference to those prevailing in this country?

Whether I would favor the use of international accounting standards in preference to comparable U.S. standards would depend on the specific standard, and the tradeoffs that would be involved compared with use of the American standard. Accounting standards that are not "as stringent" as those used at any given time in the U.S. may still provide a relevant and reliable presentation of financial condition. Conceivably, in some areas accounting standards developed outside the U.S. may be superior to U.S. standards. Certainly the development of mutually agreeable international accounting principles and auditing guidelines would reduce unnecessary costs resulting from disparities among the various national standards. However, I do not believe that convenience or uniformity are sufficient reasons for the U.S. to accept accounting principles that are inadequate in their presentation of relevant and reliable information.

12. Financial Instability

> The threat of systemic financial instability in the United States, and in the world, appears to have grown considerably in the last decade due to the growing integration of financial markets, faster execution of transactions, decreased transaction costs, and the telecommunications revolution which makes information available instantly throughout the world.
>
> What specific steps do you believe should be taken now to reduce the threat of such systemic instability? How likely do you think it is that such instability -- or another market crash along the lines of the one we experienced in 1987 -- will occur any time in the next 4 years?

The factors suggested, such as improved communications and faster execution of transactions, may also reduce risks, and they do not necessarily harm systemic stability. Excessive levels of risk or speculation, backed by insufficient capital, would be more likely to lead to problems if such conditions were widespread, or occurred in major firms. Certain risks, such as liquidity risks, may be greater today than was true in previous times, at least for certain firms.

In the past decade, the unprecedented growth and change in financial markets (including, among other things, the increased internationalization of securities markets and the growing tendency of firms to take proprietary risk positions in dealing with their customers) have resulted in the need for broker-dealers to accumulate large capital bases. To obtain the levels of capital necessary to compete on a global basis, some large firms have become public companies through equity offerings, some have increased their leverage, and others have affiliated themselves with other entities. Many firms have created holding company structures to facilitate their world-wide growth.

As the structure of large securities firms has grown more complex, and their scope of operations has widened, registered firms may have moved many potentially risky activities, such as interest rate swaps, bridge loans and foreign currency transactions, out of broker-dealers and into affiliates or holding companies that are not under direct regulatory oversight. In some cases, this results in the avoidance of significant capital requirements that would be applicable if such activities were conducted in the broker-dealer.

One important method of reducing systemic risk would be to give the Commission explicit authority to monitor and to evaluate risk-taking in affiliates of broker-dealers that could adversely affect the liquidity of any such firm. Analyzing and monitoring the risk to large broker-dealers based on a review of consolidated activities would help the Commission predict and control excessive risks to the stability of the overall system. However, since the integrated securities firms now conduct a major part of their business in holding company affiliates outside the registered broker-dealer, any such proposal for consolidated risk analysis would have to be carefully reviewed, and the specific comments of the industry taken into careful consideration to avoid unnecessary costs or unnecessarily expanded regulation.

Another specific step that could materially reduce instability would be to improve the speed of global clearance and settlement procedures. The 1989 Group of Thirty Report on Clearance and Settlement in the World's Securities Markets made useful suggestions on improving international clearance and settlement.

If confirmed, I will pursue an active program to address systemic risk on a domestic and international level. While I do not have any basis for predicting the likelihood of specific market events, the steps I have suggested would put the Commission in a better position to evaluate the risks and to reduce the likelihood of instability in the world's financial markets.

13. Glass-Steagall

> What is your position on repeal of the Glass-Steagall Act? If the Act is repealed who should regulate the activities of both banks and broker-dealers?

The Commission has supported repeal of the Glass-Steagall Act, so long as repeal is accompanied by the requirement that banks conduct most of their new and existing securities activities in separate securities affiliates or subsidiaries subject to Commission regulation. I support the Commission's general position, but only if the entire regulatory structure that would replace current law was adequate to protect the integrity of securities markets and to provide competitive opportunities that would be both theoretically and practically equal for different types of financial firms. To this end, I believe that the Bank Holding Company Act of 1956 would have to be amended significantly simultaneous with any repeal of Glass-Steagall in order to achieve competitive equity and stability.

In general, I do not favor arbitrary or artificial restrictions on competition *per se*. I do believe that it is perfectly appropriate to limit the manner of competition in order to achieve legitimate supervisory objectives such as maintaining safe operating conditions or preventing undue conflicts of interest.

14. Capital Adequacy of Investment Banks

> As investment banking firms become more actively engaged in providing high risk capital such as huge bridge loans for takeovers and LBOs, how should the system for evaluating their own capital adequacy change? Is our current surveillance in this regard adequate?

Ideally, capital adequacy should be measured both at the broker-dealer level and on a consolidated holding company basis. To help prevent market instability, the Commission needs to understand the current financial condition of major firms, including their overall capital and liquidity position. This parallels the ability of banking regulators to review the overall condition of a bank holding company, rather than limiting examination solely to actual banking subsidiaries.

Traditional capital rules may not be sufficient to assess liquidity risks, which could be the most damaging to systemic stability. However, specific changes in current practices must be carefully weighed to determine that significant supervisory improvements will justify increased compliance costs.

15. <u>Enforcement</u>

> What additional steps should the SEC take to prevent what appears to be rather widespread fraudulent and manipulative activity?

I do not personally know how "widespread" fraudulent and manipulative activity is in the marketplace as a whole. The Commission should continue vigorous efforts to combat insider trading, and it should monitor SRO enforcement of rules against front-running practices as described in response to an earlier question. International enforcement cooperation should be strengthened, and the Commission should continue vigorous efforts to combat penny stock fraud through rulemaking, information sharing, criminal referrals and other techniques.

One example of the Commission's resolve to take necessary actions to enhance enforcement is the penny stock fraud area. As of August 1, 1989, the Commission had brought 46 enforcement actions in this area compared to 25 actions in all of FY 1988. The Commission also is making more criminal referrals to U.S. Attorney's offices and assisting the FBI and various U.S. Attorney's offices in their criminal investigations of penny stock fraud.

16. <u>Enforcement</u>

> Do you believe that the securities laws currently provide adequate penalties for securities law violations?

No. Under current law, the Commission has the authority to seek civil money penalties only in three limited circumstances. First, civil penalties may be obtained from persons who engaged in insider trading or who controlled a person who engaged in insider trading under the Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988. Second, under recent amendments to the Foreign Corrupt Practices Act, the Commission may seek civil penalties against an issuer and/or certain persons acting on behalf of an issuer who violate Section 30(a) of the Exchange Act. Third, under Section 32(b) of the Exchange Act, issuers may be assessed a civil penalty for failure to file certain required information.

The authority to impose substantial civil money penalties for other types of securities laws violations would be beneficial to the Commission. While injunctive relief remains a powerful tool, the potential of serious fines could serve as a powerful deterrent to unlawful activity, especially in certain types of cases. Indeed, at present the Commission does not have as much flexibility in imposing civil money penalties as several of the self-regulatory organizations that it oversees. In addition to expanded civil money penalty authority, I believe that giving the Commission cease and desist authority comparable to that of the bank regulatory agencies should be carefully explored.

17. Enforcement

> What are your views on self-regulation and the ability of the securities industry to police itself? How might the self-regulatory apparatus be improved?

In considering a self-regulatory system when promulgating the Exchange Act, Congress attempted to balance the possible dangers of total industry self-regulation (i.e., lax enforcement and conflict of interest concerns) against the perceived ineffectiveness of wide-scale government regulation. Under the Exchange Act, the SROs exercise authority subject to Commission oversight. This is designed to ensure that the SROs meet their obligations regarding investor protection and the public interest.

The degree of supervision exercised by the SROs in the securities markets is largely unique in financial regulation generally. With an ability to pay more competitive salaries than government, the SROs have a better ability to maintain a sufficiently large and experienced staff than the Commission. In addition, the working relationship between the Commission and the various SROs seems to be generally very good, with the result that surveillance and investigatory programs of the SROs have improved as a result of Commission suggestions as well as other input.

Although the tradition and record of the self-regulatory approach has been good, improvements can always be made. It is important for the Commission and the SROs to maintain a high degree of consultation and cooperation in determining the best possible means of achieving supervisory goals.

18. Enforcement

> The press has widely reported the fact that Federal prosecutors are investigating possible theft, money laundering and kickbacks in the stock-loan departments of a number of major brokerage firms and that one of the largest is expected to plead guilty

> and cooperate with the Government shortly. What can you tell us about your understanding of how these schemes work? How serious are they? What steps do you plan to take to curtail future abuses?

Stock loan abuses take two distinct forms. The first is embezzlement by employees of a broker-dealer of stock loan fees a firm receives in the form of rebates. This illegal activity often occurs in conjunction with stock loan finders -- persons who locate securities for a fee at the request of a borrowing broker-dealer. The second is the illegal lending by broker-dealers of customer fully-paid securities and/or excess margin securities in violation of Rule 15c3-3 (the customer protection rule). The end result of this violative activity is that customer securities that should be in segregation have been lent, without the customer's knowledge or approval, to another broker-dealer for the securities' cash market value. In some cases this occurs without adequate credit behind such loan.

The funds obtained by converting customer securities into cash could easily be placed at risk by the broker-dealer. Expending this cash on proprietary trading with the accompanying market risks or on payment of salaries are two examples of that risk. If at a later time the broker-dealer is unable to make its customers whole, the liquidation of the firm may be necessary, along with the concurrent harm and financial loss to S.I.P.C., to the investing public and to confidence in the overall market.

Illegal stock loan activity is a serious abuse. Employees who steal money from broker-dealers have no place in an industry that acts as a custodian for customer funds and securities. These employees also present a threat to the financial well-being of the embezzled broker-dealer. The integrity of the marketplace and the protection afforded the investing public are jeopardized by the illegal practice of a broker-dealer who uses customer fully paid and/or excess margin securities for stock loan purposes.

To combat this problem, the Commission (along with the SROs) should maintain a highly trained and experienced broker-dealer examination staff. Examiners should regularly audit for stock loan abuses, and the Commission should actively take enforcement measures in this area, including making criminal referrals wherever appropriate.

19. <u>Failure to Supervise</u>

> Over the past few years there have been significant violations of law involving hundreds of millions of dollars. What is your understanding of the failure to

supervise laws and under what circumstances do you believe such a case should be brought by the Commission?

The system of self-regulation for the securities industry established by the Exchange Act places heavy reliance on effective supervision by the firms and their supervisory personnel over branch office operations and personnel. Section 15(b) of the Exchange Act, at paragraphs 4(E), for broker-dealers, and (6), for associated persons, provides the Commission with the authority to bar, suspend, censure or otherwise limit the activities of firms or employees for such failure to supervise others who violate the law. Firms and their supervisory personnel may defend against charges of failing to supervise persons subject to their supervision by proving that reasonable supervision had in fact been exercised, notwithstanding an employee's violation of the Act.

Last year Congress also concluded that more specific supervisory prescriptions that would complement Section 15(b)(4)(E) were necessary to prevent the misuse of material, nonpublic information. The Insider Trading and Securities Fraud Enforcement Act of 1988 creates as new Section 15(f) of the Exchange Act a "new affirmative statutory requirement for broker-dealers and investment advisers to establish, maintain and enforce written supervisory procedures to prevent the misuse of material, non-public information." The legislation also provides in new Section 21A for substantial civil money penalties for control persons based on violations of insider trading prohibitions by persons subject to their control (e.g., employees).

The Commission should be prepared to bring cases where it appears that persons in authority in firms have not exercised vigilance when irregularities come to their attention. This may include cases involving patterns of (i) failure to identify or follow indications of wrongdoing, (ii) failure to ensure compliance with remedial instructions; or (iii) inappropriate reliance on branch office personnel to carry out supervisory functions. In general, it is important for the Commission to review the adequacy of internal procedures and systems for supervision.

20. Failure to Supervise

What is the responsibility of the self-regulatory organizations to bring failure to supervise cases.

Under the Exchange Act, the SROs are required to enforce their own rules, as well as the securities laws in general.

Thus, all SROs have a responsibility to enforce their rules regarding supervision.

To the extent that a member firm fails to supervise reasonably the activities of its employees, the firm is violating a rule of the exchange or association, and disciplinary action may be warranted. The various SROs are expected to review supervision in any significant matter involving violations of its rules or of the securities laws.

21. Failure to Supervise

> If a brokerage firm learns of alleged employee misconduct, what obligations do you believe that firm has under the law?

Section 15(b)(4)(E) of the Securities Exchange Act, and various rules of the NASD and the exchanges impose on broker-dealers a responsibility to supervise the activities of their employees for compliance with the securities laws. A firm's responsibilities include following up on customer complaints, reviewing transactions effected by all employees for possible irregularities, and taking corrective action when violations are discovered. In addition, when a firm terminates an employee because of the employee's violation, it must notify the NASD or exchange of the termination and the reason for the termination. See, e.g., NASD Manual, Article IV, Section 3.

22. Crash and Market Reform Issues

> Are there any measures that Congress and/or the Commission should take to forestall another market break like that in October 1987?

Following the market break of October 1987, the Commission submitted proposed legislation on market reform, which Congress has not yet acted upon. This legislation included useful proposals for enhanced authority to develop an integrated clearance and settlement system; reporting requirements for affiliates of broker-dealers concerning certain financial and operational risks; and large trader reporting requirements.

More comprehensive systems for assessing and controlling liquidity and other risks for both direct market participants and their holding companies, and better coordination between stock and futures exchanges and regulators would create a stronger system.

The implementation of "circuit breakers" between securities and futures exchanges is one example of a new mechanism to protect against market instability. Other desirable systems improvements would include enhancements to permit higher capacity, increased flexibility and better performance in processing trades. Many such enhancements have been made, or are under way, by the NYSE and other exchanges.

23. Crash and Market Reform Issues

> In addition to the recommendation that one agency should coordinate regulatory issues which have an impact across related market segments, other Brady Commission recommendations following the October 1987 market crash were as follows:
>
> i. Clearing systems should be unified across marketplaces to reduce financial risk. Has enough been done to unify clearance systems?

I do not agree that there should be a single agency to "coordinate regulatory issues ... across related market segments." Effectively regulating cross-market issues would be extremely difficult if the agency performing this function did not have the expertise obtained from regulating the underlying market.

I do not believe that enough has been done to unify or improve clearance systems, although improvements have been made. For example, more rapid settlement and cross-margining should be considered.

> ii. Margins should be consistent across marketplaces to control speculation and financial leverage. What are your views on who should set margin requirements, and the need for them?

Margin plays a somewhat different role in futures markets than in securities transactions. Therefore, uniformity of margin requirements may not be necessary. However, margin levels should ideally reflect prudential considerations as well as the private purposes margin serves. However, any decision to revise the structure of regulation of the futures exchanges, including margin-setting authority, should be made by Congress, not the Commission.

> iii. Circuit breaker mechanisms. What are your views on the need for circuit breakers and the efficiency of circuit breakers currently in place?

I believe the development of "circuit breaker" mechanisms promotes market stability. However, I do not have any basis for judging the efficiency of the mechanisms and procedures now in place. To my knowledge, only one of these mechanisms (the NYSE's Individual Investor Express Delivery Service) has been activated in the securities markets, and this system has not reported any difficulty. The Division of Market Regulation needs to monitor actively the initial design of circuit breakers, their periodic simulated testing and enhancements as necessary.

> iv. Information systems should be established to monitor transactions and conditions in related markets. It is currently easier to track information relating to commodities trades than it is securities trades. What is your view on giving the SEC more authority over large trading reporting.

I believe that the large trader reporting rulemaking authority would assist the Commission in its surveillance of U.S. markets. Comparable authority has proven beneficial in futures markets, and would help the Commission detect manipulative and other abusive trading activities. However, the cost and competitive impacts of any specific proposal would require careful analysis before action is taken. I would work closely with industry to determine the least costly or disruptive means of achieving the Commission's objectives prior to taking action to implement any specific proposal.

24. <u>Crash and Market Reform Issues</u>

> Suppose the day after you take office the market drops 500 points. Please tell us in the greatest possible detail exactly what steps you would take during and at the close of that day to restore investor confidence in the market and prevent it from falling further. With whom would you consult? In what order? What questions would you ask? What statements would you issue? What actions would you order or encourage other parties to take?

It is not possible to respond to this question without the specific facts surrounding the hypothesized market fall of 500 points. My actions would be affected by such facts as volume and price movements in other domestic and international markets, operability of data processing and other systems, status of clearing houses and their members, conditions in domestic and international futures markets, liquidity conditions for major firms, specialists and other market participants, and possible causes for the market fall. At a minimum, however, substantial market volatility would require the Chairman and his staff to remain in close touch with the NYSE, NASD and other exchanges, heads of major securities firms, other financial agencies (including the CFTC and Federal Reserve), major foreign securities regulators and key Administration officials, including the Secretary of the Treasury.

25. Crash and Market Reform Issues

> Would there come a point at which you might consider closing the market? What point might that be?

No. The Chairman of the Commission does not have the independent authority to "close the market," and I would not consider such a step. While the President does have this authority for securities markets, it has never been exercised. Discretionary authority to close the market has the disadvantage that market participants do not have any means of knowing how or when such authority might be utilized. In a crisis, this uncertainty and the related rumors concerning its likelihood could have seriously adverse consequences.

Nondiscretionary circuit breakers have been developed to respond to market instability by creating planned trading halts. These brief, pre-determined intervals will allow traders and others to assess market conditions and redress operational or financial problems. At the same time, all market participants would know that the markets would shortly reopen to permit market participants to execute transactions they deem appropriate.

26. Crash and Market Reform Issues

> Suppose the market continues to drop the next day and eventually bottoms out 800 points below its level when you took office. Would this second market crash lead you to reconsider any of your conclusions regarding appropriate legislative and regulatory responses to the first crash. If so, which ones?

Please see my answers to Questions 24 and 25.

27. Individual Investor and Investor Confidence

> Some observers have suggested that small investors may be deterred from entering the market by a perception of widespread fraud and insider abuse. These observers maintain that this perception comes about because, in regulating the securities industry, the Commission has too often contented itself

> with reasonable assurances of fraud, rather than insisting on a higher, fiduciary duty. Do you agree that the Commission should insist that market participants adhere to a fiduciary duty in executing transactions on behalf of investors? What specific steps will you take as Chairman to correct the perception that the Commission is satisfied with a lower standard of care?

There are many factors, including competition from other types of investments, that affect individual investor participation in the market. I do not believe that there is a perception that the Commission tolerates fraud or violations of fiduciary duties. Indeed, the securities laws and rules impose strict standards in this area, which the Commission assiduously enforces.

A contribution factor is that the process of investing is unfamiliar to many Americans. Stock investments may be perceived as inconvenient and unduly risky due to price volatility or other factors. Many Americans may also have a perception that self-interest and corruption among securities industry participants are widespread. The Commission can help correct this perception through vigorous enforcement, but much of this change must be accomplished by the industry itself through renewed attention to retail customers and dedication to ethical business practices.

28. Private Placements

> Private placements of securities in the United States have increased from approximately $16 billion in 1980 to $200 billion last year, constituting 42 percent of all corporate financing. What steps, including new regulations, should be taken to prevent abuses of the private market and what plans, if any, do you have for ensuring that private placements comply with existing laws and regulations?
>
> The SEC has been considering for some months proposed Rule 144A which would facilitate private trading of securities in the secondary market without SEC regulation. The Commission originally proposed a very broad rule and has since narrowed its proposal. Are you familiar with the proposal and, if so, what is your view as to its advisability and its consistency with the SEC's obligation to protect the investing public?

While I do not presently know of any reliable information concerning significant abuse with private placements warranting new regulations, I would of course be alert to any such suggestion. I am aware of proposed Rule 144A, and I think that its objectives are generally sound.

29. Long-Term Versus Short-Term Investment

> What steps, if any, do you think should be taken to encourage long-term investment? Do you see any problems with the short-term horizon of many pension fund managers and investors?
>
> How do you respond to concerns expressed by many people that our markets have become too speculative and volatile and that this is adversely affecting the long-term planning and research and development plans of corporate America?

Long-term investment is vitally important to our capital markets and to our economy. Long-term capital formation should be strongly encouraged, with greater national emphasis on all forms of savings. While there may have been a shift in emphasis from long-term to short-term returns among some portfolio managers, as to at least some portion of their assets under management, the causes for any such shift should not be oversimplified. Any corrective measures would have to be carefully and thoroughly analyzed for their impact. While most specific proposals for legislative and regulatory change in this area are outside the Commission's direct area of responsibility, legislative or regulatory steps that would create incentives for long-term investment perspectives would be desirable.

I am not aware of any empirical evidence correlating volatility in securities market pricing to corporate R&D expenditure levels. However, to the extent that some institutional investors focus on short-term trading strategies rather than on the economic fundamentals of particular stocks, such investors might respond less favorably to expenditures such as R&D that are designed to enhance long-term corporate earnings capacity.

30. Accounting and Auditing

> The Commission has considerable authority over the accounting industry. Do you believe the SEC should take a more active role in the process of setting generally accepted accounting principles? Do you believe that accountants share part of the responsibility

> for the problems of the thrift industry as a result of their poor audit and accounting performance?

Although I do not believe the Commission should set generally accepted accounting principles, the Commission has an interest in reviewing the relevance of accounting standards to providing accurate disclosure to investors, and the impact of accounting standards on U.S. competitiveness. Therefore, I believe the Commission should retain its authority to override, supplement or otherwise amend the standards established by professional accounting bodies.

Individual accounting firms may share responsibility for problems of individual failed thrifts. However, in my view the ability of the Federal Home Loan Bank Board ("FHLBB") to establish its own "regulatory" accounting principles was a greater accounting problem in the thrift industry. The FHLBB's ability to adopt accounting standards that overstated significantly the net worth of many thrifts was possible in large part due to the exclusion of thrifts and securities issued by thrifts from the Securities Act and the Exchange Act. In my opinion, oversight of such matters by the Commission, rather than the FHLBB, would have resulted in stronger accounting rules for thrift institutions.

31. <u>Accounting and Auditing</u>

> Do you believe that certified financial statements provide reasonable protection to investors? If not, what additional steps should be taken by independent auditors to protect investors?

Yes. Standards should of course be updated and improved as necessary to meet changing business and economic trends.

32. <u>Accounting and Auditing</u>

> Under what conditions, if any, should accounting firms be permitted to have direct business relationships with their audit clients? How should the independence of the audit be maintained?

This is a difficult question involving balancing the need for a truly independent auditor and with the need to avoid interfering unnecessarily in the provision by accounting firms of other types of services to their audit clients. I do not wish to take a specific position until I have an opportunity to review the work of the Commission staff on its existing study of this issue.

33. Accounting and Auditing

> Book value accounting with its historical cost basis has been blamed for many things. Some say that manufacturing and commercial companies have been subject to takeover leveraged buy-out offers from management insiders because management has a true idea when depreciated assets are undervalued and future liabilities are not discounted to present value. On the other hand, banks and thrifts have used book value accounting to hide problem assets until the problems become overwhelming. In general, do you believe that securities disclosure should include market based valuations? Also, specifically, do you support the Statement of Policy issued by the Federal Home Loan Bank Board on May 19, 1989 that would require thrifts to at least disclose the market value of assets that are held for purposes of a later sale or trade (as opposed to assets held to maturity)?

Market value rather than historic cost valuation is an important element in understanding the condition of financial institutions. However, the question of market value accounting and disclosure is complex, and the FASB is studying cost, reliability and other issues that should be carefully analyzed. In some cases it may be desirable to report historic costs and market values in parallel. I have not reviewed the detailed provisions of the FHLBB policy statement, but I support a movement toward mark-to-market accounting (already used by securities firms) by banks and thrifts.

34. Accounting and Auditing

> The large accounting firms that audit most public companies are rapidly merging. The "Big 8" may now become the "Big 5." Should the Commission be concerned with declining competition, excessive size, audit quality or any other implications of these mergers?

I believe the implications of these mergers would be more appropriately addressed by federal agencies with antitrust responsibilities, such as the Department of Justice.

35. Accounting and Auditing

> What have you learned about the accounting industry from your active involvement in dealing with the problems of the thrift industry?

The problems of the thrift industry demonstrated the danger of allowing bank or thrift regulators to determine the degree of financial information that would be disclosed by regulated institutions as issuers of securities, or the specific accounting principles to be followed. I have not formed an opinion regarding the accounting industry itself as a result of this experience.

36. Jurisdiction over Securities Issued by Banks and Thrifts

> Currently, Section 12(i) of the 1934 Act places securities issued by banks and thrifts under the separate regulatory structure for such institutions. Do you think that 12(i) should be repealed with regulation of all securities centralized at the SEC?

Sections 3(a)(2) and 3(a)(5) of the Securities Act exempt securities issued by banks and thrifts from registration requirements, while Section 12(i) of the Exchange Act places responsibility for reporting as a public company in the respective bank and thrift regulatory agencies, rather than the Commission. The result is that five different agencies have authority over the disclosure practices of banks and thrifts or bank and thrift holding companies. This situation reduces protection for investors and increases overall costs to the Federal Government. I strongly believe that repealing the bank and thrift exemptions of Sections 3(a)(2), 3(a)(5) and 12(i) would significantly improve disclosure to investors and to the market. In my opinion, the result would be a stronger and more effective regulatory system, at less expense to the Federal Government.

37. Municipal Securities

> Should the exemptions in the securities laws related to issuers of municipal bonds be continued or should such issuers be subject to the same regulation as issuers of other types of securities?

I do not have an opinion as to the cost effectiveness or constitutionality of any such proposal. Investors in municipal securities generally need reliable financial data as much as investors in other types of securities. The Commission recently has clarified that the anti-fraud provisions of the securities laws impose a duty on municipal securities underwriters to be confident of key representations made in the issuer's official statement. In addition, the Commission adopted Rule 15c2-12, which ensures availability of the official statement to investors and financial analysts and requires access by underwriters to that document prior to bidding for those securities. The effect of these actions should be carefully monitored prior to additional regulatory or legislative action.

38. Soft Dollars

> Do you believe that the practice of payment for order flow with hard and soft dollars, which was recently the subject of an SEC roundtable session in July, is detrimental to the industry?
>
> If so, how do you believe that the practice should be regulated, given the fact that Section 28(e) of the Exchange Act specifically permits certain "soft" dollars practices by money managers?
>
> Should the Commission consider banning the practice in any respect?

I have not formed any specific opinion on this issue. I do not believe that any conclusions as to the advisability of regulations or legislation in this area should be reached until the empirical surveys that the Commission's staff and the SROs are now preparing as to the extent of these practices are available.

39. Corporate Governance Procedures

> As more and more corporate shares are held by major institutional investors such as pension funds, what specific changes in corporate governance procedures would seem appropriate?

Corporate governance procedures generally are matters for state law, with exceptions such as the proxy rules, among others. While the trend toward equity ownership by institutional investors may raise new issues concerning voting confidentiality and fiduciary standards, I am not prepared to support any specific changes in federal law applicable to corporate governance procedures at this time. However, I would also plan to review carefully analysis of this issue from the Commission, commentators, the American Law Institute and others.

40. Trading Systems

> Many people believe that the trading systems of the future will be fully automated along the lines of London and Tokyo. What is your view of the trading system of the future?

It is a misperception that either the London or Tokyo markets is "fully" automated. The International Stock Exchange in London adopted, at the time of "Big Bang," a screen-based quotation dissemination system modeled after the National Association of Securities Dealers' NASDAQ system. Trades in that market largely are still negotiated over the telephone, however, as they are in the U.S. over-the-counter market.

The Tokyo Stock Exchange ("TKE") introduced an automated order routing and execution system called the Computer-Assisted Order Routing and Execution System ("CORES") in 1982. CORES provides facilities for the electronic entry of orders from member firms' offices, display of the contents of the limit order book and execution of matching orders. This occurs either automatically or through manual entry by "saitori," who are TKE members that function somewhat like specialists on U.S. exchanges. Approximately 90% of the domestic stocks and all foreign stocks listed on the TKE are traded in CORES. The 150 stocks not traded in CORES, however, are the most actively traded and account for approximately 75% of total TKE share volume.

In the United States, both traditional exchange markets and screen-based systems are used actively. I cannot project what type of system will prove most dominant in the future, although both types of systems are likely to continue to evolve.

41. Disclosure

> Do you believe that the current disclosure requirements for American corporations are effective and efficient? What disclosures, if any, would you reduce or eliminate? Are there areas in which disclosure is insufficient to properly inform investors? Do you believe that investors would be better informed if market based valuation was more widely applied? Should mark-to-market financial statements be prepared as a supplemental to existing book value statements?

Yes, I believe that the current disclosure requirements for American corporations are both effective and efficient, although they can always be improved. These disclosure rules provide comprehensive information as to a company's business, financial condition and securities. Obviously no system is perfect, and the Commission should continuously review its disclosure policies in light of market developments.

42. <u>Functional Regulation</u>

You have been a strong advocate of "functional regulation" in the financial services industry but this concept has been criticized by a number of people.

For example, in a speech to be delivered November 2, 1989, former SEC Enforcement Chief, Judge Stanley Sporkin calls the concept "unworkable" in the enforcement area. In advocating a single enforcement arm in the financial services regulatory scheme he writes:

The rationale behind a single enforcement arm is to assure that an organization that is dealing in a multitude of products will be precluded from operating where it is not acting responsibly in any of its various business phases. This concept would in effect recognize that functional regulation simply is unworkable. What did not make sense to me when I was Director of Enforcement at the Securities and Exchange Commission was that when we discovered a brokerage firm was cheating its securities clients we were without jurisdiction to examine the firm's non-securities operations. It was obvious to me that a firm that would churn a customer's securities account would do likewise with respect to that customer's commodities transactions. This jurisdictional impediment made us at the SEC look like a bunch of Inspector Clousseaus.

If the regulated are able to cross functional lines, the regulators should be able to do the same. So for those who advocate functional regulation, I suggest they consider that view. It would only perpetuate the Balkanization that now exists.

What is your reaction to this criticism of functional regulation by Judge Sporkin?

I do not believe the Enforcement Division of the SEC has ever looked like a collective group of "Inspector Clousseaus," and certainly not under Judge Sporkin. "Functional regulation" is a term that is used by different people to describe vastly different concepts.

Law enforcement in this country is not generally unified in a single agency, but rather is divided by geographic jurisdictional boundaries as well as specific "functional assignments" (drugs, customs, etc.). In a decentralized society, our financial regulation as well as our entire political system will always have jurisdictional boundaries among agencies and governmental units. Coordination and cooperation among all financial agencies should be active, including authority for agencies to bar persons convicted of fraud or wrongdoing in other financial sectors. Indeed, in appropriate cases the Commission should also refer information regarding potential violations to the U.S. Attorney, the FBI, state law enforcement or to other regulatory agencies. In general, I believe enforcement can be effective notwithstanding jurisdictional boundaries.

43. Tender Offers

> Since the junk bonds and corporate notes the Goldsmith Group is offering will not be listed on the London Stock Exchange, they will not be subject to regulatory review in the United Kingdom. If the SEC does not require registration of the securities, there will be no regulatory review here. Is it not troubling that the second-largest tender offer in history will not be reviewed on either side of the Atlantic for its effect on U.S. shareholders of B.A.T. Industries?

I have been informed that, based on a careful review of all relevant facts, the Commission's staff has concluded that the registration requirements of Section 5 of the Securities Act have not been triggered by the offer in question. In addition, the staff has concluded that the Commission does not have any regulatory jurisdiction over this offering under any other provision of the federal securities laws.

The Commission should not take action in cases where it has determined that it does not have jurisdiction. Indeed, imprudent attempts to assert jurisdiction over offshore transactions could lead to counterproductive foreign assertions of jurisdiction over capital market transactions within the United States.

Foreign issuers making an exchange offer of this kind frequently do not extend offers to U.S. holders because they are unwilling to bear the costs and other burdens of registering securities in the United States. The U.S. securities laws and the principles of international comity would not permit the

Commission to force a foreign issuer to enter the U.S. securities markets against its will, even though U.S. investors may be excluded from investment opportunities.

44. Foreign Ownership

> Should the SEC or any Federal government authority take steps to monitor the increasing foreign ownership of American industry?
>
> Are you at all concerned about increasing foreign ownership of American industry?

Foreign investment in the U.S. has helped to provide capital to support the construction of facilities in the U.S. that have increased production and employment since the earliest days of our nation. The disclosure requirements of the federal securities laws apply to foreign ownership interests in shares of publicly-held U.S. companies, as such requirements apply to domestic holdings. Beyond enforcing current disclosure requirements, I do not believe the Commission should have any responsibility for "monitoring" foreign ownership of assets located in the United States.

45. Public Utility Holding Company Act

> You are no doubt aware that efforts to secure the repeal of the Public Utility Holding Company Act several years ago failed. Would you expect to make its repeal a legislative priority for the Commission?

The Commission has a longstanding position in favor of repeal of the PUHCA, or transfer of its responsibilities to a more appropriate agency. I do not anticipate making this issue a priority concern of the Commission, although the fundamental soundness of this recommendation is demonstrated by the consistency of the Commission's views on this subject.

II. Questions from Senator Alan Cranston

46. Multiple Trading of Options

Mr. Breeden, on May 25th of this year, the Securities and Exchange Commission adopted Rule 19c-5, permitting the multiple trading of standardized options on exchange-listed securities. This new rule is to take effect on January 22, 1990, and would fundamentally alter the manner in which stock options have been traded for the last decade.

The SEC has chosen to pursue this course of action despite strong opposition from a majority of the options exchanges as well as from numerous brokerage firms, both regional and national. In addition, serious reservations have been raised by many in the Congress, including myself, in a number of letters to the Commission.

As these letters point out, the multiple trading of options would entail a major restructuring of a complex component of our nation's overall securities market. Such a step would present several possible serious repercussions for the securities industry and the public investor.

I realize that the answers to some of the more technical questions that have been raised may not be possible to determine until multiple trading has commenced. However, I am greatly disturbed that several basic items, such as a cost/benefit analysis, or safeguards necessary to protect public orders, have yet to be clearly identified.

This Senator believes that the Congress has a duty to ensure that answers to such basic questions as these are provided by the regulators before multiple trading is implemented.

Therefore, Mr. Breeden, I would like to have your assurance that, if confirmed, you will carefully review this entire proceeding to satisfy yourself that the Commission's rule is well-grounded in fact and can withstand

> the close scrutiny that a decision of this nature deserves to be given. Specifically, I would ask that you consider postponing the implementation of Rule 19c-5 until you are able to certify to the Congress that multiple trading can be implemented in a cost-effective manner; that it will not harm the public investor, and that it will not impede the development of a national market system that the Congress has found to be in the public interest.

I am aware that the Commission's action with respect to the multiple-trading of standardized options on exchange-listed securities (Rule 19c-5) is controversial, and that it has raised serious concerns. At the same time, it is worth noting that the Rule was adopted unanimously, based on extensive staff consideration, and more than two years following its initial proposal for comment. As I understand it, the Commission's final action was based on a conclusion that the benefits from the proposal would be significant, while its problems would be small and manageable.

If confirmed, I will carefully review this proceeding to satisfy myself as to the desirability of this rule. I would include in this review consideration of any developments that may have occurred since the Commission's action, such as the degree of movement toward market integration systems. However, I cannot commit that I will recommend any specific action, or that other Commissioners would change their views irrespective of my conclusions.

47. Financial Reform

> S. 530, a bill introduced by Senators D'Amato, Garn and myself imposes a comprehensive approach on reform by setting up a system of functional regulation of all new activities permitted by financial entities rather than a piece meal approach with Congress handing over several powers at a time over many years. In your role as the new Chairman of the Securities and Exchange Commission, how would you recommend that this Committee approach banking reform proposals? i.e., piece meal or comprehensively?

A comprehensive update of financial services statutes would be desirable. I would certainly hope that the Commission could work with the Congress to outline a blueprint for comprehensive change. However, I would also favor enactment of specific, targeted reforms while awaiting "comprehensive" legislation where such narrower reforms would be consistent with broader objectives.

III. Questions from Senator Christopher J. Dodd

48. Over the years, this committee has had a very constructive working relationship with the Commission and the Commission staff. Senators, as well as our staffs, have felt free to call and talk with any of the individual Commissioners. We have had the Commission staff come to the Committee on many occasions for informal meetings, often on short notice, to provide information we may require on fast-breaking problems. The Commission staff routinely provides technical assistance on legislation. Will you continue to support and encourage these practices without restriction?

I will continue current practices in this area, as I believe that a full exchange of views between the Commission and Congress is a healthy process.

49. From time to time, we have requested and received from the Commission documents -- internal, nonpublic documents -- which we review and discuss with the Commission and its staff as part of our oversight function. Will you continue to support that practice?

I am not familiar with specific practices in this area, so I cannot make any specific commitment. However, I appreciate the significance and importance of Congress' oversight responsibilities.

50. Describe, in your own words, what you believe the relationship of the SEC should be:

- to the White House?
- to OMB?
- to Congress?

The Commission should be a source of expertise, analysis and policy advice for the White House, OMB and Congress, all of which have an interest in the issues relating to U.S. capital markets and the federal securities laws.

51. You have pointed out to a number of people that you are the President's personal choice for SEC Chairman. What steps do you intend to take to ensure that you avoid even the appearance of compromising the independence

of the SEC or being overly influenced by your relationship to the President or to your former colleagues in the Administration?

The President selects all nominees to the independent commissions. If confirmed, I intend to carry out my responsibilities fully, and without partiality of any kind.

52. If you are confirmed, what are your priorities for the SEC?

If confirmed, my first priority will be to maintain, and hopefully to enhance, the tradition of excellence of the Commission in its staff, and the professionalism of its work product. The Commission represents an institutional resource of extreme value to the capital markets of the U.S., and to the protection of investors.

Among my other high priorities will be to:

- improve the capacity of the Commission, working with other national securities regulators, to reduce risks and improve stability in global capital markets. This requires improvements in clearance and settlement systems, market surveillance, capital standards and mutual enforcement cooperation;

- help enhance the international competitiveness of U.S. markets and the ability of issuers to raise capital in the U.S. at the lowest possible cost; and

- prevent or detect and prosecute financial fraud and manipulation of all types, to maintain the honesty and integrity of markets.

53. In June of 1988, the SEC submitted to Congress legislation developed after its review of the October 1987 market break. Senators Dodd and Heinz introduced the legislation earlier this year as S. 648, the Market Reform Act of 1989. Section 4 of the bill, Risk Assessment for Holding Company Systems, would give the SEC authority to request information concerning the financial and operational condition of broker-dealer holding company systems. Do you feel that such an expansion of SEC jurisdiction is needed and, if so, for what reasons?

The stability of broker/dealer firms is increasingly indivisible from the financial condition of the entire company of which a broker/dealer is a part. Sudden collapse of a broker-dealer's parent firm could cause nearly instantaneous collapse of the broker/dealer's liquidity resources, with potentially enormous impact on the integrity of the market. Therefore, I believe that it is imprudent for the Commission to be unable to determine the degree of risk of such circumstances, and the threat they represent to investor confidence and the financial system as a whole.

54. The large trader reporting provision in S. 648 provides the Commission with the authority to adopt reporting rules for large transactions in publicly traded securities and related transactions in equity index futures and options on such futures. Various industry members have argued that the SEC now has ready access to information about large traders through cooperative SEC-self regulatory organization efforts, such as the electronic blue sheets. Do you believe that this new reporting requirement is needed?

Yes, I believe this authority would be useful to the Commission for use in both enforcement investigations and also in monitoring market trends and conditions to maintain stability. Carefully constructed actual rules should prevent any undue cost or interference to reporting firms.

55. S. 648 would give the SEC emergency authority to suspend all trading in U.S. securities markets. Do you support this section of the legislation?

No, I do not believe that authority of this nature should be vested in the Commission.

56. Section 5 of the Market Reform Act of 1989 would direct the SEC and the CFTC to facilitate the establishment of linked, coordinated, or centralized facilities for clearance and settlement of transactions in securities, options on securities, financial and commodity futures, and options on such futures. Do you support this measure? In light of existing tensions, how would you facilitate a cooperative environment between the SEC and the CFTC and work to implement the obvious need for improved clearance and settlement?

Yes, I believe coordinated and enhanced clearance and settlement mechanisms are very important. I intend to work diligently to create an environment of close cooperation with the CFTC in every area of mutual concern. Hopefully this measure could also promote progress toward a safer and more competitive system in both securities and futures markets.

57. The SEC's settlement with Drexel Burnham Lambert gives the SEC substantial authority to shape the management of the firm and conduct continuing oversight over some aspects of its operation.

In general, would you be willing to support those kinds of sanctions against securities firms in the future?

Yes, the Commission has made specific management changes or policies a part of settlements in other cases as well. While as a regular matter the Commission should not seek to dictate actual management of a firm, extraordinary corrective action must be an option where a firm has shown a pattern of sustained and widespread misconduct.

58. What are your views generally on the appropriateness of a "failure to supervise" sanction? Under what circumstances would you support such a charge against an officer of a broker-dealer?

The system of self-regulation for the securities industry established by the Exchange Act places heavy reliance on effective supervision by the firms and their supervisory personnel over branch office operations and personnel. Section 15(b) of the Exchange Act, at paragraphs 4(E), for broker-dealers, and (6), for associated persons, provides the Commission with the authority to bar, suspend, censure or otherwise limit the activities of firms or employees for such failure to supervise others who violate the law. Firms and their supervisory personnel may defend against charges of failing to supervise persons subject to their supervision by proving that reasonable supervision had in fact been exercised, notwithstanding an employee's violation of the Act.

Last year Congress also concluded that more specific supervisory prescriptions that would complement Section 15(b)(4)(E) were necessary to prevent the misuse of material, nonpublic information. The Insider Trading and Securities Fraud Enforcement Act of 1988 creates as new Section 15(f) of the Exchange Act a "new affirmative statutory requirement for broker-dealers and investment advisers to establish, maintain and enforce written supervisory procedures to prevent the misuse of material, non-public information." The legislation also provides in new Section 21A for substantial civil money penalties for control persons based on violations of insider trading prohibitions by persons subject to their control (e.g., employees).

The Commission should be prepared to bring cases where it appears that persons in authority in firms have not exercised vigilance when irregularities come to their attention. This may include cases involving patterns of (i) failure to identify or follow indications of wrongdoing, (ii) failure to ensure compliance with remedial instructions; or (iii) inappropriate reliance on branch office personnel to carry out supervisory functions. In general, it is very important for the Commission to review the adequacy of internal procedures and systems for supervision.

59. The Commission sent to Congress a bill entitled "The Securities Law Enforcement Remedies Act of 1989." It was introduced by Senators Dodd and Heinz at the request of the Commission as S. 647. The bill would create new civil fines for securities law violations, up to $100,000 for individuals and $500,000 for corporations. In certain cases, it would also permit a court, or the SEC in administrative proceedings, to prohibit an individual law violator from serving as an officer of director of a public company or a regulated firm.

Do you support the bill? Do you generally support the proposition of civil fines for securities law violations?

I strongly support the authority for the Commission to levy civil fines for securities law violations. While injunctive relief remains an important enforcement remedy, civil money penalties would be a significant deterrent to wrongdoing by enabling the Commission to create economic risks to those who violate the securities laws. If anything, I am not certain that the maximum levels permitted under the proposed legislation would be sufficient in extremely serious cases.

60. The SEC is best known for its high-profile insider trading cases. Are there other areas of enforcement -- for example, accounting fraud, municipal securities regulation, or other areas -- that you believe should get greater attention? Where do you see the greatest harm to investors?

Threats to investors may come from a variety of directions, and I believe that the Commission has to be vigilant and alert to all such problems, irrespective of their source. The penny stock problem deserves special emphasis due to the often severe impact of such cases on individual investors. Market manipulation should also be the subject of careful surveillance and enforcement action.

61. Do you have an opinion about how well self-regulation in the securities industry is working?

In considering a self-regulatory system when promulgating the Exchange Act, Congress attempted to balance the possible dangers of total industry self-regulation (i.e., lax enforcement and conflict of interest concerns) against the perceived ineffectiveness of wide-scale government regulation. Under the Exchange Act, the SROs exercise authority subject to Commission oversight. This is designed to ensure that the SROs meet their obligations regarding investor protection and the public interest.

The degree of supervision exercised by the SROs in the securities markets is largely unique in financial regulation generally. With an ability to pay more competitive salaries than government, the SROs have a better ability to maintain a sufficiently large and experienced staff than the Commission. In addition, the working relationship between the Commission and the various SROs seems to be generally very good, with the result that surveillance and investigatory programs of the SROs have improved as a result of Commission suggestions as well as other input.

Although the tradition and record of the self-regulatory approach has been good, improvements can always be made. It is important for the Commission and the SROs to maintain a high degree of consultation and cooperation in determining the best possible means of achieving supervisory goals.

62. In the past, the SEC has consistently supported private rights of action as a necessary adjunct to the Commission's enforcement efforts. What are your views?

For at least 25 years, the Supreme Court has permitted private rights of action under the federal securities laws as a "necessary supplement" to Commission enforcement actions. Persons who have been injured by securities law violations often will have the incentive to seek recovery for the violation. Such suits serve both a remedial purpose, and act as a powerful deterrent to violators.

Private actions do not, however, serve all of the ends served by Commission actions. The Commission may be able to sue where no private litigant can or will, and the Commission often can obtain relief in the public interest that is not generally available to a private litigant. In some areas private actions could be counterproductive, by creating excessive litigation or inconsistency in outcomes. Therefore, private actions supplement the Commission's enforcement program, but they cannot be used in every area, and they do not substitute for a vigorous and well-staffed Commission enforcement program.

63. The SEC has submitted legislation to Congress to create a self-regulatory organization for investment advisers. It was introduced as S. 1410 by Senators Dodd and Heinz at the SEC's request. In general, do you support the legislation?

I have not formed a specific opinion on this legislation.

64. We have marked up S. 646, the International Securities Enforcement Cooperation Act. You stated at your recent hearing that you support the legislation. Are there areas, other than enforcement, in the international arena where coordination is needed?

Yes, there is a great need for more active cooperation in reducing systemic risks, such as by enhancing clearance and settlement systems and developing common net capital rules. There also needs to be a stronger institutional framework for international cooperation in securities regulation. Common, or more closely harmonized, accounting, auditing and disclosure standards would also be beneficial. Finally, mutual recognition agreements can minimize the time and cost to raise capital or conduct transactions in multiple countries.

65. The Bush Task Force recommended removal of the Section 8(A)(2) exemption under the Securities Act and Section 12(i) under the Exchange Act with respect to bank amendment of securities and securities guaranteed by banks, as well as certain securities issued by thrifts. Do you believe there is a need to implement this recommendation?

Yes, this remains an extremely important issue. Unifying regulation of all securities offerings and periodic disclosure under the Commission would strengthen investor protection, provide greater accounting consistency, maximize disclosure <u>and</u> reduce overall costs.

66. What is your view on the impact of "soft dollar" practices on the integrity of the securities markets and market liquidity? Do

> you believe the current scope of Section 28(e) of the Exchange Act should be narrowed? What do you plan, if anything, as a follow-up to the Commission's recent roundtable on soft dollars?

I have not formed any specific opinion on this issue. I do not believe that any conclusions as to the advisability of regulations or legislation in this area should be reached until the empirical surveys that the Commission's staff and the SROs are now preparing as to the extent of these practices are available.

IV. Questions from Senator Alan J. Dixon

67. What are your views on Glass Steagall reform? What securities activities should banks be permitted to engage in? Should they be permitted to underwrite corporate debt and equity securities and to affiliate with firms which do so? If this should be permitted, what regulation would be appropriate? What sort of protective measures would be needed?

In general, I do not favor any arbitrary or artificial restrictions against competition *per se*. I do believe that it is perfectly appropriate to limit the *manner* of competition in order to achieve legitimate supervisory objectives such as maintaining safe operating conditions or preventing undue conflicts of interest.

In the past, the Commission has supported repeal of the Glass-Steagall Act, so long as any such repeal is accompanied by the requirement that banks conduct most of their new and existing securities activities in separate affiliates or subsidiaries subject to Commission regulation. I do not disagree with this position. However, I believe that other reforms would have to be made at the time of any change in Glass-Steagall, including significant modification of the Bank Holding Company Act and specific standards relating to conflicts of interest.

68. How should we protect against potential conflicts of interest from the combination of securities and other financial activities in a single entity or through a holding company structure? Would disclosure and other securities laws be sufficient? What sort of regulatory restrictions would you find appropriate? What role, if any, would you envision the SEC playing in Glass-Steagall reform?

Preventing conflicts of interest is one of the major topics that must be addressed satisfactorily in any reform of Glass-Steagall. Repeal or substantial alteration of the Bank Holding Company Act is another. I do not believe disclosure laws alone would be sufficient to control conflicts problems, and specific statutory provisions will be desirable.

I believe that it is critically important to achieving a fair, balanced and safe system for the SEC to play a major role in any revision of the current system. The Commission has more experience with the specific hazards and dangers that might be presented by a new system than any other agency.

Ultimately, a variety of different means ranging from disclosure to specific prohibitions may be necessary to address the many different conflicts issues. However, these conflicts questions also arise under the current system, and I do not believe that they present an insuperable obstacle to modernizing our laws.

69. I am concerned about a recent transaction, affecting Marshall Fields in my home state, which involves dollar-denominated junk bonds offered overseas. This transaction so far has escaped U.S. securities law jurisdiction, even though the junk bonds are expected by many to come to rest in the United States. I am concerned that this transaction, if allowed to go forward unregulated, will provide a model for other foreign companies seeking to escape SEC jurisdiction while still taking advantage of our securities markets. What are your views on this issue.

In general, U.S. securities laws do not and should not cover every issuance of dollar-denominated securities in the world. The Commission's jurisdiction is limited and may not be triggered by many offshore offerings, even where they may involve a control contest that will affect ultimate ownership of assets located in the U.S. This is not conceptually different than a control contest in the U.S., which may affect ownership of assets located in foreign countries whose securities regulators would not have jurisdiction over an offering in the U.S.

An unregistered distribution of securities in the U.S. is unlawful, even if the offer utilizes the device of an overseas distribution unless there is adequate assurance that such securities would "come to rest" outside the U.S. Therefore, the Commission must review the specific facts of any such transaction to determine whether there has been a violation of U.S. law.

70. <u>PUHCA</u>

The SEC has proposed a new regulation that would adversely affect several public utility holding companies in Illinois. Many members of the public utility industry, along with state regulatory utility commissioners, argue that the proposed rule would force costly and unnecessary divestitures, would interfere with traditional federal-state allocation of regulatory responsibility, and would

> exacerbate the workload problems of an already understaffed area of the SEC. What are your views on proposed Rule 17, particularly in light of the conclusion of the Task Force on Financial Services Regulation recommending repeal of the Public Utility Holding Company Act?

I am generally aware of the provisions of proposed Rule 17, but I have not reviewed it in detail. I continue to support outright repeal of the Public Utility Holding Company Act, or at a minimum transfer of its responsibilities to a more appropriate agency. If the statute is not repealed, the Commission must enforce its provisions in a sensible and efficient manner. Proposed Rule 17 includes artificial percentage limitations on non-utility businesses that are not set forth in the statute. Such artificial restraints on competition should be intensely scrutinized to determine whether they are absolutely necessary to achieve statutory purposes.

71. Multiple Trading Rule

> What are your views on the multiple trading rule and its effect on the regional exchange system?

Rule 19c-5, the rule concerning multiple trading of options on listed securities, was unanimously adopted by the Commission earlier this year. The Commission adopted staff recommendations based on several years of analysis and extensive public comment. The Commission believed that significant benefits will result from the rule, with only a small and manageable adverse impact.

I am aware that this rule is extremely controversial, and that certain exchanges are now working on means to provide market integration facilities. If confirmed, I will carefully review the desirability of this rule. In this review, I would include consideration of any developments that may have occurred since the Commission's action, such as the degree of movement toward market integration systems. However, I cannot promise to recommend any specific action, or that other Commissioners would change their views.

V. Questions from Senator Jim Sasser

72. The Secretary of the Treasury suggested recently that we should change the tax treatment of equity so that the tax code doesn't favor debt over equity. This has been the subject of debate for some time -- the double taxation of dividends. So Mr. Brady wants to lighten the tax treatment of dividends paid to shareholders. This would, of course, tend to favor wealthy individuals, and again, of course, greatly exacerbate the budget deficit.

Well what about changing the tax treatment of debt to make it more expensive? Why should the billions of dollars that are borrowed in leveraged buyouts, which to my mind sometimes benefit very few people, be fully deductible?

We passed a so-called tax "reform" bill in 1986 that mandates that a young person just starting out in his career can't deduct a red cent on his student loans. Yet we have these enormous leveraged deals that are fully deductible.

Forbes magazine estimated that because the debt incurred in the RJR Nabisco LBO was fully deductible, the government lost $5 billion in revenue. That's just one transaction -- $5 billion.

What do you think? Why not limit the amount of debt that can be deducted and raise some money around here, instead of looking for more ways to benefit wealthy individuals?

In general, I do not believe that our tax system should penalize the use of equity capital rather than debt. Unfortunately, unlike most of our major international competitors, the U.S. does not provide any form of relief from double taxation of dividends. The effect of such a punitive policy is to create a strong incentive to replace equity with debt, which is one factor that results in LBO transactions. Indeed, while the cost of debt is generally comparable in the U.S. and in most other markets, the cost of equity capital in the U.S. appears to be significantly higher than the cost of equity in Japan or other competitor nations. This disparity hurts the long-run stability and competitiveness of U.S. companies, thereby reducing economic growth and job formation.

The penalty applied to use of equity capitalization may reduce the stability of some companies, thereby making it somewhat more likely that their employees, suppliers or communities may be affected by adverse financial conditions. Reducing this type of risk is one reason eliminating the double tax on equity would benefit more people than stockholders alone.

Conceptually, some of the differential also could be eliminated by altering the tax deductibility of acquisition debt. This would of course not eliminate the general penalty against equity capitalization. In addition, such a rule could create significant issues in determining the true use of proceeds from debt issuances. Such a proposal also could have other tax policy consequences.

Obviously formulating tax policy is not the role of the Commission. However, I believe the Commission can perhaps play a constructive role for both Congress and the Administration by working to develop empirical data regarding these issues.

73. Why do we need to go the self-financing route at this time in the reconciliation bill? Wouldn't it be better for this Committee -- the Banking Committee -- to consider this issue carefully instead of trying to ram it through on reconciliation?

And what about the policy here? You have a lot of experience in government. What if every agency tried to earmark federal revenues to itself? We'd have problems raising money for those programs that weren't fortunate enough to have dedicated revenues, wouldn't we?

What makes the SEC so special? This proposal will mean that the SEC will no longer return money to the Treasury. According to one analysis it means that the Treasury could lose over $375 million over the next few years.

I did not participate in the development of the self-funding study that Congress requested the Commission to perform. I have also not participated in the legislative process with respect to the Commission in the reconciliation bill.

There are several good arguments in favor of some form of self-funding for the Commission. The Commission's responsibilities depend on inherently unpredictable levels of market activity -- such as the number of initial public offerings in a year or the volume of insider trading or other enforcement cases detected by the Commission. Use of a fee system would generally avoid the risk that the Commission's appropriations would prove insufficient to perform its responsibilities -- which are dictated by the level of market activity. In addition, the Commission produces a significant annual budget surplus so that flexibility to respond to market developments and activity levels need not cost the taxpayers anything.

Independence from the appropriations process therefore would give the Commission the flexibility to provide adequate safety examinations and enforcement actions without having to allow serious crimes go unpunished, or forcing examinations and reviews to be abandoned. All of the bank and thrift agencies -- including the Fed, FDIC, OCC, and the new OTS -- are funded with fees rather than assessments. Indeed, the OCC, a part of the Treasury Department, has followed that approach for more than 126 years.

The adverse potential of an appropriations system for financial supervision was demonstrated by the S&L disaster. The use of an appropriations process for many years in determining the number of examiners and other personnel at the FHLBB and FSLIC was a factor in the breakdown in effective supervision, as was the fact that the FHLBB was subject to pay caps that left it at a competitive disadvantage for senior supervisory personnel to the FDIC and Federal Reserve, for example. Inadequate numbers and quality of supervisory personnel was one of the factors that resulted in the greatest loss to American taxpayers in history.

The appropriations process obviously provides valuable Congressional oversight over agency activities. However, this oversight could be provided, as occurs with the FDIC and other banking agencies, without use of appropriations. The issue of returning any surplus fees to the General Fund, as the Federal Reserve now does, is of course entirely separate. There is not any inherent reason why a fee-based funding system could not also result in a surplus to help reduce the overall budget deficit.

74. Mr. Breeden, we hear a lot today about the need to encourage a longer-term view in our economy. Mr. Darman talks about "now-now-ism." And everyone has their own solution. Secretary Brady thinks we need to do something about the double taxation of dividends. Others say we need a capital gains tax reduction.

> Well, I have problems with these options. Among other things, they are major long-term revenue losers.
>
> What about a revenue raiser -- Yes, a tax -- that might accomplish the same thing. I think we forget that you can have good tax policy and raise revenue.
>
> What about a tax on the stock churning of institutional investors, particularly pension funds? I constantly hear that the fact that pensions own enormous blocks of stock, and are constantly trading them, is a major disincentive to long-term investment -- particularly R & D by companies. Companies are afraid to make any investments that might depress earnings.
>
> Why don't we make them pay a capital gains tax if they don't hold stock for -- say -- three weeks? Right now all their gains are tax exempt -- even if they hold for only 15 minutes.
>
> No less an authority in securities than Felix Rohatyn suggested this type of tax right here last July. Pensions now own half of all the shares traded on the New York Stock Exchange. Some corporations report that pension funds own 80% of their stock. Pensions turnover 70% of their portfolios every year.
>
> I think this is a big part of the short-term perspective problem. Why don't we do something about this and raise money?

The Commission has not taken a position on whether revised tax policies (e.g., a stock transfer tax or a sliding-scale capital gains tax on stock transactions by otherwise tax exempt institutions) would contribute to a longer time horizon by corporate decisionmakers. There is a heated debate among economists regarding the effects of a securities transfer tax in general. One school views a transfer tax as a reasonable method to raise much needed revenue while discouraging unnecessary speculative trading. Another school believes a transfer tax would reduce market liquidity and potentially drive trading overseas. Congress should consider any such proposal carefully, because of its far reaching impact. If longer-term investment horizons could be encouraged and volatility could be reduced, without harming liquidity (or driving assets to foreign markets), this would be a positive f.

75. Enforcement

Over the past few years the SEC really seems to have stepped up its enforcement actions. The Dennis Levine, Boesky, Drexel and now the Millken cases have attracted great attention. I think the SEC's get tough attitude is viewed favorably here on Capitol Hill and across the country.

As Chairman of the SEC do you see a greater enforcement role in the years ahead? I venture to say that you should have the funding to pay for this enforcement. This year's budget, and the recent action by the Senate Appropriations Committee provides for an 18% increase in funding fo~ the SEC.

An effective and aggressive enforcement program will continue to be essential to deter wrongdoers, preserve the integrity of the securities markets and thereby maintain the investor confidence that is vital for capital formation. The Commission must not tolerate, or appear to tolerate, fraud and criminality in our markets.

Because of significantly higher complaint levels, more complex cases and the international scope of this problem, I believe that the Commission's resources will still be stretched extremely thin, even assuming the very gratifying action of the Senate to appropriate the President's full request for the Commission is ultimately enacted by Congress as a whole. Until a more flexible funding program is enacted, the Commission's enforcement program may continue to be unable to respond as rapidly as would be desirable when major fraud cases are discovered.

76. Mr. Breeden, in the last five years corporate debt has increased by $840 billion. Corporate debt/equity ratios are at historic levels, and this is largely the result of the LBO/takeover phenomena.

The Campeau Acquisition of Federated stores last year resulted in $6 billion in new debt. The RJR Nabisco LBO resulted in a whopping $21 billion in leveraging.

A number of observers, including Alan Greenspan, have expressed great concern over this leveraging. They wonder what will happen if we have a recession and companies have trouble servicing the debt.

Now I realize this is primarily a concern for the bank regulators, since it's the banks that carry these loans as assets. But what about the SEC's role here. The SEC has a general investor protection mission. And doesn't the SEC bear some responsibility for the types of transactions that are engendering the debt? If hostile takeovers were harder to accomplish, we might have a whole lot less leveraging in the economy. Does this argue for an increase in the SEC's market regulation function?

I believe that the Commission's market regulation functions should be significantly strengthened. For example, I believe that the Commission should have the authority to examine the financial condition of all financial affiliates of a broker-dealer -- including a parent holding company. The level of exposure of the consolidated firm's capital and liquidity resources, whether as a result of bridge loans or otherwise, should be a matter for oversight by the Commission. However, the specific mechanics of such oversight should be carefully structured to avoid unnecessary costs or inappropriate extension of regulation.

As you suggest, review of the exposure of lending institutions that are not affiliates of broker/dealers is largely a matter for bank regulators. The Commission's role, other than surveillance of exposure among securities firms, is to guarantee that the facts concerning each firm's leverage risks are fully disclosed to investors. The Commission is not equipped to substitute its judgment for that of the market as to purely economic issues -- such as whether a given level of return is consistent with the risk presented by a specific security.

77. When you look out at the Stock Market today it's hard to believe that one day almost two years that market dropped 508 points. This was a greater percentage drop than that of the famous crash in the late 1920s.

Now we're back at the levels of August 1987 -- the previous all time high has been surpassed. You kind of wonder where we are headed now.

I have a Wall Street Journal article from December 1987 analyzing the factors that caused the crash. The headline says

"Speculative fever ran high in the 10 months prior to black Monday", and inside there's an interview with Nicholas Brady, the head of the Presidential Commission investigating the Crash. He says: "'Incredibly' high prices caused market plunge."

Where are we now do you think Mr. Breeden? This article analyzing the occurrences of the summer of 1987 sounds an awful lot like today.

Market conditions today are significantly different than in October 1987. For example, the average stock price-earnings multiple at that time was almost double present levels. In addition, a variety of improvements have been made in our market systems since then. The "circuit breaker" procedures that are now in place should substantially improve the ability of securities and futures exchanges to address potentially destabilizing market volatility. Significantly greater capacity to process extraordinary trading volumes also has been installed in several exchanges since October 1987. I believe that the net impact of these and other changes has been to improve overall stability. However, more work can and should be done to improve domestic and international market stability.

78. Mr. Breeden, according to a 1986 report of the general accounting office, 89.9% of corporate equities are owned by 10% of all households. (This includes investment in mutual funds but not pensions. Pension funds now control about 25% of all equity. However, given that pension investments are determined by income, I'd venture to say that the bulk of pension assets benefit relatively few.)
So based on the GAO data I think you'd have to say that ownership of the means of production in this country is concentrated in very few people. And it's getting worse. The Leveraged buyout/corporate takeover trend has resulted in the retirement of $300 billion in corporate equity since the time of the GAO study -- so that means even fewer people own stock.

So if you're confirmed for this position Mr. Breeden you'll be presiding over an equities market that's increasingly becoming the province of the select few.

> Now I happen to think that we'd be better off as a society and an economy if we had more capitalists, if there were more owners of corporate equity, more participants in our wealth creation system. What can we do to encourage more widespread ownership of equity? What about ESOPs?

Although I am not familiar with the 1986 GAO report, other data suggest that individual ownership of equity remains widespread. A 1985 survey conducted by the New York Stock Exchange revealed that 47 million individual investors in the U.S., or approximately one of every four Americans, owned stock in either a publicly traded company or in a stock mutual fund. These data indicate that equity ownership has become more broadly based over time; in both 1965 and 1975, a smaller percentage of Americans owned stock. Although large institutional investors account for a larger percentage of trading volume, many studies indicate that their share of equity ownership has not changed as dramatically.

In addition, employee participation in pension funds appears to be broad based. The 1989 Statistical Abstract indicates that in 1986, private and public pension funds held over $2,235.3 trillion dollars in assets. More than 50% of the civilian workers covered by those plans had incomes under $25,000.

I strongly agree that we should encourage greater savings and investment, and that we should encourage a broader participation in equity ownership. However, the extent of equity investment is a function of a number of macroeconomic factors, including, in the first instance, those factors influencing the rate of savings in the U.S. Public confidence in the integrity, fairness and stability of the securities markets is critical to encouraging public ownership of securities, since there are many other savings opportunities (such as bank deposits or direct real estate investments) that do not involve any type of security.

Active Commission oversight of disclosures of public companies, distribution and trading activities of market participants, and vigorous enforcement of the federal securities laws are aimed at fostering such public confidence. I believe the Commission, in its regulatory and enforcement activities as well as its rulemaking and legislative initiatives, should endeavor to foster a favorable climate for equity investing by all Americans.

79. Mr. Breeden, looking back at the two previous chairmen of the SEC, I'd have to say that John Shad was a man of great experience in the securities markets -- some would say perhaps too much experience in the securities

markets. On the other hand, David Ruder, Mr. Shad's successor, did not have market experience, but he was a professor of securities law. And I think some would say that Mr. Ruder may have been a little too professorial.

Now you are neither a legal scholar nor are you a market wiz -- but I'm not sure that's bad. Very briefly, can you give us what you think are your -- let's say -- three major qualifications for this job?

I believe that my personal integrity and commitment to public service, my professional training and experience, and my experience working with Executive Branch agencies and Congress will all serve me well in addressing the challenges that face the Commission. For a number of years I have worked with all of the federal financial regulatory programs, so I have a high degree of awareness of their structure and approach to many issues that cut across narrow market segments. I have also had intensive experience in reviewing the worst failure of financial regulation in American history. This experience taught me invaluable lessons regarding the operation of a supervisory program, the dynamics market incentives, the role of capital and sound accounting principles in maintaining stability and the dangers of widespread fraud and speculation. Working with Senior Administration personnel, members of Congress and market participants to design and enact a program to restore stability also gave me a vital perspective on dimensions of financial regulation.

In addition, please see Attachment A to my Senate Questionnaire for a longer statement concerning my specific experience and qualifications.

80. As you know, the SEC issued a policy statement in June that calls for the multiple trading of standardized options on exchange-listed securities and prohibits the restriction of these options to one exchange only. Despite repeated requests from my colleagues for studies evaluating the feasibility of a National Options Market Linkage System, the SEC has yet to provide a plan or study for market integration facilities. Are our markets ready to handle Multiple Options Trading? Are sufficient investor protections in place to ensure that the small, individual investor's orders are processed in a timely fashion? Has a

cost/benefit analysis been conducted which justifies this policy change?

I did not participate in any deliberation by the Commission prior to its unanimous action to adopt the new multiple options trading rule. I am not aware whether a detailed cost/benefit analysis was performed by the Commission. However, I have been informed that when the Commission approached multiple trading of options, it carefully weighed the reasonably anticipated benefits against the possible adverse consequences of an expansion of multiple trading -- namely, market fragmentation and domination by one market. Both the Commission and the staff apparently determined that, on balance, the benefits to be derived from multiple trading would outweigh any reasonably anticipated costs, and the problems, if any, that would result from full scale multiple trading would be small and manageable.

Rather than restricting options from multiple trading, and thereby removing the substantial benefits that such competition provides, the Commission determined that the exchanges should work on reducing any perceived market fragmentation problems. Rule 19c-5 will not take effect until January, and there will be a one-year phase-in period thereafter. During this time, the Commission should closely monitor any exchange efforts to implement cost-effective market integration systems.

In the companion White Paper to the approval order for Rule 19c-5, the Commission discussed the various means of implementing market integration facilities and discussed the advantages and disadvantages of each approach. Moreover, since issuance of the White Paper, the New York, Pacific, and Philadelphia Stock Exchanges have commenced a study of the methods for developing options market integration facilities, as has the American Stock Exchange in conjunction with the Chicago Board Options Exchange.

81. Mr. Breeden, legislation on corporate takeovers has vexed this Committee for some time. I for one believe that there are a number of needed reforms in this area that should be made.

Indeed, I have a copy of a draft takeover reform bill that's presently in circulation (by Congressman Markey Chairman of the House Telecommunications and Finance Subcommittee). I'd like to ask what you think about a number of the reforms included.

First, closing the 13(d) window -- the so-called 10 day window. I presume you support that?

> Second, what about a requirement that firm financing be in place before a takeover is commenced? This would get at the problem of the "Highly Confident Letter" that can be bought for a very small fee and contributed to the relative ease with which takeovers can be launched.
>
> Third, a so-called "Community Impact Statement?" Should we let communities and employers know what a raider may have in store for their economic mainstay. Many employees and residents of affected communities are shareholders. Do they have a right to know if the company would be "Busted Up?"
>
> Lastly, what about something not included in this bill -- but was included in last year's senate takeover bill. What do you think of giving extra time for an employee stock ownership plan to buy a company when a takeover is threatened?

I support appropriate action to "close the 10-day window," such as the Commission's proposal to set a five business day reporting period, coupled with a standstill requirement as to further purchases until a filing is made. Such a standstill provision protects against any further accumulation of securities until the market is informed of the triggering acquisition. However, the Commission has also taken the position that anything less than five business days would impose significant compliance costs and logistical problems for some acquiring persons.

The Commission has traditionally opposed legislation requiring that firm financing be in place before a takeover is commenced. In general, bids that are not credible, in which the bidder is not seen as able or willing to fund the bid, will have little effect in the marketplace. Item 4 of Schedule 14D-1, the principal tender offer document, mandates disclosure of the source and total amount of funds and other consideration to be used if the bidder were to purchase the maximum number of shares in a tender offer.

Although Item 4 does not require that a bidder finalize financing before commencing a tender offer, once a significant portion of the financing is arranged, the bidder must amend its tender offer documents to disclose that fact. In addition, shareholders must have at least 5 business days, depending on the materiality of the information, to consider this new information. The change of financing status from uncommitted to legally committed, or "firm," is a material change that triggers an additional "waiting period" for information dissemination.

The Commission has traditionally objected to a community impact statement requirement for several reasons, including the fact that the Commission has not felt that such information is directly relevant to an investor's decision. I share the Commission's view that such a requirement would not assist shareholders in making an informed investment decision. Such a requirement might also result in lengthy litigation as to the adequacy of the statement in every hostile bid. The result would be to tilt the careful neutrality of federal law toward protecting incumbent management.

Limitations on the Commission's jurisdiction necessarily confine its interest in ESOPs to disclosure-related issues. The Department of Labor's Pension and Welfare Benefits Administration regulates the investment and fiduciary aspects of employee benefit plan participation in such transactions, while the Internal Revenue Service administers applicable tax provisions. Under ERISA, the use of an employee benefit plan, either offensively or defensively in connection with a takeover, may be illegal if deemed inconsistent with the best interests of the plan. ERISA provides that failure by the plan sponsor and other fiduciaries to establish and to operate a plan prudently and in the sole interest of employee participants will result in ERISA liability.

In considering any changes affecting ESOPs, Congress should take into account that its original purpose for ESOPs was to enhance employee ownership of U.S. corporations. This purpose does not appear to be served by favoring the use of ESOPs as a defensive takeover device.

VI. Questions from Senator Terry Sanford

82. Mr. Breeden, one of the aspects of corporate takeovers that is most troubling to me is the financing for such deals. Indeed, I am convinced that one of the reasons that we have seen such a tremendous rise in the number and dollar value of hostile transactions is the development of new, creative financing techniques that allow bidders to put companies in play with virtually no money down and none of their own funds at risk.

During your work on the savings & loan bill, you worked hard to stress the importance of firms having their own capital at risk. I wonder how you feel about greater requirements in takeovers and leveraged buyouts for the bidders to have to put up real money -- not highly confident letters or other loose arrangements or bridge loans. Indeed, I was reminded upon reading the story in today's Wall Street Journal about the bid by Campeau for Allied Stores. When the deal was financed, First Boston committed $1.8 billion at a time when First Boston's holding company balance sheet had $1.1 billion in equity. By using its parent company and not its broker-dealer affiliate, First Boston avoided the broker-dealer net capital rules.

Some have suggested that we require that bidders demonstrate firm financing commitments. I have proposed that bidders be prohibited from financing more than 50% of their acquisition through pledging of assets of what they are trying to takeover. There are doubtless other ways, through margin requirements and other mechanisms to get at this problem of loose financing of these deals.

What specific steps do you think the SEC could or should take to address the problem?

I share your concerns over the potential exposures for unsafe lending practices, especially with large financing commitments by the holding company or other affiliates of a broker-dealer, which are not now subject to oversight by the

Commission. Such commitments can be of a magnitude that could expose the broker-dealer to substantial liquidity risk and raise systemic concerns for the larger securities system. Additional Commission authority to address bridge financing exposures may be appropriate.

The Commission has not supported a requirement that tender offers be financed prior to commencement. The Commission's rules for such transactions require disclosure of the source of financing, including the absence of such arrangements, and require the disclosure of any plans to obtain the financing. On the basis of that disclosure, the market evaluates the nature and extent of the bidder's financing in assessing the probability that an announced takeover attempt will be consummated.

When an offer is commenced without financing in place, and financing is later obtained, that fact will constitute a material change in the information previously provided to shareholders. The bidder will be obligated to amend its tender offer materials, disseminate the information to shareholders, and extend the offering period, if necessary to provide shareholders with adequate time to consider the information.

83. A related concern to corporate takeovers and leveraged buyouts that have been troubling me for some time is the increasing short-term focus of management and the resulting cutback in research and development and other activities that would lead to long-term competitiveness. In an article last year, Professor Peter Drucker observed that "the fear of the raider is undoubtedly the largest single cause for the increasing tendency of American companies to manage for the short-term and let the future go hang."

While every manager agrees that one of the best defenses of a corporate raid is a high stock price, the company investing in a long-term strategy is likely to suffer a short term decrease in its stock price, thereby opening itself up to an unwanted raid. A Partner at Goldman, Sachs once noted "I don't think any company can afford a long-term investment unless its managers own 51 percent of it." In a recent hearing before this Committee on the Defense Production Act, Norm Augustine, the Chairman of Martin-Marietta remarked on the experience of his company following the announcement of a major research and development effort -- the institutional investors immediately dumped their shares of the company, resulting in a major drop in stock price.

What specific steps do you think the SEC could or should take to address this problem.

The Commission should encourage policies that will foster long-term savings and investment. All of the Commission's programs, and especially the Enforcement program, should reinforce the safety and integrity of the market so that investors will have the confidence to follow long-term investment strategies.

84. Most of the debate on corporate takeovers and leveraged buyouts has focused on the effect these transactions have on stockholders. Indeed, the main thrust of the Williams Act is to give shareholders sufficient time and information to evaluate takeover bids. The theory seems to be that if the stock price is up, all is right with the world.

I am afraid that is too narrow an approach, as a corporation is much more than its stock price. While stockholders' interest certainly deserve protection, others, including creditors, employees, pensioners and the corporate community deserve some consideration as well.

One of the major constituencies that has clearly suffered through this wave of takeovers are the bondholders of our corporations. In the recent buyout of RJR Nabisco,, RJR bonds lost 20% of their value nearly overnight. As early as 1985, Business Week observed that "the takeover and leveraged buyout craze may be a boon for shareholders, but it is slaughtering owners of high-grade corporation bonds."

Do you think that, as a matter of public policy, it is appropriate to permit deals to be done that basically take from the bondholders to give to the shareholders? Should the SEC do anything about it?

Under long established corporate governance principles, a corporation's directors owe fiduciary duties, including duties of care and loyalty, to the company and its equity shareholders. While the scope of the duties owed to bondholders has recently been questioned, the law to date has been fairly clear that a fiduciary relationship does not exist under state corporate law between a bondholder and the company and its directors. A bondholder's rights are largely a matter of contract. The contract or indenture underlying the bond establishes the rights and responsibilities of the two contracting parties at the time the securities are purchased, and bondholders are legally entitled to all the rights set forth in such indenture.

The Division of Corporation Finance's staff is reviewing and evaluating disclosure in the offering materials distributed to prospective bondholders. If necessary, the staff will propose changes in the appropriate rules and schedules to ensure improved disclosure of the risks of going-private or other leveraged transactions.

In addition, the market may respond to the risk of a significant change in the capital structure of an issuer by requiring more protective covenants for bondholders. Generally, such provisions allow the bondholder to exercise an option to sell the debt instrument back to the issuer upon the occurrence of a certain specified event, such as a change of control resulting in a downrating of the issuer's bond rating. Full disclosure of the types of covenants that protect bondholders should be required by the Commission. Generally, however, the scope of duties of directors to the corporation, shareholders and others is a question determined by state rather than federal law.

85. I would like to ask you for your opinion on various possible changes to our securities laws that would effect corporate takeovers and leveraged buyouts. I am looking for your opinion, not that of the SEC.

a. Closing the 13(d) window -- Virtually every witness to appear before this Committee has agreed that the 13(d) window should be closed. Do you agree and how would you close it?

Yes, I would support a change to require the filing of a 13D within 5 business days, and to provide for a stand-still in purchases until the filing was made. The standstill provision protects against further accumulation of securities until the market is informed of the triggering acquisitions.

86. Lower the 13(d) 5% threshold -- Last year, a bill that many on this Committee supported was introduced with a provision to lower the 5% threshold to 3%. Would you support that provision?

No. The purpose of the Schedule 13D filing is to disclose holdings that may have control implications. The Commission historically has concluded that the 5% threshold is sufficient to serve this purpose. The 5% threshold is a benchmark commonly used in other statutes, such as the Bank Holding Company Act, as a point below which control is conclusively deemed not to exist. Reducing the level would be inconsistent with such other statutes, as well as creating costs that the Commission has believed would be significantly in excess of any benefits to be gained.

87. Extend the tender offer time period -- Many believe that shareholders and management do not have sufficient time to respond to offers or to arrange counter offers. Would you favor an extension of the tender offer time period? From 20 days to what? 45 days? 60 days?

The rules and regulations governing tender offers are designed to assure that security holders have adequate time to make an informed investment decision. The Commission has consistently taken the position that the current time periods required by the rules under the Williams Act provide adequate time for investors to make an informed decision, i.e., the 20 business day minimum offer period, the minimum of 10 business days following changes in the number of shares being sought or the price, and the 5 to 10 business days (depending on the nature of the change) for other material changes.

Given the pervasive use of poison pills, and the extent of various other devices that give management additional time (usually significantly in excess of 20 business days) to review alternative transactions, the minimum offering period of the Williams Act has become largely academic. Therefore, I do not believe any time extension is necessary at this time.

88. Many others feel that a more accurate description of what constitutes a "group" should be included to preclude individual members of groups from each buying 4.9% without crossing the 13(d) threshold. Do you think a statutory change should be made to tighten the definition along the lines outlined in S.1323, as reported out of this Committee last year?

The definition of a "group" should certainly embrace individuals who each acquire a 4.9% interest under an express or implicit agreement in order to avoid crossing the 13(d) threshold. Existing Commission rules, appropriately enforced, are sufficiently broad to address arrangements or understandings that are not written or express. Under existing law, parallel conduct can be evidence of the existence of a group, and I strongly support the use of such evidence in Commission enforcement proceedings in all cases where the facts warrant.

At this time I do not believe legislation is needed to detect and penalize the type of abuse you describe. However, if confirmed I will be alert to developments that suggest a need for legislation.

89. Many others feel that two-tiered offers are particularly manipulative. To combat this, an "all or none" requirement could be added to require all shareholders with more than 25% of a company to purchase any additional shares through a tender offer for all of the outstanding shares. Would you favor such an approach? If not, what steps, if any, do you think are appropriate to combat two-tiered or creeping offers?

Judicial response to two-tier offers, market forces and so-called "fair price" charter amendments and state statutes appear to have corrected any perceived problems that may have existed. Indeed, because of these developments it is more common that two-tier offers would be undertaken by the target or friendly bidder, as in the case of the Time bid for Warner in response to a hostile third party bid.

As a practical matter, hostile two-tier offers have greatly decreased in frequency. As a result, additional legislative restrictions do not appear necessary at this time.

90. In the bill reported out last year, S.1323, the Committee adopted a provision for the recovery of greenmail profits. Do you favor this approach? If not, what should be done about greenmail?

The regulation of the use of corporate assets to repurchase an issuer's shares is traditionally subject to state law. If a board of directors fails to fulfill its fiduciary obligations, appropriate remedies are available under state doctrines of corporate waste and breach of fiduciary duties. An appropriate federal response to greenmail would be the use of the disclosure mechanisms to alert remaining shareholders to a substantial securities repurchase. Because this issue was being addressed by court cases and charter amendments, the Commission in 1986 and 1987 decided not to support federal proposals limiting greenmail. I concur with Commission's determination.

91. Do you favor any changes in the proxy process and if so, what changes?

I am aware that a number of institutional investors have raised questions about the proxy process, and that the staff of the Division of Corporation Finance is reviewing these matters. If confirmed, I shall give careful consideration to the concerns that have been identified and to the staff's proposed responses.

92. Numerous examples have been brought to our attention where managements have taken companies private in a leveraged buyout and then relatively shortly afterwards taken the companies public again at astronomical profits. What is your response to charges that there is an obvious conflict of interest in these leveraged buyouts?

I agree that there are potential conflicts of interest and informational advantages in management buyouts. These factors have long been recognized and addressed by the Commission and the courts. The duties of a corporation's directors, including the duties of care and loyalty to the company and its equity shareholders, are well established under state law. Where a transaction involves the potential for self-dealing, courts have required directors to demonstrate good faith and the inherent fairness of the bargain. As a practical matter, the inherent informational advantage of management cannot be eliminated. However, procedures can be designed to isolate interested directors from the consideration of the transaction, and to enhance the level of disclosure.

While evaluation of the substantive fairness of transactions has developed under state law, the federal securities laws have focused on the disclosure needed by security holders to assess the fairness of the transaction. Disclosure of management's interest in a transaction and a description of the procedures followed to evaluate a transaction permit security holders to evaluate whether interested directors have effectively neutralized conflicts of interest. In addition, Rule 13e-3 is intended to elicit material information regarding the transaction, including the board's deliberative process in assessing the transaction, so that security holders independently can evaluate the fairness of the transaction and pursue legal remedies available under state law.

93. What is your response to the allegation that "anybody can buy a fairness opinion?"

Legitimate concerns have been raised as to the reliability of fairness opinions. Indeed, Rule 13e-3 currently addresses these concerns through disclosure of the compensation to the advisor and any existing relationships with the parties. Disclosure also is required of the procedures and methodologies employed by the financial advisor. In addition, the adequacy of the procedures used by the financial advisor in rendering its opinion may bear on the degree to which directors will be credited with reasonable care under state law in determining whether they satisfied their fiduciary duties.

State law standards of care may be violated if the board of directors places unreasonable reliance on a fairness opinion in evaluating the fairness of the consideration offered in a transaction. In this regard it is worth noting that there is ongoing state court litigation concerning allegations of malpractice in connection with the preparation of fairness opinions in certain transactions.

94. What should be the role of the Commission in ensuring that shareholders are treated fairly in these leveraged buyouts?

Because of the informational advantages of management, and the inherent conflicts of interest that arise when management is on both sides of a transaction, the Commission should actively promulgate and enforce disclosure rules, such as Rule 13e-3, designed to provide shareholders with the information necessary to make an independent assessment of the fairness of the transaction. The Commission should review its rules in light of market developments to ensure that shareholders receive adequate information to make that determination.

95. What reforms to Rule 13(e)(3) would you favor?

The Division of Corporation Finance is preparing a rulemaking proposal for Commission consideration that would amend the transactional disclosure requirements to enhance shareholder analysis of extraordinary corporate control transactions recommended or approved by the board of directors. The proposals also would amend Rule 13e-3 to ensure that its disclosure requirements reach all going private transactions in which management has a significant interest. I generally agree with the goals of these proposals.

96. Would you support a requirement prohibiting fairness opinion authors from having a financial stake in the outcome of a transaction?

Federal law does not mandate that a fairness opinion be obtained, and it does not impose restrictions on the independence of persons providing such an opinion. As noted, Rule 13e-3 requires disclosure of the compensation of the advisor and any existing relationships with the parties. Disclosure of any conflicts of interest are intended to help shareholders avoid placing undue reliance on an opinion by a financial advisor with a financial stake in the transaction.

97. Would you favor disclosure of all studies and analyses and projections prepared by or for management in preparation for a management buyout?

Since reports, opinions and appraisals from an outside party materially relating to a transaction are presently required to be disclosed, I would support extending this requirement to include similar disclosure by management of its internal reports, opinions and appraisals that are materially related to the transaction.

98. Would you favor extending the time period following the announcement of an LBO and the time of the consummation of the deal? If so, to how many days.

No, my current view is that existing statutory waiting periods are sufficient. Current transactions generally last much longer than the minimum federal requirements. I would of course remain open to reviewing the adequacy of time periods if current conditions change.

99. In defending his restraint on Commission resources, former SEC Chairman Shad argued that the SEC is not the sole defense in enforcing full disclosure. He contended that false or misleading disclosures will be subject to attack by the private bar in the form of class action suits. What is your view on the Commission shifting some of the burden to the private investors? Should we provide greater rights for private action under Section 13 of the Securities Exchange Act?

For at least 25 years, the Supreme Court has permitted private rights of action under the federal securities laws as a "necessary supplement" to Commission enforcement actions. Persons who have been injured by securities law violations often will have the incentive to seek recovery for the violation. Such suits serve both a remedial purpose, and act as a powerful deterrent to violators.

Private actions do not, however, serve all of the ends served by Commission actions. The Commission may be able to sue where no private litigant can or will, and the Commission often can obtain relief in the public interest that is not generally available to a private litigant. Therefore, private actions supplement the Commission's enforcement program, but they cannot substitute for a vigorous and well-staffed Commission enforcement program. I do not believe that legislation to provide greater private rights of action under Section 13 of the Exchange Act is needed at the present time.

100. The surge in instances of fraudulent securities activities by persons associated with savings and loans and other financial institutions raises serious questions. An enhanced governmental enforcement presence is clearly warranted. Does the SEC intend to step up its activities in this area? How will the SEC coordinate with interested bank regulatory agencies to address this serious issue?

The Commission has a long history of taking effective enforcement action against financial institutions and persons associated with such institutions for violations of the federal securities laws. For example, the Commission's enforcement activities were instrumental in bringing to light fraudulent accounting practices being utilized at Financial Corporation of America, then the nation's largest savings and loan holding company. The Commission's enforcement efforts directed at financial institutions and persons associated with financial institutions will continue and should be expanded as needed.

The Commission does not have primary jurisdiction over the securities of banks and savings and loan associations that are not subsidiaries of a holding company. Section 3(a)(2) of the Securities Act exempts from the Act's registration requirements "any security issued or guaranteed by any bank," and Section 3(a)(5) exempts securities "issued by a savings and loan association." In addition, under Section 12(i) of the Exchange Act, each bank regulatory agency administers the periodic reporting and proxy provisions of the Exchange Act for banks and savings and loan associations under its jurisdiction.

In my opinion, these exemptions may place bank regulators in a conflict of interest in applying the securities laws, and they weaken the protection of investors and the ability of the Commission to police fraud by these depository institutions. These provisions are also inconsistent with the Commission's authority to administer the Securities Act and the Exchange Act for the securities of publicly-held bank and thrift holding companies. While cooperation will always be important, repeal of the bank and thrift exemptions described above would provide more effective enforcement at lower cost to the public.

101. A number of witnesses have appeared before this Committee to stress the paramount importance of maintaining the integrity and fairness of the securities markets. They point to the rising apprehension of the individual investor faced with massive securities trading scandals, increasingly complex securities products, and alarming short-term volatility. What is your response to the arguments that the individual investor is not getting a fair shake in today's marketplace?

?

However, because of the large number of competitive alternatives, the securities industry must convince investors of the fairness and desirability of investing in the securities markets. Through an active enforcement program, the Commission can help to create a favorable climate for investors by helping to maintain the fairness and integrity of the market and preventing abusive practices.

Individual investors in securities continue to play an important role in the nation's markets, increasingly through collective investments in securities such as pension plans and mutual funds. Indeed, over the long term, individual investors who purchase and hold specific stocks due to their investment fundamentals have historically realized significant long-term appreciation. However, because of the large number of competitive alternatives, the securities industry must be able to convince investors of the fairness and desirability of investing in the securities markets. Through an active enforcement program, the Commission can help create a favorable climate for investors by helping to maintain the integrity of the market.

102. As you know, a number of members of Congress are concerned about the implications of the bid by Hoylake Investments Limited -- a Bermuda corporation controlled by Sir James Goldsmith and his partners -- for B.A.T. Industries. B.A.T. has a major subsidiary in the U.S., BATUS, which owns a number of America's most prominent businesses -- Marshall Field's, Saks, Brown & Williamson, Hardees Foods, Iveys, the Farmers Insurance Group and others.

The offer by Hoylake is a highly leveraged offer which would leave U.S. investors in B.A.T. with unidentified securities in a "squeeze out transaction." The bid is to be financed through the issuance in the U.K. of junk bonds that will inevitably come to rest in the United States, given the lack of a junk bond market in the U.K.

As you know the SEC has declined to assert jurisdiction over this transaction.

Do you believe the SEC should assert jurisdiction over this type of bid?

Should our laws be amended to ensure that the SEC will apply our securities laws where a tender offer for a foreign private issuer has the requisite "substantial effects" in the U.S. to support the jurisdiction of our securities laws?

Should our securities laws apply to dollar-denominated junk bonds issued abroad when the issuer knows they will inevitably come to rest in the U.S.?

The Commission can only act where it has jurisdiction under the law. As noted above, the staff of the Commission, after a thorough review of all pertinent issues, determined that the Commission does not have the basis for asserting jurisdiction.

Foreign issuers making an exchange offer of this kind frequently do not extend offers to U.S. holders because they are unwilling to bear the costs and other burdens of registering securities in the United States. The U.S. securities laws and the principles of international comity would not permit the Commission to force a foreign issuer to enter the U.S. securities markets against its will, even though U.S. investors may be excluded from investment opportunities.

Because of the negative impact of this situation on U.S. securityholders, I would support efforts to reduce U.S. regulatory disincentives to extending offers to U.S. holders on equal terms with those of other shareholders, where the home country's regulatory scheme is adequate to protect investors and the percentage of shares held by U.S. persons is not significant. However, in any such system jurisdiction over fraudulent conduct that has an effect on U.S. persons should be retained. The multijurisdictional disclosure system, currently proposed for comment with respect to rights offerings and cash and exchange tender offers involving Canadian companies, may be a useful model for further reform.

An unregistered distribution of securities in the U.S. is unlawful, even if the offer uses the device of an overseas distribution unless there is adequate assurance that such securities would "come to rest" outside the U.S. Therefore, the

Commission must review the specific facts of any such transaction to determine whether there has been a violation of U.S. law.

VII. Questions from Senator Richard C. Shelby

103. Leveraged buyouts and hostile takeovers are the focus of national concern. These transactions may be burdening many American corporations with a dangerous level of debt, which will restrict their ability to modernize, withstand economic downturns, and meet challenges from both domestic and overseas competitors. I am concerned that some of these hostile takeovers and leveraged buyouts may not comply with the law. It is my understanding that most federal courts are presently denying standing to private parties who attempt to raise the issue of whether or not a particular tender offer violates the margin requirements set out by the Federal Reserve Board. This means that the initiation of a enforcement action by the SEC is the only practical way to obtain such a court determination. Are you familiar with what internal standards and criteria are applied by the SEC in deciding whether or not it is appropriate to file such an enforcement action?

It is my understanding that the Federal Reserve Board sets the margin requirements and that the SEC is charged with enforcement. In a situation with which I am familiar, the recent takeover of West-Point Pepperell by Farley Industries, the Federal Reserve took the position that a private party should be permitted to enforce margin regulations. In a memo from Gary Lynch to Chairman Ruder of December 20, 1988, Mr. Lynch states his understanding "that the Board's limited staff resources make it difficult for the Board or its staff to become involved in a detailed factual analysis of every potential margin violation." This situation gives arise to two concerns. First, the Board's suggestion that a private right of action for West-Point Pepperell shareholders is desirable implies that the Board suspects that margin requirements may have been violated. Yet the SEC took no enforcement action. What is the nature of the communication between the Board and the SEC on the issue of margin requirement violations? Does the SEC not

> have the authority to act when it suspects that margin requirements have been violated? Is it necessary for the Board to explicitly request enforcement action? Second, Mr. Lynch's comment concerning the limited resources of the Board is also true for the SEC. Are staffing and resource shortages responsible for the SEC's failure to act? If the SEC receives its current funding request, is it likely that enforcement of margin requirements will receive a higher priority?
>
> In light of the limited resources of the SEC and the Board, and the magnitude of other responsibilities, would it be beneficial to provide for a private right of action for the enforcement of margin requirements?

I am not familiar with the specific criteria used by the Commission in deciding whether to file an enforcement action for a violation of margin rules. I am also not aware of the nature or sequence of communications between the Commission and the Federal Reserve Board (the "FRB") concerning enforcement of the margin rules in the West-Point Pepperell case.

The Commission will not hesitate to enforce the margin rules where there are violations. Indeed, several counts in the Drexel complaint were based on margin violations, and the Commission recently commenced an action against Toronto Dominion Bank and others based, in part, on margin violations. The Commission does not require an explicit request from the FRB for the Commission to commence an enforcement action. However, the Commission's staff would normally seek the FRB's views on any interpretive question that might arise under the margin rules, and it is unlikely that the Commission would proceed with any enforcement action if the FRB took the position that a violation had not taken place.

104. In light of the limited resources of the SEC and the Board, and the magnitude of other responsibilities, would it be beneficial to provide for a private right of action for the enforcement of margin requirements?

Section 7 of the Exchange Act does not provide an express private right of action. While the Commission once supported an implied private right of action for borrowers, most courts have held that a borrower lacks standing to sue its lender for a violation of the margin rules.

The case law regarding whether there is an implied right of action for a tender offer target under Section 7 is unsettled, and the Commission has never specifically endorsed an implied private right of action for actions brought by tender offer targets under Section 7. Before endorsing this remedy, I would want to compare the benefits from private actions against the costs. In particular, I would want the Commission's staff to analyze the impact of widespread private litigation, which would create greater dangers of inconsistent interpretation of the margin requirements.

105. The Business Roundtable has challenged the SEC's "one-share/one vote" rule in the U.S. Court of Appeals. If the court overturns the SEC's action, what action would the SEC take on this issue?

There is not any reason to suppose that the Court of Appeals will not sustain the Commission's authority to issue the rule in question. However, in the event of an adverse result, the Commission will have to consider additional steps, including presenting this issue to Congress.

106. The twenty business day minimum offering period required by current SEC tender offer regulations often has proven inadequate to give most shareholders a full opportunity to receive, digest, and act on tender offer disclosures. Would it be preferable to increase the tender offer period to thirty-five business days? If a qualified employee stock ownership plan (ESOP) holds stock subject to the tender offer and announces an intention to make a substantially equivalent bid, the tender offer period could be extended, for as long as 95 business days. An ESOP would not qualify unless the plan owned at least 10 percent of the voting securities of the company for at least six months when the competing tender offer commenced. In your opinion, is it appropriate to provide an extended tender offer period for ESOPs or will this increase management abuses of ESOPs?

The regulations governing tender offers are designed to assure that shareholders have adequate time to make an informed investment decision. The Commission previously has stated that the minimum 20 business day period coupled with the additional requirement that an offer remain open for 10 business days following changes in the number of shares being sought or the price, and other extensions for material changes, provide adequate time for investors to make an informed decision. Additional delays do not appear necessary.

Limitations on the Commission's jurisdiction necessarily confine its interest in ESOPs to disclosure-related issues. The Department of Labor's Pension and Welfare Benefits Administration regulates the investment and fiduciary aspects of employee benefit plan participation in such transactions, while the Internal Revenue Service administers applicable tax provisions. Under ERISA, the use of an employee benefit plan, either offensively or defensively in connection with a takeover, may be illegal if deemed inconsistent with the best interests of the plan. ERISA provides that failure by the plan sponsor and other fiduciaries to establish and to operate a plan prudently and in the sole interest of employee participants will result in ERISA liability.

In considering any changes affecting ESOPs, Congress should take into account that its original purpose for ESOPs was to enhance employee ownership of U.S. corporations. This purpose does not appear to be served by favoring the use of ESOPs as a defensive takeover device. Moreover, Congress may wish to consider the extent to which ESOPs constitute a further subsidy for debt over equity financing, because of the special interest deductions provided for ESOP-related debt.

107. The repurchase of shares of stock by the issuing corporation from a shareholder at an excessive premium or greenmail is an abuse of corporate assets. Would you support limiting the payment of greenmail by giving a company the right to recover any profit by a person who sells the company its own stock, if that person held more than 3% of the stock and has held it for less than a year? Further, do you support permitting shareholders to sue derivatively to recover "greenmail" profits on behalf of the company if the company either fails to bring action within 60 days after the shareholder request or fails diligently to prosecute any such action?

Although the Commission proposed limitations on greenmail payments in 1984, it has since twice revisited that issue, in 1986 and 1987, and determined that the matter should be left to state law. If a board of directors fails to fulfill its fiduciary obligations, appropriate remedies are available under state doctrines of corporate waste and breach of fiduciary duties. An appropriate federal response to greenmail would be the use of disclosure mechanisms to alert remaining shareholders to a substantial securities repurchase and to the possibility of state law remedies. In addition, federal tax liabilities have been created that apply to certain greenmail payments, and in some state-law cases greenmail has been found to be unlawful.

108. "Golden parachutes" or payments in excess of three times annual compensation as defined by the Internal Revenue Service, would be prohibited in my legislation, unless affirmed by a majority of the outstanding voting securities of the company. Do you support this protection of shareholders?

In recent years, the Commission has deferred to state law with respect to golden parachutes, as a matter involving the duties of officers and directors and the internal affairs of the corporation. However, I am not unsympathetic to the desirability of reconsidering the necessity for a shareholder vote to approve any such plan that might reasonably be expected to have a material impact on the value of a corporation's shares.

109. "Poison pills" or issues of securities designed by corporate management to discourage a hostile merger could be limited by prohibiting such issues unless approved by a majority of shareholders or exempted by the SEC. Do you support limiting poison pills?

The Commission has devoted substantial attention to poison pills. It filed an amicus brief in the Delaware Supreme Court expressing concern with the effect that such plans may have on proxy contests and tender offers. It also issued a concept release to elicit public comment on what, if any, response should be taken by the federal government to the proliferation of such plans. The Commission subsequently determined not to support legislative curbs on poison pills because they involved matters of corporate governance traditionally subject to state oversight.

However, while the Commission in the past has determined not to respond to defensive measures adopted by management such as poison pills, I am not unsympathetic to the desirability of reconsidering the necessity for a shareholder vote to approve any poison pill or similar charter amendments that might reasonably be expected to have a material impact on the value of a corporation's shares.

110. The proxy voting process is currently subject to manipulation by corporate management with strong vested interests in the outcome of controversial issues put to a shareholder vote. I believe that pressure from corporate management on pension fund managers, institutional investors, and individual shareholders could be limited by providing for confidentiality in the proxy voting process. My legislation would require the

> SEC to promulgate regulations that require confidentiality in the granting and voting of proxies and that would provide for vote tabulation by an independent third party. Please comment.

The Commission, in reviewing disclosure made in proxy materials and otherwise administering the proxy rules, is engaged in an ongoing examination of these rules. In the past, the Commission also has urged careful study of proposals to change the proxy system prior to any legislative actions mandating such changes. This has included such proposals as mandating confidential voting and independent tabulation of votes as well as granting significant shareholders greater access to the corporation's proxy statement. Particularly in the case of fiduciaries voting securities on behalf of others, absolute confidentiality and the resulting lack of oversight may increase the risk that fiduciaries will vote the securities contrary to the interests of the beneficiaries. On the other hand, confidential voting may serve to eliminate any real or perceived coercion by corporate management on the voting decisions of employees. This is particularly significant at a time when, as a result of the proliferation of ESOPs, employees are gaining a greater say in corporate governance.

VIII. Questions from Senator Robert Graham

111. The '34 Act mandates that insiders are required to file (with the SEC) evidence of their transactions in their own companies stocks. This information is currently disseminated by much of the news media, including the Wall Street Journal and USA Today. Investors and investment advisors also gain access to this information via on-line computer services such as Dow Jones News Retrieval. A proposal is under consideration that would alter the filing requirement so that many of those officers who presently file will no longer have to do so. Since many middle management employees, that would be in a financial position to invest in their own company's shares, would have in their possession by nature of their duties, information not available to the general investing public, or even top management (i.e. faulty design problems, product development problems, slumping divisional sales), why does the public interest require doing away with this reporting requirement?

The proposed rules were not intended by the Commission to eliminate this requirement, but rather to modify the definitions now used in order to make the current disclosure more focused and meaningful. Under the Commission's proposal, the definition of "executive officer" now used in the Commission's proxy rules (i.e., president, any vice president in charge of a principal business unit or function, or any other person who performs a policy-making function for the company, and any officer of a subsidiary who performs a policy-making function for the issuer) would be used for this purpose. Principal financial officers, controllers or principal accounting officers and officers of a parent company who perform policy-making functions for the issuer also would be added.

Consistent with the statutory purpose and recent case law, an officer's title alone would not be determinative. Instead, an officer's executive or policy-making duties would govern. The Commission anticipates that there may be a reduction in the number of officers filing Section 16 reports with respect to companies that currently use a broader interpretation of the term and include all titled vice-presidents, regardless of duties. However, many companies already use the proposed definition for determining who is an officer for purposes of Section 16.

The designation as an officer for purposes of Section 16 has effects beyond reporting obligations. An officer also is subject to the short sale prohibition and to short-swing profit recovery for purchases and sales within a six month period, even if the officer was not in possession of inside information. Thus, it is important that the definition of officer be clear and limited to one that will achieve the statutory purpose. To the extent that persons outside the proposed definition come into possession of inside information and conduct transactions based on this information, they will be subject to the insider trading prohibitions of Sections 10(b), 14(e), and 21A of the Exchange Act.

In reviewing the public comments concerning this proposal, the purposes and benefits of these filings will be a very important factor. If confirmed, I will inquire very carefully as to the justification for any reduction in the scope of the current filing requirement.

112. This same proposal permits changes in filing requirements for corporate insiders with regard to the reporting of their employee stock options so that an insider will be able to defer reporting the fact that he has exercised options for up to a year after the event. Currently however, this information has been made available by the tenth day of the month following the event. Experts agree that investors, financial advisors, and stock analysts routinely use this information to make buy, sell, and hold decisions.

Since critics argue that it is the exercise of options, not the granting of them, that signals that an insider has made a "buy" decision, if this proposal is adopted, it will be possible for insiders to accumulate stock unnoticed for up to a year until they report those exercises on an annual filing.

As the practice of exercising options is the primary form of accumulation by insiders in large capitalization companies, critics also argue that insiders, seeking to avoid publicity of their trades, will alter their company option policies so that option buying will virtually replace conventional open market buying, creating a "loophole" in the system.

Since a year time lag for this type of reporting represents an eternity for today's

> markets where hundreds of millions of shares are traded daily, please explain why it is in the public interest to delay this reporting for as much as a year.

The Commission's original proposal has now been significantly revised, and the revised proposal is now subject to public comments. If confirmed, I will carefully review the comments concerning this important issue.

113. Have you undertaken a detailed cost/benefit analysis that demonstrates convincingly that any burdens of reporting are not outweighed by investors' need to know this important information so as to make fully informed investment decisions?

No, I have not undertaken any cost benefit analysis of this proposed rule. However, I would note that the Commission's proposing release summarized the costs and benefits of this proposal as perceived by the Commission.

IX. Questions from Senator Timothy E. Wirth

114. Bank Powers and Glass-Steagall

> One of the most important policy debates in recent years has focused on the powers and regulatory treatment of commercial and investment banks. You have made thoughtful and important contributions to this debate and, in the past, you had advocated bringing down the Glass-Steagall separations between commercial and investment banking.
>
> Do you believe the SEC or its chairman should take a position on whether or not commercial banks should be permitted to engage in the securities business?
>
> If Glass-Steagall is to be modified, would you agree that any major changes should be made by Congress and not regulatory agencies?
>
> What specific securities activities do you believe the commercial banking industry should be allowed to engage in? For example, should banks generally be permitted to underwrite corporate debt and equity securities?
>
> What regulation or safeguards, if any, would be appropriate or necessary, if banks were allowed to underwrite corporate equity?

I believe that the Commission should give Congress the benefit of the Commission's views as Congress considers how, or whether, to allow commercial banks to engage more fully in the securities underwriting business. The Commission has the best perspective on the risks, conflict of interest potential and structural problems that should be resolved prior to the time of any such Congressional action.

I strongly agree that modernization of Glass-Steagall should be accomplished by Congress. This is particularly important because regulatory modifications that would accompany any such change should be planned, not accidental.

I do not know of any aspects of the securities business that should be unlawful *per se* for banks. However, I do not believe that the Glass-Steagall Act should be modified until several related protections can be simultaneously adopted. First, most new and preexisting securities activities of banks should be required to be conducted in a separate securities affiliate under the exclusive regulation of the Commission. Second, the Bank Holding Company Act should be amended to allow non-banking financial companies to acquire banks without becoming subject to that act. Third, specific protections against undue conflicts of interest and other abusive practices should be adopted. These reforms could be accomplished in a manner that would permit reduction in the barriers to competition without creating excessive risks or other significantly adverse effects. The Commission has previously taken a generally similar position with respect to modification of Glass-Steagall. In so doing, the Commission appropriately suggested that Congress:

- consider means to limit the improper sharing of confidential client information among units of a diversified financial services company;

- examine potential conflicts of interest arising out of bank underwriting activities of securitized assets and of securities of bank borrowers;

- examine the conflicts of interest arising in transactions between bank trust departments and affiliated entities;

- consider prohibitions on banks from extending or arranging credit secured by, or for the purpose of purchasing, any security that is underwritten by a bank's securities affiliate or in which the affiliate is an active participant; and

- examine the possibility of requiring disclosure statements clarifying a bank affiliate's separate status.

115. Lessons of the Thrift Crisis

> Congress recently enacted the most far reaching government rescue program in our history. The financial problem in the savings and loan legislation is of enormous proportions -- the total cost to the government will far exceed the combined cost of the assistance provided to Lockheed, Chrysler, Penn Central, New York City and even the Marshall Plan.
>
> There is no single culprit behind the thrift crisis. But we all know that a few factors -- such as the rush to deregulate, imprudent industry responses to deregulation and

> inadequate supervision by regulators -- contributed substantially to the industry's decline.
>
> With this in mind, what do you believe are the most important lessons we should learn from our recent experience with the savings and loan industry? Are there lessons we can apply to the current debate about the powers of commercial and investment banking?

Some of the lessons that I have learned from the disaster in the thrift industry include:

- Accounting principles play a vital role in allowing regulators, policymakers and others to judge the condition of a financial institution. Distorted accounting principles adopted for "regulatory" purposes other than full disclosure can cause deteriorating trends to remain unnoticed.

- Capital plays an essential role in providing discipline for financial institutions to deter against unwarranted risk-taking, especially by institutions with federal deposit insurance. Capital standards set by supervisors are essential to establish a minimum benchmark for prudent operations.

- Disclosure policies for insured institutions and their securities should be established by an agency <u>other than</u> the primary bank or thrift supervisory agency to insure that risks tolerated by supervisory authorities would be publicly disclosed.

- Supervisory authorities must be allowed to take appropriate enforcement action free of political pressures -- from Congress or an Administration. Institutions engaged in serious fraud or other wrongdoing must not think that they can obtain political relief from enforcement action.

- Delay in resolving problem situations of deteriorating financial condition and violation of regulatory standards often results in much larger ultimate losses than would have resulted from swift enforcement action.

The thrift experience has largely confirmed my prior views rather than changing them. I have always believed in strict enforcement of safety and soundness standards. Government regulation should seek to establish and to enforce minimum standards and rules of conduct, including capital, accounting, disclosure and other regulations necessary to prevent fraud, manipulation or similar abusive practices. At the same time, market entry and exit, product offerings, pricing, locations for doing business, affiliations and other aspects of economic competition should be left to market forces as much as possible.

If anything, the thrift situation has also confirmed the absolute desirability of eliminating "regulatory" exceptions to the Securities Act and the Exchange Act, including the bank and thrift exemptions in Sections 3(a)(2) and 3(a)(5) of the Securities Act and the bank and thrift reporting provisions of Section 12(i) of the Exchange Act.

116. Globalization of Securities Markets

With the growing globalization of the securities markets, the SEC will face a number of important issues in the next few years -- from issues like international clearance and settlement to the potential standardization of securities regulation between nations. There is no question that these and other issues in the international arena will have a profound affect on the competitive position of the securities industry and our financial markets.

One of the most important issues involves continued access to international capital markets. In recent years we have witnessed a significant increase in the movement of capital without regard to geographic boundaries. Foreign offerings, euro-offerings, and multi-national offerings are established features of corporate finance and undoubtedly will become a more important source of capital for U.S. companies in the future.

What actions should the SEC take to enhance the ability of U.S. companies to raise capital in this emerging world market? Would a standardized system of disclosure for world-wide offerings create an environment to promote capital formation throughout the world?

In an increasingly competitive international market, some have questioned whether the U.S. can keep our financial markets both competitive <u>and</u> well policed at the same time. Do you share this point of view?

I do <u>not</u> believe that investor protection and international competitiveness are inconsistent. Investors around the world are concerned with the safety of their investments, which requires a "well-policed" system to prevent fraud, manipulation and other abuses. International competitiveness can be enhanced by flexibility in applying traditional standards and concepts, and in some areas by substantial streamlining of inefficient or unnecessary programs. However, stable and honest markets also can be a significant competitive advantage, and basic core protections of our system should be consistently applied.

Standardized disclosure, accounting and auditing standards would enhance the ability of U.S. companies to raise capital at the lowest cost in a worldwide market. They might also contribute to greater efficiency in global capital formation. Unfortunately, truly standardized disclosure, accounting and auditing standards may not be achievable over the near term. Substantially increased systems for multijurisdictional offerings, based on mutual recognition of established systems of securities regulation, offers the much more immediate prospect of achieving many of the same results as standardization. Mutual recognition would also eliminate many of the incentives for excluding U.S. shareholders from largely foreign offerings.

117. <u>Foreign Investment</u>

In recent years, some, including several Members of Congress, have focused increased attention on the level of foreign investment in the United States. As foreign investment has increased, so has the interest to restrict foreign participation in our markets.

In my view, some of the proposals to limit foreign investment are shortsighted and could work to damage our economy. It seems to me that access to capital -- regardless of its source -- is critical to American industry and continued economic growth.

I would be interested in your thoughts on foreign investment in the U.S. and its impact on economic growth and job creation. At this time, do you see any reason to act to restrict foreign investment in the U.S.? What do you see happening if we act to restrict foreign investment in the U.S.? How would this impact American companies doing business abroad?

I share the view that having the widest possible access to both domestic and foreign capital promotes economic growth and job formation in the U.S. Restricting foreign investment in the U.S. would tend to increase the cost of capital in the U.S., thereby making U.S. companies less competitive internationally. Even trying to isolate the U.S. from global capital markets would cause enormous harm to U.S. financial markets, U.S. issuers of capital and their employees, and savers and investors in the U.S.

118. Economic Effects of LBOs

> The leveraged buyout has become one of the most talked about and perhaps least understood methods of financing a business. The sheer size of some recent transactions has focused attention on LBOs and, in some cases, distorted the public's perception of LBOs.
>
> In the wake of an avalanche of publicity about LBOs, some have advocated reforms, either in our tax laws or the securities laws. However, I think it's clear that a quick fix is not possible or practical.
>
> We know that an excessive reliance on leverage can create a number of problems for a company. But we also know that leverage can increase productivity and result in a more efficient use of resources, which increases our ability to compete in the international marketplace.
>
> Do you see any reasons to be concerned about the number or size of leveraged transactions in the economy? If so, what steps would you recommend to restrict LBOs?
>
> What can we do to more fully understand and track the impact of LBOs on the economy? Should the government, through the SEC or some other agency, be required to collect data on LBOs and their impact on employment, research and development, etc.

Initially, I would like to underscore your point, which is often overlooked, that leverage can have beneficial effects on a corporation's efficiency and competitiveness. When a corporation increases leverage, the corporation and its lenders review its ability to service its debt under all types of economic conditions. While some commentators argue that with increased leverage U.S. corporations will be unable to compete with Japan, Japanese firms are significantly more levered on average than U.S. firms. Leverage also can strengthen managerial incentives to maximize earnings and value.

The increased leverage of American corporations is a matter that should be of concern, at least to the degree that we should understand the trends at work in our market and the factors affecting such trends. Rather than making policy based on anecdotal or isolated situations, we should track and carefully analyze empirical data regarding the nature and effects of such transactions over time.

I do not currently favor any steps to restrict LBO transactions as a class. However, regulators should carefully monitor the risk to banks, thrifts, insurance companies and other regulated lenders who finance LBOs. At the same time, the primary concern of the Commission should remain full and fair disclosure to protect individuals, in financial institutions and mutual funds that invest in noninvestment grade bonds.

119. As you know, after the October 1987 market break the Brady Commission recommended that one agency should coordinate regulatory issues which have an impact across related market segments. For example, in Japan and the U.K., one agency regulates both the traditional securities markets and the markets for derivative products.

What is your view on the separate SEC-CFTC jurisdiction over financial instruments? How do you believe the current regulatory structure in the United States impacts our competitive position in international markets?

I believe that Congress should decide the issue of separate SEC/CFTC jurisdiction. Many argue that unified regulatory jurisdiction over financial instruments would eliminate numerous regulatory disparities. However, regulatory differences often exist within a single "MOF"-style agency. In addition, a single agency is much more vulnerable to mistakes of judgment due to the absence of other senior-level regulators to act as a check and balance against unwise decisions.

Having two different agencies governing related products, even within a single broader market, does require the agencies to cooperate on common operational or supervisory issues. Comparison of the records of the thrift industry, with a single all-powerful regulator, and the commercial banking industry, with three separate agencies, does not suggest any inherent advantage from having a single regulator.

While having two different agencies need not prevent workable supervision and regulation, the lack of clarity as to jurisdictional authority does adversely affect U.S. competitiveness. This occurs due to both higher nonproductive overhead (to finance litigation), and also the disincentive to bringing new products to market that is caused by such uncertainty. Consequently, I believe that pending any broader action by Congress, the SEC and CFTC should try to develop mutually acceptable proposals to define product and jurisdictional lines. Most importantly, the "exclusivity" feature of the current Commodities Exchange Act needs to be repealed to permit efficient allocation of regulatory authority over particular products.

120. Individual Investor Confidence

> From all reports, it appears that individual investors have not been a large participant in the most recent market rally. In fact, the individual investor has remained on the sideline since the October 1987 market break. Meanwhile the markets have become increasingly institutionalized.
>
> How important is the individual investor to the markets and what specific measures, if any, do you believe should be initiated to restore investor confidence and bring the individual investor back into the markets?

In recent years, many individuals have made collective investments in securities through pension plans and mutual funds. However, individual investors in individual securities continue to play an important role in the nation's markets. Indeed, the most recent survey of stockholding by the NYSE, as of mid-1985, showed that more than 47 million Americans owned stock in a publicly-traded company or a stock mutual fund.

One of the most effective means to increase individual investor confidence and participation in the market is for the Commission and other regulatory agencies and self-regulatory organizations to enforce aggressively rules against insider trading, front-running, and other manipulative practices that compromise the integrity and fairness of the markets. In addition, tax policies that operate to disadvantage or discourage savings in general, or securities holdings in particular, should be reexamined. Finally, the industry needs to reexamine the convenience and cost of individuals acquiring or disposing stock, and the public's perception of the safety and prudence of investing.

121. Arbitration

> Do you believe that arbitration is an appropriate forum for settling disputes between a broker-dealer and a customer? Do you believe it is appropriate for a broker-dealer, as part of a new account agreement, to require a customer to agree to arbitration proceedings in the case of a dispute?

Arbitration can be an appropriate forum for settling disputes between a broker-dealer and a customer. Indeed, arbitration is an important alternative to litigation in many contexts, including alternative securities markets. However, the rules governing arbitration must be both fair, and perceived to be fair, to both broker-dealers and their customers.

Earlier this year the Commission approved a series of SRO rules designed (1) to improve the procedural fairness of SRO-sponsored arbitration, (2) to assure that investors received adequate notice of whether a contract contained an arbitration clause and of the basic differences between the resolution of disputes through arbitration vis-a-vis litigation, and (3) to prohibit agreements that limit or contradict the rules of any SRO or limit the ability of a party to file any claim in arbitration or the ability of arbitrators to make any awards.

122. Accounting

> The SEC has extensive regulatory and oversight responsibilities with respect to the accounting profession pursuant to the Securities Exchange Act of 1934.
>
> In the past few years, the House Energy and Commerce Committee has conducted a number of hearings concerning the effectiveness of the SEC's oversight responsibilities with respect to the accounting industry. One result of the hearings was the establishment of the Treadway Commission, which issued recommendations on ways to detect and deter financial fraud. As I understand it, many of the Treadway recommendations directed at the accounting profession have been implemented, including the adoption of a series of new auditing standards that clarify auditors' responsibility for detecting fraud.
>
> As you know, several mergers among the Big Eight accounting firms are pending. These developments are, in part, a response to the

> globalization of business and markets and the premium on competitiveness these new dynamics require. In addition, the profession is grappling with the difficult problem of increasing liability.
>
> With the above in mind, I am interested in learning what specific objectives and policies you want the SEC to accomplish with regard to the accounting profession.

The importance of full financial disclosure was recognized at the time the Securities Act was enacted, and its significance continues undiminished under our current integrated disclosure system. While primary responsibility for the provision of accurate, reliable and timely financial information rests with management (subject to oversight by the board of directors), independent accountants play an important role in assuring that honest information concerning their clients reaches the public.

The object of the Commission's accounting program is to ensure compliance with the accounting and financial disclosure aspects of the federal securities laws. This program is carried out through four closely-related activities that result in an active and visible presence in the accounting area: (1) the review and comment process; (2) the enforcement program; (3) the oversight of private standard-setting; and (4) rulemaking. The Commission's oversight of accounting practices and standards is a key element in maintaining the full disclosure system and in assuring that public investors receive useful, reliable information.

123. Commission Vacancies

> Several other vacancies are likely to be filled on the Commission in the near future. Do you expect to be in the position to advise the President with respect to candidates for vacancies on the Commission? If so, what criteria will you employ in making your recommendations to the President?

Yes, I expect to have a voice in the selection of candidates for vacancies on the Commission. I would recommend persons with the best possible combination of intelligence, public and private experience, judgment and character in filling these positions.

X. Questions from Senator John Heinz

124. On August 18th, the United States Court of Appeals for the Seventh Circuit in Chicago Mercantile Exchange v. SEC set aside SEC orders approving the applications of three securities exchanges to trade index participations. The Court held that if an instrument is both a security and a futures contract then the CFTC has exclusive jurisdiction over the instrument.

a. The Seventh Circuit panel viewed this case as a repeat of the jurisdictional dispute between the SEC and CFTC that occurred in 1981 over the trading of options on Ginnie Maes and predicted that with the inevitable creation of novel instruments with attributes of both securities and futures "[o]nly merger of the agencies or functional separation in the statute can avoid continual conflict." Do you agree with this prognosis?

Since this case is still on appeal, I do not think it appropriate to concede the validity of the decision of the panel regarding the scope of the exclusivity provision in the Commodity Exchange Act. This is especially true given the SEC Savings Clause in that legislation, and the longstanding intent of Congress that the SEC should have jurisdiction over securities instruments broadly defined.

Products that are not largely or exclusively futures products should not, in my opinion, be subject to exclusive jurisdiction of the CFTC or a requirement that they be traded on a futures exchange. For example, a hybrid product with characteristics that were 99% those of a security and 1% "futurity" should not trigger exclusive CFTC jurisdiction.

I believe that it may prove useful, in light of this decision, for Congress to clarify the jurisdictional lines between the agencies. Ideally any legislation would be based on recommendations by the Commission and the CFTC. Any such clarification should eliminate the exclusivity provisions of the Commodity Exchange Act, at least as to all products that could be deemed to be a security. Just as banking products may be regulated by any one of three different federal agencies, there is not any conceptual reason why a financial product with some element of futures characteristics could not be traded or regulated through either a securities or futures exchange.

125. b. Assuming solely for arguments sake that the court's reading of the Commodities Exchange Act is correct that the CFTC has exclusive jurisdiction over all instruments that have attributes of both securities and futures, do you agree with the court's observation that "if both categories [of securities and futures] expand, then the SEC's jurisdiction shrinks"? If so, what are the regulatory and market implications?

If the court is correct that the CFTC possesses exclusive jurisdiction even where a trivial portion of a product's overall characteristics involve some degree of futurity, then there would be highly negative implications for both the Commission and overall market regulation. In essence, the Commission's jurisdiction would shrink steadily, probably together with that of the bank regulatory agencies.

Over time, if hybrid products become more common, the CFTC's role would expand well beyond its current scope, as would be true with the futures exchanges as well. Finally, the development of new securities products would be inhibited due to the risk that any new product subsequently might be found to be "tainted" with some element of "futurity."

7

Several innovative products, such as swaps and commodity-backed bonds, cannot as a practical matter be traded and cleared through futures markets and associated clearinghouses due to certain inherent characteristics of such systems. In my opinion, this interpretation of the law could stifle innovation, and reduce the overall competitiveness of U.S. securities markets internationally in a manner that was never considered or intended by Congress.

126. c. The Seventh Circuit panel acknowledged that its decision did not reflect a value judgment as to which agency was best equipped to regulate index participations. In your judgment, which agency is best able to regulate this product, and why?

As the Commission discussed in its order approving the exchange proposals to trade index participations (IPs) and indicated in its Petition for Rehearing in this case, the securities markets may be better suited for IPs trading than the futures markets. IPs were designed as a product to appeal to retail investors, who, as a rule, participate less frequently in the futures markets. In addition, many potential IPs investors may be effectively prohibited from participating in the futures markets as a result of regulatory constraints or contractual provisions.

127. d. In your view, should the inventors of innovative hybrid products such as index participations be able to decide which exchange is best suited to its product? Does it make a difference in which exchange or under which set of rules or regulations hybrid products are traded? If so, why?

I do not believe that the exchanges that developed these new products should be denied the legal right to compete with futures exchanges by offering this product to their customers. Indeed, under the 1982 SEC-CFTC Jurisdictional Accord, the SEC has jurisdiction over options on foreign currency if they are traded on national securities exchanges, and the CFTC has jurisdiction over such options if they are not traded on a securities exchange. This is a similar process to that in effect for all banks or thrift institutions, which are regulated based on the type of charter each firm selects.

The Commission has stated on several occasions that the regulatory and market structures under which a product is traded can make a difference. For example, due in part to the separate clearing systems utilized by each futures exchange, trading on a futures exchange would reduce the possibility of competition in any such product among various exchanges. Similarly, the retail orientation of the securities markets may be better suited for a product like IPs than the more institutional character of the futures market. Finally, futures regulation may create difficulties for many types of hybrid instruments.

An example of the latter type of problem is the case of debt instruments with returns linked to the movement of a stock index, foreign currency, precious metal, or oil. This has been the most common type of hybrid instrument in the U.S. capital markets to date. Requiring those instruments to trade exclusively on a board of trade would have constituted a serious obstacle to the development of these products. The exclusivity requirement would remove these products from the over-the-counter market, where most corporate debt instruments trade. This could discourage their purchase by persons or institutions who either choose not to trade in the futures markets, or are prohibited from doing so. Futures market regulation also is not designed to focus on disclosures relating to particular issuers, information that is particularly important for this type of hybrid instrument.

Rather than courts or agencies deciding the exchange on which new hybrid financial products must be traded, it would be better to leave that decision to the private market. For example, one possible approach to the jurisdictional issue would allocate jurisdiction based on whether a hybrid product is accepted for trading on a securities or futures exchange. In either case, the SEC or CFTC, respectively, would apply its normal regulatory oversight and the same rules that it applies to other instruments traded on the same exchange. In this manner, the public would be guaranteed all of the protections associated with products traded on the same exchange, yet innovation would be protected and unnecessary litigation avoided.

128. On May 25, 1989, the SEC adopted Rule 19c-5 under the Securities Exchange Act to prohibit any options exchange from restricting the listing of any new stock options class to a single exchange. The rule repeals the Allocation Plan for exchange listed options approved by the SEC in 1980 and eliminates all restrictions on the multiple trading of options.

a. At the time restrictions on the multiple trading of exchange listed options were approved by the SEC in 1980, the Commission contemplated the development of a market integration system that would alleviate many of the market structure and investor protection concerns (e.g., market fragmentation, trade-throughs and order routing practices) posed by the multiple trading of options. In approving Rule 19c-5, the SEC stated that "there are sound reasons for pursuing the development of market integration facilities." Do you agree? If so, what role should the SEC play in facilitating the development of an integration system?

Yes, I agree that market integration facilities would be useful. The SEC should maintain an oversight role, since it would have to approve any exchange proposals regarding integration systems. However, the private sector should select and design specific market integration facilities, if any. The Commission should only take direct action through rulemaking if divisions among the options exchanges make the development of needed market integration facilities otherwise impossible.

129. b. If integration facilities are feasible and cost beneficial, are there advantages to having all options exchanges joined by the linkage system?

Yes, although there may also be costs or disadvantages.

130. c. Following the adoption of Rule 19c-5, certain of the options exchanges initiated a study to determine the feasibility of developing market integration facilities. These exchanges have expressed concern that implementation of multiple trading pending completion of this study and the development of integration facilities may be counterproductive. Should the SEC consider the deferral of Rule 19c-5 if the development of integration facilities appears imminent?

Yes, I believe the Commission should consider deferral if implementation of integration facilities was imminent, although I cannot commit the other Commissioners to this position.

131. The recent controversy surrounding Sir James Goldsmith's tender offer for British American Tobacco (B.A.T.) has brought into focus the question of the extraterritorial application of U.S. securities laws. The transaction was apparently structured to avoid the jurisdiction of the federal securities laws, purportedly because compliance with our laws was viewed as both costly and time-consuming. As a result, U.S. shareholders of B.A.T. have been excluded from participating in the offer.

a. How do you reconcile the fact that laws designed to protect U.S. investors may have the effect of depriving these investors of participation in offers made to non-U.S. shareholders?

b. How should the SEC balance its mandate to protect U.S. investors with the goal of fostering an international securities market?

c. When should the federal securities laws apply to transnational securities transactions? In other words, where should the jurisdictional lines be drawn?

The increasing internationalization of securities transactions and markets may be the single greatest factor affecting the Commission in the years ahead. Issuers will increasingly offer securities in a variety of markets. In this environment, U.S. investors and markets could be disadvantaged seriously if foreign or U.S. issuers choose to eschew U.S. markets due to the costs and delays associated with complying with U.S. law.

If confirmed, I will encourage the Commission to explore ways to remove U.S. regulatory disincentives for extending offers to U.S. holders on equal terms with those of other shareholders, where the home country's regulatory scheme is adequate to protect the interest of investors and the percentage of shares held by U.S. persons is limited. However, deferral to other registration or disclosure systems would not extend to eliminating jurisdiction with respect to fraudulent conduct that adversely affects U.S. persons, which should be retained.

The Commission has proposed a limited multijurisdictional system for disclosure with respect to rights offerings and cash and exchange tender offers involving Canadian companies. This proposal is an attempt to respond to the realities of our international capital markets in a positive and constructive manner.

In addition to mutual recognition systems for offerings, the Commission needs to be sensitive to the impact of international differences in accounting standards. While core U.S. standards should not be weakened solely due to international differences, the Commission must be prepared to reexamine past practices to avoid any unnecessary disadvantage for U.S. firms, markets or investors.

132. The SEC has under consideration recommendations to revise Rule 13e-3 regarding "going private transactions." The recommendations include broadening the scope of the rule to require disclosures in all negotiated transactions, not just those initiated by an unaffiliated third party. This revision is intended to address the concern that management is at times on both sides of an LBO transaction, whether directly as part of the buyout group, or indirectly, as a potential recipient of an offer to participate in the transaction.

Do you support broadening the scope of Rule 13e-3 in this manner?

The Division of Corporation Finance is preparing a rulemaking proposal for Commission consideration that would amend the transactional disclosure requirements to enhance shareholder analysis of extraordinary corporate control transactions recommended or approved by the board of directors. The proposals would amend Rule 13e-3 to ensure that its disclosure requirements reach all going private transactions in which management has a significant interest. The proposals also would impose a new set of disclosure requirements upon issuers engaged in all negotiated extraordinary corporate transactions affecting control of the company, such as mergers, acquisitions and sales of assets, as well as certain issuer tender offers and buybacks, recapitalizations and reorganizations. The proposals would require a detailed description of the factors supporting the target company's recommendation or approval of the transaction to its security holders, including information about the board's evaluative processes and the intrinsic values of the transaction and the target company.

While I generally agree with the goals of the staff's proposals, I have not had the opportunity to study the proposals in detail. Therefore, I must reserve judgment as to whether I would support them if presented to the Commission.

133. **Is disclosure sufficient to address actual or perceived conflicts of interests of management or are substantive rules warranted?**

The Commission previously rejected a substantive fairness concept in Rule 13e-3 transactions in light of opposition by commentators, the implication of the Supreme Court decision in Santa Fe Industries v. Green, and the potential administrative problems of such a requirement. The Commission instead decided to leave the substantive law of fairness to the states and to require certain disclosures to allow security holders to view the transaction from management's perspective including the purpose of the transaction, the alternatives considered, and the advantages and disadvantages to all parties.

The concept of fairness under state law historically has recognized fairness as a range and has recognized that a "fair price" is not necessarily the highest price currently obtainable. This historic view of fairness may reflect in part the inexact nature of modern valuation techniques and the difficulty in predicting the highest currently obtainable price, particularly in a highly active market environment.

Recent case law suggests a change in this historic view and may require fairness to reflect the highest price currently obtainable. Moreover, experience has shown that state courts will entertain legal challenges to the fairness of going private transactions and will provide shareholders with the appropriate legal remedies.

As indicated in the release adopting Rule 13e-3, the Commission continues to monitor developments in this area and the efficacy of the rule. The Commission vigorously enforces the existing disclosure requirements of the rule by improving disclosure through the comment process and when necessary instituting enforcement actions.

134. Rule 13e-3 currently requires disclosure of the "fairness" of transactions to shareholders. Are subjective concepts such as fairness meaningful in the context of disclosure or would comprehensive disclosure of more objective data relating to value of the company (e.g. break-up value) be more helpful to shareholders attempting to analyze the merits of the offer.

The Commission's disclosure requirements currently are designed to elicit objective information to allow shareholders to make an independent assessment of the fairness of the transaction and the adequacy of the consideration. For example, Item 8 of Schedule 13E-3 requires that the issuer and any affiliate engaged in the transaction not only state whether each reasonably believes that the transaction is fair to unaffiliated shareholders, but also that such party discuss the factors (including liquidation value) and weight to be given the factors important to determining fairness. This would include the analysis and conclusions with respect to each factor, as conclusory statements are not considered sufficient disclosure.

In connection with the proposals to amend Rule 13e-3, I understand that the staff is currently considering ways to develop a more comprehensive list of factors normally considered in these transactions. If confirmed, I would inquire thoroughly into these issues.

XI. Questions from Senator Alfonse M. D'Amato

135. Glass-Steagall

> Is it your impression that the thrift legislation has taken us closer to, or farther from, a consensus on Glass-Steagall reform?

It does not appear that the process of enacting the thrift legislation has affected the level of support for repeal of the Glass-Steagall Act. The thrift crisis does, however, illustrate the need to accompany any revision of Glass-Steagall with adequate supervision of any new securities powers given to banking organizations. Reform of the regulatory structure must be an integral part of any change in "powers," not simply an after thought.

136. Glass-Steagall

> The Cranston-D'Amato-Garn approach to financial services reform gives all companies the opportunity to get into the banking business and the securities business providing they meet the stringent firewall, functional regulation and other requirements: Do you agree or disagree with the breadth of this approach?

I generally support a broad approach to reform that considers powers, conflicts of interest, regulatory structure and stability concerns simultaneously. It would be particularly unwise to commence full-scale activities in securities markets without making necessary revisions in the regulatory structure at the same time.

XII. Questions from Senator Christopher S. Bond

137. Should U.S. securities laws apply to a takeover battle between two foreign companies if there are substantial U.S. holdings of one of the companies?

The presence of assets in the U.S. owned by a foreign issuer of securities, without any other jurisdictional nexus, has never been sufficient to create jurisdiction under U.S. securities laws over such issuer or its securities outside the U.S. This traditional legal standard recognizes the practical limits of extraterritorial application of U.S. law, as well as principles of international comity.

138. We have a system of country-by-country securities regulation which in many ways is not compatible with global financial markets. How can our regulatory structure be updated to reflect the realities of truly international financial markets? How can we avoid a competition in laxity as countries compete to attract securities business?

Increased regulatory coordination and mutual recognition of home country securities laws can increase the efficiency of the global capital markets, while assuring investor protection. Under such a system, an American prospectus could be used, for example, to offer securities simultaneously in the U.S., Canada, U.K. and Japan. Similarly, in certain types of situations a U.K. disclosure document would be recognized in the U.S. and other countries.

Similarly, coordination and accommodation of legitimate, ordinary course foreign market practices will most likely prove to be the most practical and timely means of addressing differences in stabilization and other distribution regulations among jurisdictions.

The alternative to a "mutual recognition" system would be the development of common international standards. Such standards could cover matters such as disclosure requirements, accounting principles, and audit standards.

Fortunately, these two approaches are not mutually exclusive. The Commission should continue to work with the International Accounting Standards Committee and the International Federation of Accountants to develop acceptable uniform international accounting principles, auditing standards, and auditor independence standards. Such international standards, accepted as assuring sufficiently reliable and relevant disclosure, would greatly reduce issuers' costs, provide investors with adequate and comparable financial information and would not unduly disadvantage U.S. issuers in the U.S. market. However, development of such standards will almost certainly require a long-term effort, because of the substantial variation among jurisdictions.

Despite increased competition between the world's securities markets, a "race to the bottom" must be avoided. Notwithstanding the desirability of facilitating international markets, the U.S. should continue to insist on core protections for U.S. markets and investors. At the same time, the Commission must seek to encourage its foreign counterparts to move toward standards that would reduce the costs or disadvantages to firms adhering to U.S. standards.

139. The philosophical basis of our securities laws is full disclosure to investors and neutrality between bidders and targets. Are these principles still valid in this new global environment?

Yes. I continue to believe that full disclosure and neutrality best serve the interest of shareholders. If anything, more complex and widespread investment opportunities on a transnational basis make it more important to allow each investor to make independent investment decisions based on full and fair disclosure and personal choice.

140. The North American Securities Administrators Association has estimated that U.S. consumers are robbed of two billion dollars a year by penny stock swindles. In testimony before the Energy and Commerce Committee, the Utah securities commissioner stated, "With very few exceptions, the non-NASDAQ over the counter penny stock market no longer fulfills its traditional role as the cradle for America's new start up companies and expanding firms. Instead the penny stock market has been flooded with spurious and insubstantial schemes dreamed up by profiteering brokerage firms and behind the scenes manipulators, who include chronic securities law violators, convicted felons and organized crime figures." Do you agree that the problem with penny stock fraud is this serious?

I do not have any independent information concerning the extent of this problem. Penny stock fraud is a very serious matter. The number of complaints from investors has risen sharply, and the number of enforcement referrals from broker-dealer examinations has also risen sharply. Investors who are defrauded in penny stock manipulations, and others who learn of such abuses, may lose confidence in the securities market and not invest in legitimate small businesses. This hurts the capital-raising efforts of small companies and, consequently, the nation's economy.

If confirmed, I will strongly support efforts to attack this problem. Penny stock fraud manipulators will be vigorously prosecuted, and I will support legislation giving the Commission authority to impose fines upon persons who violate the federal securities laws. Finally, the Commission should continue to explore regulatory initiatives that can improve protection for penny stock investors.

141. SLERA

> Does the SEC need additional legal authority to go after this fraud? Are the additional powers in S. 647 sufficient? How do we go after the chronic securities law violators who are not deterred by civil fines?

The Commission has requested additional enforcement authority to prosecute penny stock fraud and other serious securities law violations. The sanctions proposed in S. 647 are intended to enhance the Commission's enforcement ability in several important respects. For example, by altering the economic consequences of the violations, the addition of the penalties provided by the bill to the Commission's enforcement arsenal should deter those who would commit securities law violations for financial gain. These penalties also should deter persons who violate the securities laws in spite of the prior imposition of other remedies against them for the same or similar conduct. A money penalty should give the courts and the Commission greater flexibility to tailor a remedy to the gravity of the violation.

Criminal prosecution often would be available with respect to chronic securities law violators who are not deterred by civil fines. In the past, the Commission has often determined that many enforcement actions it brought did not warrant criminal prosecution. However, in areas of widespread abuse, criminal fines and imprisonment may be necessary to restore a climate of deterrence, and respect for the law.

XII. Questions from Senator Connie Mack

142. PUHCA

Are you generally familiar with the Public Utility Holding Company Act of 1935 (the "1935 Act") and the Commission's duties thereunder?

Yes.

143. Are you aware of the Commission's prior recommendation that the Act be repealed?

Yes. For many years the Commission has supported legislation to repeal the 1935 Act, or at a minimum to transfer the Commission's responsibilities to another agency. Support for repeal of the 1935 Act is not universal. Different utility companies have both supported and opposed efforts to repeal the statute. In addition, certain consumer-oriented groups have opposed repeal of the statute.

144. We assume you are aware that the Bush Task Force on Regulatory Relief recommended that the Act be repealed. Do you concur in that recommendation?

Yes.

145. Are you familiar with proposed Rule 17 under the Act?

Do you favor the adoption of that or a similar rule relating to diversification by exempt utility holding companies? If so, would you explain why?

I am generally aware of the provisions of proposed Rule 17, but I have not reviewed it in detail. I continue to support an outright repeal of the Public Utility Holding Company Act, or at a minimum transfer of responsibilities to a more appropriate agency. If the statute is not repealed, the Commission must attempt to enforce its provisions in a sensible and efficient manner. Proposed Rule 17 includes artificial percentage limitations on non-utility businesses that are not set forth in the statute. Such artificial restraints on competition should be intensely scrutinized to determine whether they are absolutely necessary to achieve statutory purposes.

146. Are you familiar with the "Casey/Loomis" guidelines concerning diversification by exempt utility holding companies set forth in the 1973 Pacific Lighting case?

The "Casey/Loomis Guidelines" were standards articulated by these two commissioners concerning investments by exempt holding companies in non-utility businesses.

147. Do you believe that those guidelines should still be applied by the Commission? If not, do you favor any revision of those guidelines or should they be abandoned altogether?

I do not currently have a view concerning whether these guidelines should continue to be applied. This issue will, of course, be part of the Commission's rulemaking proceeding as it considers Rule 17. Therefore, I would give close attention to this question, and all public comments, at that time.

XIII. Questions from Senator William V. Roth, Jr.

148. What is your general philosophy regarding hostile takeovers, LBO's and MBO's. Do you believe there are some rules governing the marketplace that should be changed? If so, which?

As set forth in the Williams Act, federal law has long sought to protect shareholder rights in corporate control contests. These include full disclosure of information shareholders need to make an informed investment decision, and procedures necessary to create an environment conducive to a sound investment decision (minimum offering period, price adjustments, proration, and withdrawal rights).

Federal law requires disclosure by both those seeking securities through a tender offer, and those who are accumulating shares through other means once their holdings exceed a 5% threshold. Finally, it penalizes fraud, manipulation and other abusive practices. Thus, federal law establishes a neutral policy -- sometimes characterized as "a level playing field" -- whose objective is full disclosure to shareholders and protection of their ultimate ownership rights.

I generally believe that the federal policy set forth in the Williams Act is correct. It is also extremely important to maintain an integrated national securities market that will facilitate the raising of capital and enable U.S. markets to remain internationally competitive.

If confirmed, I intend that the Commission will continue to monitor its disclosure requirements to ensure that security holders are adequately protected. Thus, the Commission is presently examining the adequacy of its disclosure requirements with respect to management buyouts and other negotiated transactions, as well as disclosure to debt holders. I would support proposals to close the so-called "13(d) window," such as by reducing the filing period to five business days, with an automatic standstill in purchases until a filing is made.

149. Are you concerned by the level of debt involved in LBOs? Are you concerned by financial institutions holding such debt? If so, how would you address these concerns?

Yes, I am concerned about the degree of leverage of certain issuers of securities, as well as the issue of overall debt levels. Ultimately I believe that the current tax provisions that penalize the use of equity capital by U.S. corporations should be altered, as this imbalance is a factor in many transactions in which debt financing is used to buy out shareholders' equity.

150. The current effort of Hoylake to take over B.A.T. raises the question of what mechanism should there be to govern transactions with multinational aspects. As a matter of policy, in such a situation should U.S. shareholders receive the protections of U.S. law, British law, or none at all? What are your thoughts jurisdictionally regarding this type of takeover?

The staff of the Commission has determined that the Commission does not have regulatory jurisdiction under U.S. law over the B.A.T. offer. The Commission cannot act where it does not have regulatory jurisdiction. Of course, antifraud liability might apply if the offer were to effect a fraud on investors in the U.S.

Unfortunately, U.S. investors are often prevented from participating in rights offerings by foreign firms and tender and exchange offers for foreign firms, because of the costs and delays associated with complying with U.S. law, even where the percentage of shares held by U.S. persons is insubstantial. I support efforts to find ways to remove U.S. regulatory disincentives for extending offers to U.S. holders on equal terms with those of other shareholders, where the home country's regulatory scheme is adequate to protect the interest of investors and the percentage of shares held by U.S. persons is limited. Of course, jurisdiction over fraudulent conduct that adversely affects U.S. persons should be retained.

151. Do you believe that our securities laws are a bit dated? If so, what general problems are not adequately addressed by current law?

Yes, I believe our basic financial services laws, including the securities laws, would benefit from modernization. Current law often excessively restricts competition, which is critical to maintaining U.S. efficiency and competitiveness in a global marketplace. Improvements in the regulatory structure itself should also be made to improve our ability to maintain the integrity and stability of the markets and to achieve greater consistency in regulation.

152. What do you believe to be the role of the SEC in improving our competitiveness as a nation?

The SEC can contribute to improving the nation's competitiveness by continuing to ensure the integrity of the markets through enforcement and regulatory initiatives. Ensuring the honesty and fairness of the securities markets encourages participation of investors in the market, thereby promoting capital formation. The Commission must also continue to eliminate unnecessary regulation that increases the costs to issuers of raising capital in the U.S. Finally, the Commission should continue to encourage foreign securities authorities to allow U.S. issuers and market participants greater access foreign markets. Taken together, these steps to encourage savings and investment and to reduce the cost of capital can positively affect growth, employment and prosperity of the U.S.

153. Glass-Steagall Repeal

> Should banks be allowed to own securities firms and vice versa? Should Glass-Steagall be repealed?

The Commission has supported repeal of the Glass-Steagall Act, so long as repeal is accompanied by the requirement that banks conduct most of their new and existing securities activities in separate securities affiliates or subsidiaries subject to Commission regulation.

The Commission has also stated that securities firms should be permitted to engage in the full range of banking activities, subject to banking regulation. I agree with the Commission's basic position. However, I do not believe that the Glass-Steagall Act should be repealed unless the Bank Holding Company Act is also substantially amended to make it possible for firms that are not predominantly engaged in banking to own a bank without being regulated as a bank holding company. In addition, other appropriate reforms of regulatory structure and conflict of interest provisions would have to be enacted simultaneously.

XIV. Questions from Senator Nancy L. Kassebaum

154. We are rapidly entering a market where financial instruments will have both securities and futures features. I am concerned that our present regulatory structure is not designed to regulate such hybrid instruments. Such regulation, however, must not fall through the cracks. Do you have any ideas as to how the SEC and CFTC can better coordinate the regulation of such instruments?

Yes, I believe that there are several areas in which the SEC and CFTC may improve supervision over hybrid financial instruments. One important reform would be the repeal of the exclusivity provisions of the Commodity Exchange Act ~~so that there will not be~~ to eliminate a legal impediment to joint regulation of hybrid products. Products that are not largely or exclusively futures products should not, in my opinion, be subject to exclusive jurisdiction of the CFTC or a requirement that they be traded on a futures exchange.

For example, a hybrid product with characteristics that were 99% those of a security and 1% "futurity" should not trigger exclusive CFTC jurisdiction. Just as banking products may be regulated by any one of three different federal agencies, there is not any conceptual reason why a financial product with some element of futures characteristics could not be traded or regulated through either a securities or futures exchange.

In a recent decision, the Seventh Circuit held that the CFTC possesses exclusive jurisdiction, even where a trivial portion of a product's overall characteristics involve some degree of futurity.

If upheld, or not altered by legislation, this decision could have highly negative implications for both the Commission and overall market regulation. In essence, the Commission's jurisdiction would shrink steadily, probably together with that of the bank regulatory agencies. Over time, if hybrid products become more common, the CFTC's role would expand well beyond its current scope, as would be true with the futures exchanges as well. Finally, the development of new securities products would be inhibited due to the risk that any new product subsequently might be found to be "tainted" with some element of "futurity."

Several innovative products, such as swaps and commodity-backed bonds, cannot as a practical matter be traded and cleared through futures markets and associated clearinghouses due to certain inherent characteristics of such systems. In my opinion, the continuation of this exclusivity could stifle innovation, and reduce the overall competitiveness of U.S. securities markets internationally.

XV. Questions from Senator Larry Pressler

155. Many of us, as you know, are very much concerned over the proliferation of highly leveraged buyouts. I am concerned with the threat to our economy posed by the massive build-up of corporate debt. I am equally concerned with the loss of tax dollars as a consequence of these transactions. Today, however, I would appreciate getting your thinking on offshore LBOs that affect the interests of U.S. investors.

Specifically, I refer to the hostile bid of Hoylake Investments Limited (controlled by Sir James Goldsmith and his partners) to acquire all of the stock of B.A.T. Industries in a highly leveraged transaction involving $6 billion in dollar-denominated junk bonds that are likely to "come to rest in the United States." The SEC response has been that it lacks jurisdiction to apply the Securities Act registration requirements in this situation. What do you think can or should be done to assert the SEC's jurisdiction to protect U.S. investors and interests when a hostile offer such as this is structured to avoid the reach of U.S. securities laws?

Foreign issuers making an exchange offer of this kind frequently do not extend offers to U.S. holders because they are unwilling to bear the costs and other burdens of registering securities in the United States. The U.S. securities laws and the principles of international comity would not permit the Commission to require a foreign issuer to enter the U.S. securities markets against its will, even though U.S. investors may be excluded from investment opportunities. Foreign citizens and corporations are free to decline to do business in this country, exactly as some U.S. companies choose (or are ordered) to avoid doing business in certain foreign countries.

The B.A.T. transaction demonstrates the benefits of lifting U.S. regulatory disincentives for extending offers to U.S. holders on equal terms with those of other shareholders, where the home country's regulatory scheme adequately protects the interest of investors and the percentage of shares held by U.S. persons is limited. At the same time, jurisdiction over fraudulent conduct that has an effect on U.S. persons should be retained.

With respect to your concern that dollar-denominated securities will come to rest in the United States, the Commission has obtained a great deal of experience in applying its securities registration requirements to offerings of securities overseas. It is not unusual even for U.S. issuers to offer dollar-denominated securities overseas without compliance with U.S. registration requirements where there are adequate assurances that the securities will come to rest outside the U.S.

I do not have any independent knowledge of factors that would suggest that the securities in question would come to rest in the U.S. Therefore, I do not have any present basis for determining whether this transaction is structured in a manner intended to violate U.S. laws.