SECURITIES AND EXCHANGE COMMISSION
MAJOR ISSUES CONFERENCE

January 13-15, 1977
Hyatt Regency Washington
Washington, D.C.

Agenda

Agenda

All Conference functions will take place on the Conference Level or in Conference Parlors at the Hyatt Regency. Specific rooms will be posted on bulletin boards in the hotel lobby and on the Conference Level close to the registration desk.

Thursday, January 13

6:00 p.m. -- Welcoming Reception

6:45 p.m. -- Guests please be seated for dinner.

6:55 p.m. -- Welcome and introduction of Keynote Speaker by The Honorable Roderick M. Hills, Chairman, U.S. Securities and Exchange Commission.

7:00 p.m. -- Keynote Address by The Honorable William E. Simon, Secretary of the Treasury.

7:45 p.m. Dinner

Friday, January 14

8:30 a.m. -- First Working Session --Agenda Topic One:
"The Most Appropriate Procedure for Creation of a New Policy and Standards With Respect to the Applicability of the Federal Securities Laws: Speeches, Panel Programs, Information Internal Guides, White Papers, Published Guidelines, Rulemaking, Warning Letters, Public Investigatory Proceedings, Adjudications, etc."

Groups A, B, and C, meet separately.

10:30 a.m. -- Break

l0:45 a.m. -- Second Working Session --Agenda Topic Two:

"The Impact of Trading Options on Market Making in the Underlying Securities, on the Capital Raising Capacity of Corporate Issuers and the Development of a National Market System."

Groups A, B, and C, meet separately.

12:45 p.m. -- Break

1:00 p.m. -- Lunch

2:00 p.m. -- Third Working Session -- Agenda Topic Three:
"What Can and Should the Commission Do to Maintain Investor Protection and Still Encourage the Internationalization of the Securities Markets?"

Groups A, B, and C, meet separately.

3:45 pm. -- Break

4:00 p.m. -- Fourth Working Session -- Agenda Topic Four:
"What Should Be the Relationship Between the Commission and the Private Sector With Respect to the Setting of Accounting and Auditing Standards?"

Groups A, B, and C meet separately.

5:45 p.m. -- Break

6:30 p.m. -- Reception

7:30 p.m. -- Dinner

8:30 p.m. -- Remarks by Chairman Hills

<u>Saturday, January 15</u>

9:00 a.m. -- Corporate Disclosure Panel Discussion, to be led by Al Sommer, Esq. (All Conference Participants)

11:30 a.m. -- Break

12:00 p.m. -- Lunch

1:00 p.m. -- Plenary Session (All Conference Participants)

2:30 p.m. -- Conference closes

Index To Discussion Papers

AGENDA TOPIC ONE: The Most Appropriate Procedure for Creation of a New Policy and Standards with Respect to the Applicability of the Federal Securities Laws: Speeches, Panel Programs, Informal Internal Guides, White Papers, Published Guidelines, Rulemaking, Warning Letters, Public Investigatory Proceedings, Adjudications, etc.

AGENDA TOPIC TWO: The Impact of Trading Options on Market Making in the Underlying Securities, on the Capital Raising Capacity of Corporate Issuers and the Development of a National Market System.

AGENDA TOPIC THREE: What Can and Should the Commission Do to Maintain Investor Protection and Still Encourage the Internationalization of the Securities Markets?

AGENDA TOPIC FOUR: What Should Be the Relationship Between the Commission and the Private Sector With Respect to the Setting of Accounting and Auditing Standards?

* The attached discussion papers have been prepared by the staff of the Commission for the use of the participants in the "SEC Major Issues Conference." The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any publication by any of its members or employees. The views expressed in the discussion papers are intended to stimulate a dialogue and do not necessarily reflect the views of the Commission or its staff.

Agenda Topic 1

The most appropriate procedure for creation of a new policy and standards with respect to the applicability of the federal securities laws: speeches, panel programs, informal internal guides, white papers, published guidelines, rulemaking, warning letters, public investigatory proceedings, adjudications, etc.

l. How is Commission policy developed?

2. Is Commission policy developed and communicated effectively?

3. Who should influence the development of Commission policy?

4. How will new federal statutes providing greater public access to governmental decision-making affect the development of Commission policy?

5. How can the Commission improve its policymaking functions?

INTRODUCTION

The purpose of this discussion paper is to analyze the Commission's methods of formulating and enunciating new policies and standards under the federal securities laws and to stimulate discussion of ways in which the Commission may improve its existing procedures or develop new procedures for the creation and communication of policy.

1. HOW IS COMMISSION POLICY DEVELOPED?

To a large extent, the policy-making procedures available to the Commission are defined in the various statutes under which the Commission operates. These include, of course, the six federal securities acts, the Administrative Procedure Act and a number of other more recently-enacted statutes, most notably the Freedom of Information Act and the Government in the Sunshine Act. But, within the parameters established by these statutes, the Commission retains broad discretion to determine both the form and substance of the policies it believes necessary and appropriate to carry out its mandate, and the means by which its policy determinations will be communicated to the public.

In certain instances, the procedural steps necessary to implement policy determinations are specified in the applicable statutes. Certain provisions of the federal securities laws, for example, can be implemented only through the adoption of rules and regulations by the Commission. Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") is one such provision. That section prohibits the use or employment, in connection with the purchase or sale of any security, of:

"* * * any manipulative or deceptive device or contrivance in <u>contravention of such rules and regulations as the Commission may prescribe</u> as necessary or appropriate in the public interest or for the protection of investors" (emphasis supplied) 15 U.S.C. 78j(b).

Section 10(b), therefore, is not self-executing, and the Commission was compelled to adopt implementing regulations, such as Rule 10b-5, 17 CFR 240.10b-5, setting forth the Commission's antifraud policies under the Act.

Other statutory provisions, such as Section 12(h) of the Exchange Act, do not require implementing regulations, but instead authorize the Commission to grant exemptions from their requirements by "rules and regulations, or, * * * by order." 15 U.S.C. 78l(h). Similarly, Congress has specified, <u>inter</u> <u>alia</u>, the law enforcement procedures which may be utilized by the Commission (see, e,g., Sections 15 and 21 of the Exchange Act, 15 U.S.C. 78o and u, and Section 20 of the Securities Act of 1933, 15 U.S.C. 77t); the procedures available to the Commission for reviewing the activities of the securities industry self-regulatory organizations (see Section 19 of the Exchange Act, 15 U.S.C. 78s); and occasionally has directed the Commission to reevaluate or to formulate major policy determinations through detailed formal studies (see, e.g., Section 11A(c)(4)(A) of the

Exchange Act, 15 U.S.C. 78K-l(c)(4)(A), which required the Commission to report to Congress on the effects of rules of national securities exchanges which limit or prevent transactions by members other than on such exchanges). A variation on this latter theme is found in Section 11A(d) of the Exchange Act, 15 U.S.C. 78kk(d), which directs the Commission to establish a National Market Advisory Board to advise the Commission "* * * on significant regulatory proposals made by the Commission or any self-regulatory organization concerning the establishment, operation, and regulation of the markets for securities in the United States" (Section 11A(d)(2)).

Absent such specific statutory directives or limitations on its authority, however, the Commission is free to select the procedures which it believes are most appropriate to create new policies and standards under the federal securities laws. The procedures historically utilized by the Commission include: (1) traditional rulemaking; (2) law enforcement actions, including administrative proceedings, injunctive actions in federal district courts and referrals of matters to the Department of Justice for possible criminal prosecution; (3) formal fact-finding proceedings for rule-making or legislative purposes; (4) the recommendations of advisory committees; and (5) recommendations to the Congress for new legislation.

In addition, a wide variety of highly effective informal procedures for establishing or communicating new policies and standards have been developed by the Commission over the years. These include (1) unofficial expressions of views by members of the Commission and the staff through speeches or participation in panel programs; (2) published staff guidelines; and (3) staff interpretative and "no- action" letters, as well as official expressions of the Commission's views through releases, "white papers" and the like.

Each of these methods by which Commission policy may be created and communicated has its own advantages and disadvantages, which vary with the particular facts and circumstances involved in each situation.

A. Formal Procedures

I. Rulemaking

Formal rulemaking, pursuant to the "notice and comment" procedures specified in the Administrative Procedure Act, 5 U.S.C. 553 et seq. ("APA") is probably the method most frequently used by the Commission to establish new policies and standards under the federal securities laws. In some instances, as noted above, rulemaking may be required to implement certain statutory provisions. In other cases, the Commission may conclude that formal rulemaking is the most effective procedure available to establish new policies and standards, particularly where the policies and standards involved are novel or go beyond the scope of existing rules and practices.

Formal rulemaking proceedings afford the public notice and an opportunity to comment on the Commission's proposals and permit the Commission to have the benefit of the views of interested persons prior to taking final action. In addition, rulemaking has the important advantage of producing legally enforceable and relatively specific standards of conduct which provide a degree of certainty to persons who must comply with the law, in advance of any enforcement action. In addition, rules are subject to court review and often create important private rights of action which investors may invoke to supplement the Commission's own enforcement efforts.

On the other hand, there are several disadvantages to formal rulemaking as a method for creating new policies and standards. Among other things, rulemaking procedures often are time-consuming and cannot be used effectively to redress a violation of the law which already has occurred; nor can they immediately stop an undesirable practice which is in progress. Rules, if specific and detailed, may be too rigid or confining to cover all factual situations to which they are intended to apply, and raise the risk of creating loopholes or roadmaps for the unscrupulous. Or, if broad and flexible, rules may confuse the public or prohibit legitimate activities.

2. Law Enforcement Proceedings

Law enforcement proceedings, both administrative proceedings and injunctive actions brought in the federal district courts, also are a method which the Commission frequently uses to enunciate standards and policies under the federal securities laws. Indeed, in recent years the Commission has been criticized for relying too heavily on enforcement as a policy-making technique.

Enforcement proceedings are especially well-suited to certain aspects of the Commission's work, particularly the discharge of its responsibility to protect investors against fraud. Unlike rules of general applicability, a law enforcement action may be tailored to meet the unique facts and circumstances of a particular case. Such proceedings also enable the Commission to act promptly to stop ongoing violations of the law, to obtain remedies which redress wrongs already committed, and to provide notice to the public of its views as to the applicability of the law in specific factual situations. In addition, in a litigated case, the merits of the Commission's view of the law is judicially tested in an adversary setting.

Nonetheless, law enforcement as a po1icy-making technique has certain disadvantages. The investigations which precede many Commission enforcement actions often are lengthy, with the result that relief is not obtained until several years after a violation has occurred. If the Commission's action is contested, a final determination of the matter may take substantial additional time. Further, the principles enunciated in enforcement actions may not be applicable to differing factual situations. Indeed, there is sometimes a tendency for the bar and others to extrapolate broad, generic principles from unique factual occurrences. In addition, the Commission has been subject to some criticism for using its law enforcement programs to expand the law in new directions, at the expense of those persons named as defendants or respondents in particular actions, without first providing adequate notice to the public as to its view of the law.

B. Informal Procedures

1. Speeches and Panel Programs

Traditionally, the Commission has encouraged its members and senior staff officials to speak before a wide variety of groups interested in, or affected by, the commission's work, in order to educate the public on the Commission's activities and views as to the standards of behavior required by the federal securities laws. While the views expressed are solely those of the individual and do not necessarily represent the views of the Commission, speeches and participation in panel programs are a highly effective means of raising questions, suggesting possible approaches to problems, and communicating previously established Commission policies to the public.

Through these fora, the Commission and its staff may articulate new ideas and provide notice of the Commission's views, in advance of formal rulemaking or enforcement action, to those who must comply with the federal securities laws. Frequently, the ideas and policies articulated in speeches become the subject of public discussion and debate, and, as a result, the Commission may receive valuable input in the initial stages of its policy-making process.

While public speaking is a useful tool of communication, it too has certain drawbacks. Among other things, speeches are seldom widely publicized, and thus the message imparted usually is received only by those present when it is delivered. The Commission itself only occasionally publishes highlights of speeches in its News Digest, and does not routinely make prepared texts of speeches, particularly those given by staff officials, available to the public. In addition, speeches may in fact represent only the views of the speaker, and not those of the Commission. Thus, the public may be misled or confused as to the Commission's position, particularly where a novel or unique view of the law is expressed. In at least one instance, the views expressed by a Commission official have been used to defend against a contrary position taken by the Commission in an enforcement action.

2. Guidelines - Published and Internal

Published staff guidelines have occasionally been used as a means of informally communicating Commission policies to the public. Disclosure guidelines, such as the recently-published Guides 61 and 3 for statistical disclosure by bank holding companies, appear to be an effective method of communicating to the public the staff's views on the type of disclosures which should be made in certain filings with the Commission.

In areas where the law is rapidly evolving, however, as in the case of questionable or illegal corporate payments, the Commission has declined to publish specific guidelines. In the recent past, in three separate areas -- questionable payments, insider trading, and corporate directors' responsibilities -- officials of the Commission announced plans to publish guidelines, which were later determined to be impractical and were, therefore, abandoned. In each instance, the standards which the Commission could comfortably articulate appeared to be too broad to be useful to anyone, while guidelines which were specific enough to be helpful were criticized by some as providing "road maps for fraud."

Where guidelines have been successfully developed, however, they have served the purpose of providing notice to the public of the Commission's policies and practices while still preserving the Commission's ability to be flexible and responsive when unique facts and circumstances demand action. On the other hand, since guidelines are not formal rules, they are not enforceable or subject to court review, although as a practical matter, persons who do not comply with such guidelines do so at their peril and risk both private suits and Commission enforcement action.

Informal internal guidelines, other than purely procedural guides, have not been widely used by the Commission, although they may be a useful means to ensure uniformity in the application of Commission policy by the various operating offices and divisions of the Commission and to assure that the day-to-day policy-making decisions of the staff are consistent with the views of the Commission itself. Perhaps the Commission's hesitancy to use such guidelines results from the realization that internal guidelines might unduly restrict the staff's exercise of discretion and its ability to respond flexibly to issues not contemplated when the guidelines were drafted.

3. Interpretative and "No-Action" Letters

The Commission's staff traditionally has provided significant assistance to the public by articulating staff views concerning policies and standards under the federal securities laws in response to requests for interpretative or so-called "no-action" letters. The interpretative and "no-action" letter process is generally considered to be a highly effective, efficient and prompt method of providing the public with the staff's views with respect to the applicability of the law in specific factual situations. Although not binding on the Commission, such informal advice reflecting the staff's interpretation of the law, or, in the case of "no-action" letters, the staff's enforcement position, has the advantage of providing some measure of certainty to the public, and, since each letter is limited to its facts, preserving the flexibility of the Commission and its staff to modify policies to meet new and emerging problems.

The principal disadvantage to these informal procedures sterns from the fact that they are not subject to court review and review by the Commission, although generally granted upon request, is entirely discretionary. In addition, the large volume of interpretative and "no- action" letters written each year necessitates limited Commission involvement in the process, although generally the staff will apprise the Commission of particularly significant positions taken. Further, the large volume of such letters reduces their usefulness as a means of communicating with the public, although the recently-adopted staff practice of identifying and publishing letters which are particularly significant has alleviated this problem.

4. Releases and White Papers

Occasionally the Commission has published its views with respect to new policies and standards under the federal securities laws in official releases or so-called “white papers”. Releases have been used successfully to alert the public to new and emerging problems and as a warning to persons who are engaged, or may be about to engage, in activities which the Commission believes to be unlawful. Examples of the subjects addressed in such releases include whiskey warehouse receipts, “spin-offs”, timely disclosure of material corporate developments, sales of unregistered securities by brokers or dealers, and “Ponzi” schemes. When used as an alternative or predecessor to enforcement action or rulemaking, releases are particularly useful warning devices, since they can be issued quickly and disseminated widely and rapidly. The principal disadvantages are that releases are not enforceable or reviewable, and cannot be used to redress wrongs that already have occurred.

Releases also have been effectively used by the Commission, although less frequently than as warning devices, to set forth the Commission’s official views on major, long-term policy issues. Two excellent examples of this type of release are the so-called “white papers” published by the Commission in 1972 and 1973 entitled Future Structure of the Securities Markets and Structure of a Central Market System. In these position papers, the Commission set forth, in broad terms, the basic principles and policies it believed should be followed in modernizing and reshaping the nation’s securities markets in the decade ahead. These white papers have since served as the focal point for discussion and action by the Congress, the Commission and the securities industry toward realization of the goals articulated by the Commission. Such articulations of the Commission’s long-term objectives, while subject to change, are useful and desirable techniques in developing policies with respect to significant issues such as the central market system.

2. IS COMMISSION POLICY DEVELOPED AND COMMUNICATED EFFECTIVELY?

A certain number of policy determinations, of necessity, must originate from specific and unique factual dilemmas which cannot be anticipated in advance. And the flexible tools provided to the Commission by the statutes under which it operates, as well as the flexibility and ingenuity of the Commission and its staff, have enabled the Commission to address new and emerging problems with a success that is unique in government. Nonetheless, the Commission has been criticized, in recent years, for failing to establish adequate long-range objectives. For example, in 1973, the Office of Management and

Budget conducted a review of the Commission's operations and recommended, inter alia, that the Commission make "a greater effort to take the lead in anticipating problems and to base this endeavor on more extended economic and policy research." Securities and Exchange Commission, 38th Annual Report (1972) at p. 135. In response to this recommendation, as well as recommendations from the Congress and the Commission's 1972 Advisory Committee on Enforcement Policies and Practices (the so-called Wells Committee), in October, 1972, the Commission established an Office of Policy Planning "to improve the Commission's ability to anticipate and plan for, rather than react to, possible future capital market and investor needs." Securities and Exchange Commission, 39th Annual Report (1973) at p. 133. The office was initially staffed with two professionals.

Subsequently, in July, 1975, the Office of Policy Planning was merged with the Office of Economic Research into the Directorate of Economic and Policy Research. The Directorate is charged with the responsibility of integrating the Commission's economic analysis and data-gathering capabilities with its policy-planning activities.

Is the extent to which the Commission develops new policies in reaction to problems and events as they arise appropriate, or should the Commission increase its efforts to establish long-range policy objectives and to plan the steps necessary to achieve those objectives? Does the wide variety of subject matter for which the Commission is responsible lend itself to long-range planning? Or is a case-by-case approach more effective? If more long-range planning is needed, in what areas should it be focused? How can the Commission best accomplish long-range planning? Is a larger policy-planning staff likely to be effective? What type of staffing and resources would be required? Can adequate participation by the Commission and the operating staff in policy-planning be assured? Will the Commission's present system, which has been relatively successful in the past, be adequate to meet future needs?

It is a basic tenet of our legal system that, both in the interests of fairness and of encouraging compliance, the law should be made as clear as possible to those who are expected to conform to it. Indeed, this principle underlies the creation of administrative agencies, which are charged with the responsibility of providing the details necessary to implement Congress's broad statutory objectives. The Commission, through rulemaking, enforcement actions, and other policy-making procedures has done much to give specific content to the federal securities laws.

In certain areas, however, a detailed and exhaustive cataloging of prohibited and permissible conduct is both impossible and counter-productive. The effective administration of the securities laws requires that the Commission preserve its ability to respond flexibly to an infinite variety of new and emerging problems, such as the devices formulated by those who seek to overreach in securities transactions.

The tension between the desire to define standards and the reluctance to make advance determinations, independent of concrete facts, also is illustrated in the Commission's corporate disclosure requirements, For example, Forms 10 and 10-K, for registration statements and reports filed under the Exchange Act, give very specific guidance as to the type of information, if material, which should be included in the description of a registrant's business. In contrast, in newly evolving or rapidly changing areas, the Commission has found it impossible or undesirable to attempt to articulate disclosure standards without reference to the facts and circumstances involved in each particular case. Current areas in which the Commission has refrained from offering specific disclosure guidelines and has instead relied on registrants and its staff to determine what is material, on a case-by-case basis, include questionable or illegal corporate payments; involvement in the so-called Arab boycott; and the environmental consequences of a registrant's manufacturing activities.

Whether the Commission has properly balanced its obligation to provide guidelines against the risks of drawing "roadmaps" for those intent on fraud, is a difficult question. In large measure, the strength of the federal securities laws lies in their breadth and flexibility, and legitimate concern frequently has been expressed that guidelines, or specific rules and regulations, no matter how carefully drafted, may become blueprints for avoidance of the law. But, as was noted earlier, the Commission has been criticized by some commentators for relying too heavily on law enforcement actions to create new policies and standards under the federal securities laws. Should the Commission make a greater effort to articulate, in rules, published guidelines or otherwise, its views as to the applicability of the federal securities laws as an alternative to, or in advance of, enforcement actions? If guidelines are not appropriate in certain areas, how may the Commission determine whether, in a particular instance, such guidance is impossible or undesirable, or whether the failure to formulate standards results largely from inertia? And, are there situations where, despite the risk that loopholes may be created, the Commission, nevertheless, should attempt to formulate guidelines?

When the Commission determines that guidelines or rules are appropriate, and arrives at a consensus on the substance of the policies to be expressed, an equally difficult problem remains -- how should the policy determination be communicated to the public? The determination of how best to communicate policy depends on a variety of factors, including the uniqueness of the situation involved and the extent to which enforcement action, premised on the new policy, is contemplated. An added factor which must be considered is the ease with which the public can locate and understand expressions of policy. Commission rules are published in the Federal Register, codified in the Code of Federal Regulations, and, of course, also announced through less formal channels, such as news reports and the commercial publications dealing with securities law developments. In addition, the Commission itself publishes the daily SEC Digest and the weekly SEC Docket reflecting all Commission releases.

Does the volume and variety of Commission determinations and pronouncements inhibit or discourage comprehension of the policies and goals expressed? Does the Commission use the most effective and efficient methods available of communicating policy?

3. WHO SHOULD INFLUENCE THE DEVELOPMENT OF COMMISSION POLICY?

In its 1941 report, the Attorney General's Committee on Administrative Procedure wrote that "informal procedures constitute the vast bulk of administrative adjudication and are truly the life of the administrative process." Professor Davis, in his administrative law text, has described "informal action" as "discretionary justice" and specifically mentions the Commission in elaborating upon this topic:

"The SEC in all classes of its business had only 103 formal hearings in one recent year, but in one class of business it passed upon 4,706 registration statements to determine whether they complied with standards of adequate and accurate disclosure. When a statement fails to conform, the Commission's staff sends a letter of comment, affording opportunity to file correcting or clarifying amendments. The effective power is exercised through the letters of comment, not through issuance of stop orders. During the year, 202 statements were withdrawn and only two stop orders were issued. Whether informal conferences that resolve disputes arising out of letters of comment involve adjudication, consent, or coerced consent seems to be a variable. Informal discretionary action is the meaningful category." K. Davis, Administrative Law Text 89 (3d ed, 1972).

The Commission has delegated to its staff a number of functions which, although seemingly routine, account for the great bulk of public contact with the Commission. Is informal staff action the "meaningful category" by which the Commission's policies are derived and enforced; or are the more important decisions actively made by the Commission itself, and merely implemented by the staff? What should be the influence and role of the staff in the formulation of policy? Can the Commission afford the luxury of the detailed analysis and detached reflection which are necessary for the creation of new policy; or must they, like Kutuzov, the Russian commander opposing Napoleon in Tolstoy's War and Peace, be "always in the midst of a series of shifting events * * * [so that they] never can at any moment consider the whole import of an event that is occurring, * * *"?

Of course, neither the Commission nor its staff can formulate policy in a vacuum -- they are both subject to a variety of sometimes conflicting influences. Congress, the securities industry, the business community, the courts, academic community and the investing public all have their impact on the direction in which the Commission will proceed.

The role of Congress in enacting and modifying the laws from which the Commission derives its powers presents the most obvious example of Congressional influence on Commission policy-making; but what more subtle impact does Congress have in terms of the Commission's day-to-day activities? Does or should the anticipation or realization of possible Congressional reaction influence policy choices? Is this influence, if any, beneficial or detrimental to the Commission's functions and thus to the public interest?

The conventional wisdom has long suggested that the regulatory agencies are unduly influenced by the industries they regulate and, indeed, a former Chairman, retired Supreme Court Justice William O. Douglas, suggested the need for legislation, which has now been introduced, to assure that agencies are abolished automatically after a specified period of years. Of course, any business or profession which is regulated by a federal agency will seek to influence the course of that agency's policy. Such input is not necessarily undesirable -- to the contrary, it is often quite useful in placing proposed action in proper perspective. Is the Commission's relationship with the securities industry and other groups subject to the Commission's jurisdiction appropriate?

The securities industry, the legal and accounting profession and the business community all have formal professional organizations to represent their interests; but what of the investing public? The Commission was designed to protect the interests of investors. Is the public interest sufficiently protected by the Commission? Do any particular interest groups -- professional groups, the academic community or the investing public --- have an undeserved dominion over Commission policy-making? Should the influence of any of these groups be increased or decreased? If so, how?

As stated above, the Administrative Procedure Act requires public notice and comment prior to the promulgation of rules and regulations. Since enforcement and administrative proceedings may result in policy changes as far-reaching as the promulgation of new regulations, is it wise to continue to depend on adversary presentations which involve only the parties immediately affected, Rule 9 of the Commission's Rules of Practice, 17 CFR 201.9, permits any person to be heard, at the discretion of the hearing officer, in any matter which affects that persons interests. This provision has, however, rarely been invoked by those who seek to exert an influence on policy. The Administrative Conference recently reviewed the potential impact of enforcement proceedings and proposed that public comment be solicited before an agency settles an enforcement action by consent. The Commission responded that it believed such a principle to have little or no application to its proceedings because those proceedings seldom have effects beyond the immediate parties. Should greater latitude for public participation in such enforcement action be permitted to enable interested and ultimately affected parties to present their views?

4. HOW WILL NEW FEDERAL STATUTES PROVIDING GREATER PUBLIC ACCESS TO GOVERNMENTAL DECISION-MAKING AFFECT THE DEVELOPMENT OF COMMISSION POLICY?

During the past several years, Congress, implementing what it perceived as a broad public demand for greater openness in government, has enacted several new statutes which may affect the Commission's policy-making: the Freedom of Information Act ("FOIA"); the Privacy Act; and, most recently, the Government in the Sunshine Act. The FOIA and the

Privacy Act have been in operation for several years; the Sunshine Act, which will take effect on March 13, 1977, promises to have broad, although as yet undefined, effects on Commission policy-making deliberations.

The FOIA requires the Commission to make available to any person, upon request, specifically identifiable records in its possession unless one of the Act's nine exemptions is available. As a practical matter, the Act has required the release of a wide variety of internal Commission documents which previously would not have been made public. Likewise, the Privacy Act requires the Commission, in certain circumstances, to make available to an individual records related to that person, and affords him the opportunity to correct errors therein.

Although there has been no empirical study of the impact these laws may have on Commission policy-making, it could be argued that they have caused the staff to be more circumspect in what is committed to writing. Although, at least in theory, the FOIA exemptions should protect the Commission's ability to carry on the process of policy formulation without the consequences of public scrutiny, the precise scope of the protection afforded by the exemptions is difficult to ascertain in advance, especially where policy discussion is intertwined with factual, nonexempt material.

In contrast, the Government in the Sunshine Act contains no exemption designed to protect agency policy-making discussion from public view. Indeed, one of the apparent objectives of the new Act is to expose to public observation -- but not participation -- agency deliberations aimed at formulating policy. Unless one of its ten exemptions applies, the Sunshine Act will require that the public be permitted to observe all Commission meetings and receive advance notice of the time, place and subject matter of such meetings.

For the present, one may only speculate as to the effects the Sunshine Act will have on Commission deliberations or policy-making. Both the staff and the members of the Commission may feel constrained to maintain a more formal tone at open meetings. Even at closed meetings, the ever-present stenographer or tape recorder -- coupled with the knowledge that if the discussion strays to a nonexempt topic, the transcript or recording may have to be released to the public -- may serve to inhibit some of the free and far-ranging discussion which now takes place at Commission meetings. On the other hand, the Act may serve to encourage more thoughtful and better prepared articulation of the issues involved in a particular matter by both the staff and the Commission. This, in turn, may foster a climate more conducive to considering the broader implications of particular proposed actions.

5. HOW CAN THE COMMISSION IMPROVE ITS POLICY-MAKING FUNCTION?

The foregoing discussion has focused on whether the Commission should take steps to improve the process by which it formulates policy. If some improvement in the policy-making process is appropriate, the question of how that improvement should be implemented remains. The creation of new policies requires more than analysis; it requires imagination. Are there ways in which the Commission can encourage a more imaginative and effective approach to the creation and communication of new policies and standards under the federal securities laws?

One possibility is a new staff office responsible for policy formulation. To a degree, the Commission has already taken this step through the creation of the Directorate of Economic and Policy Research. Perhaps a new “Policy Formulation Staff” should be established, charged with the broad responsibility of continuously evaluating existing policies and of formulating 1ong-range goals for the Commission. A permanent staff of this nature would have to be intimately familiar with the Commission’s work and might find that its ideas were exhausted in a relatively short period of time. If a staff members were selected for inclusion in this section on a rotating basis, from each of the Offices and Divisions, to serve for a six-month terms, would there be a sufficient influx of innovative ideas to justify the expense of establishing the section? Would it be advantageous to supplement the section by means of selected fellowships to enable academicians and practitioners to assist the staff?

A more fundamental question related to the formulation of policy is whether long-range planning is a feasible goal. Could, for example, any one have foreseen in 1971 and 1972 that four or five years later one of the most difficult issues facing the Commission would be the nature and extent of disclosure concerning illegal or improper corporate payments? Even if the emergence of such an issue could have been foreseen, could staff policy-makers realistically have formulated a Commission “policy” on this subject in the absence of any specific factual situation? Should the Commission recognize that the consequences of attempting to formulate policy in the abstract, isolated from real and immediate factual problems, are more damaging than the consequences of having to respond rapidly to such problems as they arise?

Would the Commission’s resources be better spent by conducting further seminars and conferences such as the present conference? Or would it be more beneficial to the Commission to create a committee of staff personnel and Commissioners to travel through the country to hold regional hearings and discuss policy on a r “grass-roots” level?

If the creation of a staff planning office is not the solution, perhaps an increased sensitivity and awareness by the Commission to the long-range consequences and effects of its actions might be the only realistic improvement in the policy-making process which is available. If this is the case, is there any formal or institutional way in which the Commission could encourage the development of this type of sensitivity?

Agenda Topic 2

The impact of trading options on market making in the underlying securities, on the capital raising capacity of corporate issuers and on the development of a national market system.

1. Should the economic merits of options be relevant to the Commission's decision-making processes?

2. Are "pilots" or "experimental programs" the appropriate methodology for permitting the initiation and expansion of options trading programs?

3. What are the potentials for market manipulation resulting from the introduction of standardized options trading programs? Would a more competitive system of market making serve to substantially eliminate those potentials? Are the potentials for manipulation likely to be reduced or increased if options and stocks trade side by side? What are the appropriate considerations in striking a balance between the optimally efficient and the optimally equitable marketplace for options?

4. Should institutions, block brokers and dealers, specialists, market makers or others be barred by rule from trading on inside market information concerning blocks of stock or options without first disclosing, or awaiting disclosure of, such information?

5. Does the availability of standardized options impact upon the markets for the underlying securities and/or the markets for new and unseasoned companies on which options are not traded?

6. What is the impact of standardized options trading on the development of a national market system?

INTRODUCTION

At the convening of this colloquium, the organized trading of standardized options will be nearing its fourth anniversary. Judged by investor and industry participation, by indices of volume growth and by the continuing efforts by the various exchange markets and the NASD to initiate new options trading programs or to expand existing ones, standardized option trading is a major presence in our securities markets.

The characteristics of standardized options set them apart as a different type of security than the familiar OT option market instrument . [Footnote: The term "standardized options," as used in this paper, means options which give the owner the right to purchase a designated unit of trading (100 shares) of a security at a particular price (the striking price) within a set period of time. The contractual right to such purchase is guaranteed by the Options Clearing Corporation. All such options are standardized as to expiration date and striking prices. The term "OTC options" refers to those options not guaranteed or cleared through the Options Clearing Corporation, although a particular broker-dealer may act as obligor of the contract. The terms of OTC options are individually negotiated between the buyer and seller. Traditional OTC options should not be confused with those standardized options which may soon be traded in the OTC market under the sponsorship of the NASD.] The inherently inefficient and cumbersome transaction procedures for the buying and selling of OTC options historically have made the use of such trading instruments both difficult and expensive. There has been essentially no secondary market in such OTC options; no dissemination of timely transaction information; and no market mechanism designed to provide competitively-determined prices. Conversely, the introduction of standardized options has fostered the initiation of secondary market options trading on five exchanges, and it is likely that, in the near future, standardized options on major OTC securities will be traded in the OTC market utilizing NASDAQ quotation facilities. The availability of secondary markets for standardized options has significantly increased the liquidity in buying or selling such trading instruments, and has markedly increased flexibility in investment strategies involving options. The voluminous paperwork and extended negotiations prior to execution which characterized trading in OTC options have been greatly eased in standardized options trading. The premium costs over the " true" or intrinsic value on standardized options is substantially less than for OTC options. Additionally, the Commission has, in view of the multiplicity of market places trading standardized options, required a common clearing system, standardization of option terms and conditions, a common tape for real-time reporting of transactions in all standardized options and access to current options quotations. Finally, the introduction of standardized options trading has brought with it some notable innovations, instituted by the self-regulatory organizations, in the ways securities are traded in organized securities markets: competing market makers on an exchange market (the CBOE, PSE and MSE); certificateless trading of standardized options; and divestiture of the limit order book from the market maker function (the CBOE, PSE and MSE).

While the anticipated efficiencies and utility of standardized options trading compared to OTC options trading have been borne out, many of the more fundamental questions arising from the existence of such instruments -- their impact on the secondary markets for equity stocks, their impact on the primary distribution of new equity stock, their inherent economic value, etc. -- remain unresolved. [Footnote: The term "equity security" is defined by Section 3(a)(11) of the Securities Exchange Act of 1934 to include, inter alia, "...any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right...." Notwithstanding the obvious inclusion of stock options within the definitional ambit of the term "equity security," those two terms will be contrasted for the purposes of clarity in this paper.] It is apparent that the standardized options markets have provided a mechanism for the transference of risk, and some believe that this has resulted in greater public participation in the markets for the underlying securities . On the other hand, while there is little evidence thus far, it has been argued that standardized options trading has, in some degree, not only increased manipulative opportunities in the securities markets but also introduced new forms of trading opportunities of debatable merit. For example, certain segments of the standardized options industry have already experienced problems with fictitious reporting of transactions and pre-arrangement of trades (i.e.., a form of the old “wash” sale). Additionally, a number of questions have been raised as to the fairness of permitting stock market professionals to utilize “inside” market information by trading in the options market. It is the purpose of this paper to provoke discussion, not of economic imponderables better left to detailed statistical studies, but of the appropriate nature of the Commission’s regulatory response to the introduction of standardized options trading in light of the fact that such questions remain unanswered.

THE APPROPRIATE CRITERIA

The Commission has been guided, in its considerations of the various facets of standardized option trading, by four fundamental principles [Footnote: These principles are, of course, the same ones which guide the Commission in reaching its decisions with respect to issues concerning equity securities.]: (i) the need to ensure fair and orderly markets, (ii) the need to ensure the protection of investors, (iii) the furtherance of the public interest, and, since the Securities Acts Amendments of 1975, (iv) the requirement that no self-regulatory organization or Commission rule or regulation impose a burden on competition not otherwise necessary or appropriate in furtherance of the purposes of the Securities Exchange Act of 1934 (the “Act”). Stated another way, the Commission has sought to ensure that the various aspects of standardized options trading are relatively free of overreaching, manipulation and competitive restraints, but has not premised its approval of innovations in the trading of standardized options upon a conclusion that such innovations be justified by a demonstrated benefit (or, on the other hand, a demonstrated lack of detriment) to the national securities markets, the capital raising process or the economy in general.

Given this context, to what extent should the Commission, in carrying out its statutory duties, consider the merits or lack of merits of the economic function of the standardized options markets: That is, should the Commission undertake to define the economic role that options should legitimately play in competition for the allocation of savings and then control options trading and growth to that end? Should the Commission be concerned with the intrinsic societal worth of a particular trading instrument or limit itself to questions of the fairness and honesty with which a particular security is traded? What is the legal authority permitting the Commission to include within the criteria of its decision-making the economic merits of a particular form of trading instrument? Is furtherance of the “public interest” sufficient? Without prejudging the foregoing questions, it should be noted that Congress delegated to the Commission the determination of whether options trading should be permitted at all, and, if so, under what conditions (see Section 9 of the Act); the legislative history behind the Act indicates that Congress intended that the Commission, in exercising that power, weigh the economic impact of options trading.

THE APPROPRIATE METHODOLOGY

While nearly everyone would agree that manipulation should be proscribed and that competition should be encouraged, the application of these principles sometimes presents difficult choices. The balancing of these principles has been inherent in the Commission's recent decisions, discussed infra, to permit specialists and market makers in the underlying securities to trade concurrently in options on those stocks and, perhaps, make markets in them. [Footnote: Because of their use in large-scale manipulations in the early 1930's, two of the so-called "Sixteen Trading Rules" adopted by all national securities exchanges in 1935 at the Commission's urging prohibited specialists and odd-lot dealers on exchanges from trading any options in their specialty stocks and prohibited any exchange member from trading any equity security while on the exchange floor if such member holds a position in an option on such equity security.] The advocates of the "efficient market" theory argue that increased competition would provide for a more fair and orderly market necessitating fever regulatory constraints, whether in the options or equities markets. As a corollary, this theory posits that regulation qua regulation induces inefficiencies (i.e., costs) in the marketplace which, in turn, require more regulation. There have been strong arguments that, at least for securities which qualify for standardized options trading, the competitive restraints imposed by regulatory schemes which prohibit or inhibit the full interaction of all possible participants in both the options and equity markets have actually increased the potential for manipulative trading afforded by the leverage potential of the options.

The issue facing the Commission in this regard is the appropriate methodology to evaluate this theory. The inherent uncertainties in predicting future market behavior, particularly in the evolving options and equities markets, poses great difficulties in relying on a priori reasoning alone. The desiderata of perfect competition -- consumer welfare maximization and resource allocational efficiency -- have always been measured by economists relative to standards implied by various models. However, economists often assume away or underplay the significance of a real-life phenomenon when it does not conform to the intellectual parity of their models. While such assumptions may be necessary to enable economists to judge what regulations are necessary to bring reality closer to the competitive and efficient models they devise, those assumptions also introduce significant uncertainties in the viability of the model and its predictions. Because of those uncertainties, the Commission has, with respect to issues it has faced, determined that actual experience is an equally important ingredient in formulating a response to such issues. However, whether categorized, as pilots, experiments or otherwise, permitting industry sponsored initiatives to proceed in the marketplace raises questions under the Commission's duty to ensure fair and orderly markets and to protect investors. This conundrum has presented itself squarely before the Commission in the issues discussed by this paper: the impact of options trading on market making, upon the capital raising capacity of corporate issuers and upon the development of a national market system.

IMPACT ON MARKET MAKING

The existence of standardized options in liquid secondary options exchanges can present varying investment and trading strategies to participants in the securities markets depending on whether the individual participant is a public investor (including hedge funds and institutions), a trader (whether a floor trader on an equity stock exchange, a block positioner or other dealer placing orders from off-floor or a registered options trader on an options exchange) or a market maker (whether an equity exchange specialist or market maker, an options exchange specialist or market maker or an OTC or third market maker). In this respect, differences in time and place opportunities and in transaction costs weigh heavily in the relative advantages of each of the following strategies to each class of participants.

A principal strategy available to all such participants is the ability to generate additional income through premiums by the writing of options; this may be accomplished either by writing on long stock positions or writing naked (“shorting” the option). Another principal strategy is that of hedging equity stock positions by offsetting (i.e. , “opposite side”) positions in the standardized options. Both of the foregoing involve transferring to the options market some or all of the risk of holding a position in the underlying equity security. Hedging may also entail reducing risks on an options position by assuming offsetting options positions through so-called spreading transactions. And, of course, options are used as a highly leveraged, market instrument to speculate in potential price movements of the underlying equity security. Further, there is the strategy of arbitraging between options series of different expiration periods and striking prices and between options and the underlying security. However, the execution costs associated with arbitrage effectively limits that strategy to traders and market makers.

The arguments that have been advanced in favor of permitting all participants in the securities markets to trade in options are: (i) to the extent all participants are enabled to hedge their stock positions by transferring risk to the speculator in the options market, more capital will be devoted to equity investing, trading and market making; this, in turn, will promote deeper, tighter and more liquid markets in the underlying securities; (ii) more efficient markets in both the options and the underlying stocks result from increasing the amount and variety of investment and trading judgments brought to bear on those markets; (iii) to the extent specialists and members on the floor of an exchange are restricted in options trading, they are subject to competitive disabilities which may not be necessary or appropriate in view of the significant changes from 1935 in the market and regulatory conditions characterizing today’s markets for stocks which qualify for standardized options trading; specialists, particularly, may find themselves on the receiving end of increased volume and volatility generated by those market participants permitted to trade in options -- institutions, hedge funds, block positioners, etc. -- which impairs their ability to contribute constructively to stability in the market; and (iv) the Commission should not, as a matter of policy, prohibit the development of alternative means to invest in securities, absent overwhelming evidence of harm to the public or securities markets.

The argument in favor of prohibiting all or particular classes of market participants from options trading centers on the notion that the option, with its inherent leverage characteristics, poses a special manipulative threat which, it is feared, cannot be dealt with adequately by modern surveillance tools for enforcing existing legal prohibitions or by the natural and highly efficient economic forces at work in today's markets. This is so because the leverage characteristics of exchange-traded options render unnecessary large capital flows (and risks) to achieve a given absolute dollar return from a manipulative activity. For example, the closing sale (or purchase) of appreciated (or depreciated) options, following a relatively minor price movement in the underlying security, could provide the same proportional return as the sale (or covering purchases) of the underlying security, following a relatively major artificially stimulated movement in the price of that security. Thus, a fundamental question is whether any particular participant has the ability, in regular course, to manipulate the price of the underlying security over relatively small price swings (taking his profit in the options market) and remain undetected or, if detected, nonetheless impervious to charges of manipulation. In this respect, the Commission's attention has focused upon the potential abilities of equity stock market makers to manipulate the prices of those stocks and profit thereby in the options market.

As noted above, we are no longer talking primarily about the threat of broadly-based, dramatic manipulations of the kind experienced prior to 1935. Equity securities underlying standardized options have been limited to widely-traded, highly liquid and well-known stocks and as to which there are substantial quantities of corporate and financial data available on a continuing and up-to-date basis. With respect to such equity securities, our markets operate in a highly efficient manner. Under these circumstances, the ability of anyone to perpetrate the type of deception necessarily involved in a large scale manipulation is very narrow. The costs and attendant risks of such an endeavor would generally be prohibitive.

These same factors may also tend to counteract actions of market makers who might wish to engage in smaller, very short-term manipulative activities. There are many sophisticated individuals in the market on a continuing basis, and, at least in a freely-competitive environment, each can act as an effective control (e.g., by "hitting" rising bids) over attempted price manipulation. Under this view, the potential of "mini-manipulations" is more a function of the anticompetitive nature of the unitary specialist system and restrictions which tend to inhibit competitive market making both on and off exchange floors, as well as restricted access, and high costs of that access, to the marketplace. The solution, therefore, may be to open access to, and remove anti-competitive restraints on, those wishing to perform a market making function and to continue to ensure instantaneous disclosure of market information.

There is little question that competition and other market forces can be relied upon to a very substantial degree to control abuses. This is true both with respect to manipulations and conventional frauds . On the other hand, we know that such controls are far from perfect in these respects. Throughout its history the Commission has found it necessary to adopt measures to prevent fraud and manipulation to help maintain honesty and fair play in the marketplace notwithstanding the fact that it was not possible to quantify either the benefits derived (in terms of increased public confidence) or the apparent loss in market efficiency which such measures would produce. In this respect, the most plausible argument advanced in support of permitting traders and market makers to trade in options is the anticipated enhancement of the equity markets because of the availability of risk, transference to the options market. However, it may be that the risks attendant on market making roles (including, for instance, block positioning) are properly viewed as part of that function. Additionally, it may be argued that the putative enhancements to the equity markets of narrower spreads and deeper markets are speculative at best and that the notion of competitive disabilities on specialists and floor members is more than outweighed by the unique abilities of those individuals to influence the market making in equity stocks.

Some who accept the view that equity markets and market making can benefit from the existence of standardized options nevertheless would restrict equity market makers' activity in standardized options to one-on-one hedging of positions in the underlying security. In this view such hedging would facilitate equity market makers' ability to provide deeper markets in the underlying security yet prevent market makers from obtaining sufficient leverage in the option to make profitable a manipulation of the price of the underlying security. This view was not accepted by the Commission when it considered the NASD's request for the Commission's preliminary views on dual equity-options market making in leading over-the-counter stocks. In the Commission's view, such a hedging limitation was not appropriate partly because, in the absence of any substantial anti-competitive barriers and in the presence of substantial market making competition (an average of over seventeen market makers per stock), NASD market makers were not believed to have any special ability to profit by means of manipulative efforts. That decision, in part, also reflected a view that such a hedging restriction on market makers would mandate the separation of options and underlying equity market making functions and unduly restrict entrepreneurial and self-regulatory trading market innovations. The risks of manipulations were believed to be out-balanced in this competitive environment by the potential efficiencies which the NASD believed could result from dual market making.

Drawing upon your collective experiences, do you believe that, in today's regulatory environment, market makers, as distinguished from other market participants (and, separately within that class, primary exchange specialists), have the ability to manipulate at will markets in highly liquid securities? Does your answer differ if the manipulation only has to involve a very small price swing? Assume that in today's marketplace, a market maker does have the ability to move his stock up or down marginally. While it may be that the risks of losses sustained in trying to move the price of the stock are greater, in most cases, than the potential rewards after disposing of the stock positions so acquired, does the availability of secondary options markets, largely derivative in pricing from the equity stock markets, now present sufficiently greater opportunities for profit to induce such market makers into frequent manipulations?

The preceding questions have been premised on today's market environment. Do you believe that a marketplace freed of competitive restraints -- particularly those dealing with free access to all markets by all participants on equal or nearly equal terms -- will engender market forces able to check manipulative activities by any class of market participants but, again, particularly by market makers?

In any case, the Commission has, of course, approved the concept of concurrent trading and/or dual market making both on NASDAQ-listed securities and on certain regional exchanges. In the case of the NASD, this approval has been linked to the assurance that such dual market making would take place in an environment of vigorous competitive market making. In the Commission's view, its approval of the NASD's proposed dual market making will provide an opportunity to test the extent to which competition can be an efficient and effective regulator of a unified market for options and their underlying securities. In the case of concurrent trading on regional exchanges, the Commission has looked to each market's share of the total market volume in the underlying stocks to determine if there is manipulative potential in that market which the changing of the current restrictions would unleash -- and has concluded there is not.

In expressing its approval of certain regional exchange proposals to initiate concurrent and/or dual market making in options and the underlying stocks, the Commission has clearly implied that in those primary exchange markets in which specialists may possess the ability to influence the price of the stock, by virtue of their exclusive possession and knowledge of the limit order book and by virtue of being the primary market for such stocks measured by market share volume, such primary market specialists are not subject to the full degree of competition sufficient to act as a prophylactic restraint on their manipulative potential. It may be further implied that the Commission would not be inclined to permit options trading by primary exchange specialists until such time as the rules of those self-regulatory organizations are freed of anti-competitive restraints.

In this regard, do you believe that the Commission should merely satisfy itself with the removal of anti-competitive rules by the primary exchanges or should options trading by primary exchange specialists await the results of the removal of such rules to better assess the competitive environment?

TRADING ON INSIDE MARKET INFORMATION

An additional issue posed by the interaction of the options and equity markets is the ability of certain market participants, notably equity market traders and market makers, to take advantage of their unique access to the marketplaces and to react quickly to the "inside" market information that often befalls them. While not correctly viewed as manipulation, the advantages to certain market professionals of their time, place and information opportunities have always raised a question of fairness and have been, to a large extent, regulated on the equity markets. The most cannon example of this phenomenon is known as “front-running a block.” Front-running a block has traditionally been prohibited on the primary stock exchanges. [Footnote: For instance, knowledge of any transaction in a block of equity stock invokes NYSE Rule 112.10(b) which prohibits any member of that exchange with such knowledge front introducing orders from off-floor in that security until two minutes have passed after the trade has been reported (see also NYSE Rule 127(a)). However, no NYSE rule inhibits an NYSE member with such foreknowledge, other than a specialist or member on the floor, from immediately trading in options on that security.] However, the unfettered ability (except for primary stock exchange specialists and floor members) to react to foreknowledge of a block in the options market has focused the clash between those who argue for “optimally equitable” markets and those who urge “optimally efficient” markets. The ability of a block positioner to hedge in the options market a potential position he may take (if he is unable to find purchasers for all or part of the other side of a block), and thereby transfer all or part of his positioning risk to the options market, may induce a block positioner to take larger positions more frequently at less of a discount from the current market for the stock. To the extent other market professionals, notably specialists and market makers, are similarly advantaged, their ability to play a constructive role in the merchandising of blocks is enhanced. Accordingly, market disruptions which can result from block transactions may be ameliorated. On the other hand, it has been argued that it is unfair to options market makers, traders, and investors to permit an equity market professional to take advantage of his tine and place opportunities (i.e., privy foreknowledge of the block coming to market) at their expense. Thus, orders in the options market may be “picked off” by a trader with knowledge of a pending block transaction in the stock before the block transaction is reported.

What is your opinion of the merits of the notion that market efficiency is enhanced by permitting anyone, including market professionals, to trade on inside market information?

IMPACT ON CAPITAL RAISING

The impact of options trading on the ability of corporate issuers to raise new equity may be viewed from several perspectives: Does the availability of standardized options trading on certain underlying securities enhance or retard the issuers of those underlying stocks in floating new issues? It may be argued that the ability to transfer risks in holding such stocks to the options market and to generate premium income in writing calls on such stocks would increase the attractiveness of purchasing underwritten offerings and holding such stocks vis-à-vis other stocks upon which options are not available. On the other hand, it has been urged, but not yet demonstrated, that options trading adversely affects the price and the volatility of the underlying stock, particularly near expiration periods. There have been several studies of this phenomenon commissioned by self-regulatory organizations. The results of those studies are preliminary but indicate that activity in an option does not effect the underlying stock. At best, the issue is unresolved and warrants the continuing study it is being given by the industry, academia and the Commission.

A correlative question involves the relatively high “listing” standards that have been applied to limit the universe of securities on which standardized options may be issued by the Options Clearing Corporation to those which are broadly distributed and actively traded and about which a great deal of information is available to the public. The effect of such characteristics is to limit qualified securities to those which are less susceptible to manipulative practices. Assuming the availability of standardized options on a qualifying security enhances the capital raising ability of the issuer of the security, are the anti-manipulative benefits of such prophylactic standards outweighed by the extent to which many corporations whose issues do not qualify as underlying securities for standardized options are at a competitive disadvantage in attracting capital vis-à-vis their competitors on whose securities options trading may occur?

A question not yet adequately addressed by any economic study to date is whether the availability of standardized options trading, as a popular trading and speculative instrument, affects the allocation of highly liquid risk money which has traditionally funded the bulk of new equity issues by small, unseasoned companies, particularly those coming to the market for the first time. Notwithstanding the lack of statistical evidence and the extreme difficulty of segregating out the availability of options markets from all other potential causal factors (e.g., general economic conditions, investor apathy, high interest rates, etc.), some professionals in the underwriting business and managers of corporations interested in raising capital have unequivocally stated that, in their opinion, the options markets have attracted capital away from the new issues market. This view is supported to some extent by a poll of options investors commissioned by the Amex; that poll found that a significant number of investors considered options trading to be a substitute for investing in speculative stocks and new issues. Others have urged, however, that the existence and success of the options markets have re-established the interest of small to medium sized investors in the securities markets in general after the withdrawal of such persons from the securities markets in the early 1970’s. It is argued that this interest will be felt in the new issues field in due course. However, this argument has been reversed by those less sanguine with respect to options who believe that the only persons making money in the options markets are market professionals and that the resulting disillusionment and disaffection with the options markets by investors will spread to the securities industry as a whole.

IMPACT ON DEVELOPMENT OF A NATIONAL MARKET CENTER

The concept of a national market system was advanced primarily to enhance a reduction in aggregate market costs and to provide fair and equitable treatment to all participants in the securities markets. As the Commission oversees the continuing development of various component initiatives leading to the national market system, its, and the industry’s, regulatory efforts must be tailored to reflect a concern for both equity and efficiency. As former SEC Commissioner Richard B. Smith has observed:

"... any regulation aimed at protecting investors should be measured against its impact on market efficiency, so that the true cost of such regulation becomes apparent both to the regulator and to the regulated. Such analysis, I believe, should become a more integral part of the preparation and basis for administrative action. That action requires a careful weighing of both equity and efficiency factors, so as to achieve an integration of the two in order for both to serve the interest of our society." [Footnote: Richard B. Smith, Equity and Efficiency in the Securities Markets, Center for Research in Security Prices, May 16, l968, p. 11.]

Contrasting the arguments that, as a general matter, regulation is inflexible, costly, stifling to innovation and inefficient is the argument that utilizing perfect competition as a model for policy making overlooks the sometimes very high costs of disseminating knowledge and introducing competition where ignorance and monopolistic elements have long held sway. In this regard, Professor Harold Demsetz has noted:

"Public policy should design institutional arrangements that provide incentives to encourage experimentation without overly insulating these experiments from the ultimate test of survival . . . Institutional arrangements, designed to promote efficiency in situations where dynamic problems are important, must cope with three objectives: (1) investment in a wide variety of experimentation should be encouraged; (2) this investment should be channeled into promising directions and away from unpromising ones; and (3) the new knowledge produced by successful experiments should be employed extensively. (Experimentation is interpreted broadly to include developing new products, new knowledge, new reputations, and new ways of organizing activities.)" [Footnote: Demsetz, Harold, "Perfect Competition, Regulation and the Stock Market," Economic Policy and the Regulation of Corporate Securities, ed by Henry G. Manne, American Enterprise Institute (1969), pp. 7-8. Emphasis added.]

With regard to the development of a national market system, the Commission is seeking to achieve just such a balance between active regulation and the creation of an environment encouraging self- regulatory organizations to take steps which may move the securities markets closer to a viable national market system. At all times, the costs of disruptive change in the capital markets must be weighed against the proposed benefits of those changes; only changes which have positive net benefits to investors should be sanctioned.

The introduction of standardized options trading has complicated the conceptual framework of the evolving national market system. Innovative forms of trading and increased emphasis on current market information are partially attributable to the availability of standardized options as a supplemental or alternative trading mechanism. Options trading, particularly the ability of specialists to trade options on their underlying specialty stocks, has provided new and, perhaps, rather lucrative profit centers for regional exchanges, and for various market making members on those exchanges, which may increase their ability to compete with the primary exchanges in equity issues.

The development of standardized options trading has posed many of the same problems that the equity markets have presented. The relative importance of auction and dealer markets must be measured by their respective impacts on the efficient (i.e., low total cost of. trading) organization of trading markets. The availability of transaction and quotation information should not only be free of regulatory impediments, but that information flow, as it is presently constituted, may become meaningless without combining in a physical sense the information as to both the option and the underlying equity issue. One aspect of this problem is whether those NASD market makers, who have traditionally been free of last sale reporting requirements in NASDAQ stocks, should now be required to go to a real-time transaction reporting system for those stocks underlying options concurrently with the commencement of options market making on those stocks. Another issue that may be anticipated is whether there is a need for the development of some form of protection for limit orders in options as dually-traded options proliferate.

Standardized options trading is still in its infancy. We may anticipate new regulatory concerns as this trading mechanism develops and its interaction with the equity markets becomes better known and this knowledge, in turn, produces new forms of interactions or reinforces old ones. On the other hand, the future structure of the national market system is not, nor need it be at this time, clearly defined. The securities markets are in a constant state of change, and proposed regulatory changes must be re-evaluated continually with respect to efficiency and equity considerations. The national market system of the future could take any one of many forms which would enhance the existence of competitive forces.

To date, the Commission has, as previously noted, limited its regulatory initiatives in this area to requiring a common clearing system, a standardization of option terms and conditions, a common system for providing real-time reporting of transactions in all standardized options and access to current options quotations. These regulatory structures are fully compatible with the underlying principles of a national market system: efficient execution of transactions, fair competition, availability of transaction and quotation information and the practicability of brokers executing orders in the “best market.” [Footnote: Section 11A(a)(1)(c) of the Act.] Yet, clearly, more is needed.

Initiatives in the development of a national market system have so far proceeded separately for stocks and for options. Is the time ripe for a more fundamental melding of the markets for options and their underlying securities? Should the transaction and quotation information for options be required to be available for side-by-side display with such information for the underlying equity stock? Is it appropriate to require, at this early stage of dual trading in options, some form of consolidated limit order book for options and/or for options-stock limit orders? In view of the continuing innovations in the methods of trading standardized options, should the Commission begin looking at the relative efficiencies of unitary specialist systems versus competing market maker systems insofar as options are concerned or leave this matter to be resolved by competition between market centers which employ different systems? What role do you envisage options playing in the future development of a national market system?

Agenda Topic 3

What can and should the Commission do to maintain Investor protection and still encourage the internationalization of the securities markets?

1. What is meant by "internationalization" of the securities markets?

2. Should the Commission encourage the "internationalization" of the securities markets?

3. How should the Commission apply the disclosure requirements of the Securities Act and the Exchange Act to foreign private issuers whose securities are distributed in U.S. markets or traded in U.S. secondary markets?

4. How should the Commission deal with foreign mutual funds and foreign investment advisers?

5. How should the Commission regulate brokers engaged in international securities transactions?

6. How should the Commission pursue enforcement of US, laws in connection with international securities transactions?

(1) What is meant by "internationalization" of the securities markets?

(a) "Internationalization" between existing markets

The phrase "internationalization of the securities markets" may be defined in two different ways, and it is often used so as to leave doubt as to which meaning is intended.

First, "internationalization" may refer to the fact that there are separate national securities markets, and that securities issuers, investors, brokers, dealers and underwriters from one jurisdiction no longer limit their activities to their own markets, but "jump over" the national boundaries to other markets. For example, U.S. issuers distribute securities in Europe, and Japanese investors buy U.K. securities. Perhaps a more precise term for this phenomenon would be "trans-national" -- that is, between national markets.

The second meaning of "internationalization of the securities markets" is more visionary: it is the projection of the present "jumping over" of boundaries between markets into an argument that markets should exist without regard to national jurisdiction. Under this concept, buyers and sellers around the world would be linked and available to each other at all times, for example, through a satellite communications system. Perhaps a more precise term for this phenomenon would be "supra-national" that is, above national markets.

This Paper focuses mainly on the first of these two definitions of "internationalization", namely activities between national securities markets, and discusses this from the perspective of the U.S. securities markets. It is expected that most of the discussion at the Conference would be focused on this aspect of internationalization. It might be useful, however, for the participants also to discuss whether the Commission can and should take steps to deal with the growth towards truly "supra-national" markets.

(b) Elements of "internationalization" between U.S. and foreign securities markets

There are four principal elements of "internationalization" between the U.S. and foreign securities markets, and each of these involves issuers, investors and securities brokers, dealers and underwriters. These elements are: (1) primary offerings and secondary trading of foreign securities in the U.S. where Commission involvement is most immediate; (2) primary offerings of U.S. securities in foreign markets, where Commission involvement concerns the question of whether such offerings must be registered; (3) secondary trading for foreign persons in U.S. markets, where Commission involvement is active, particularly as it concerns foreign brokers; and (4) secondary trading for U.S. persons in foreign securities in foreign markets, where Commission involvement is minimal. An additional element of "internationalization" may be found in so-called "out-out" financings, which are offerings by foreign issuers in markets outside their home countries, in which a U.S. underwriter participates. An example would be the recent issue in the Middle East by the Korean Development Bank of bonds denominated in Kuwaiti Dinars. These financings do not involve U.S. markets and do not come within the purview of the Commission's responsibility, other than the fact that they would include the normal prohibitions against unregistered distribution in the U.S. This section of the Discussion Paper gives a brief description of each of the four principal elements. Those Conference participants who are familiar with these elements may wish to go directly to Section (2) on page 3-7.

(i) Primary offerings and secondary trading of foreign securities in the U. S.

<u>Issuers.</u> Because it has been felt that U.S. markets are able to absorb larger offerings and debt securities with longer maturities than other markets, foreign issuers offer their securities to investors in the U.S. through public offerings and private placements. In addition, foreign issuers feel that there is a significant element of prestige in having their securities accepted in the U.S. markets, which demand high ratings from recognized U.S. rating agencies. According to figures published by Morgan Guaranty Trust Company of New York, foreign issuers had offerings in the U.S. of $0.96 billion in 1973, $3.26 billion in 1974, $6.46 billion in 1975, and $7.79 billion in the period January through October 1976. The majority of these issues has been by governments or government agencies. Most of the private issuers, at least in recent years, have been Japanese firms.

Foreign issuers also list their securities on U.S. stock exchanges. At present, there are 248 foreign issues (36 equities and 212 bonds and debentures) listed on the NYSE, and 73 foreign issues (68 equities, 5 bonds and debentures) on the American Stock Exchange. The NYSE has recently amended its listing rules so as to encourage foreign issuers to list, and so tar two new foreign issuers have listed their shares, and others are expected to do so.

Finally, foreign securities often find their way into U.S. over-the-counter markets through no action of the issuer but solely as the result of secondary trading. While there are no exact figures on the number of such issuers, at the present time approximately 150 foreign issuers whose securities are traded in the U.S. over-the- counter markets furnish information to the Commission pursuant to a rule exempting them from more formal registration. At the same time, 32 other non-North American foreign issuers have formally registered equity securities trading in these markets.

<u>Underwriters and Brokers.</u> In order to solicit underwriting business from foreign issuers, U.S. securities firms maintain offices in foreign countries. U.S. firms maintain nearly 252 foreign offices. It may be estimated that 15 to 20 European offices of U.S. firms, principally in London and Paris, and several Japanese offices, engage in regular business calls to develop underwriting clients.

(ii) Primary offerings of U.S. securities in foreign markets

<u>Issuers.</u> U.S. issuers have engaged in public offerings and private placements of their securities in foreign markets, principally in the so-called "Euro-bond" market. [Footnote: This discussion paper does not deal extensively with the Euro-bond market. Conference participants who are interested in the latest developments in this market should read the November 8, 1976 edition of the <u>International Herald Tribune</u>, which has a special supplement on Euro-bonds. Reprints of this supplement will be available at the Conference reception desk.] Such offerings by U.S. issuers have fallen off since the removal in 1974 of restrictions on U.S. issuers transferring funds from the U.S. to finance their foreign operations. The highest rated U.S. issuers, while able to raise very substantial sums in the U.S., wish also to keep open the channels of finance in Europe and the Middle East and to keep their names before international investors. Other U.S. issuers whose ratings are lower, but with well known names, are sometimes able to borrow in the European and Middle Eastern debt markets at lower rates than they would have to pay in the U.S. market, which is very rating-conscious. According to figures published by Morgan Guaranty Trust Company of New York, U.S. issuers had offerings in the Euro-bond market of $874 million in 1973, $110 million in 1974, $268 million in 1975, and $260 million through October 1976.

<u>Underwriters and Brokers.</u> In order to participate in foreign underwritings by U.S. issuers, U.S. underwriting and brokerage firms maintain offices abroad. Through these foreign offices, the U.S. firms maintain relationships with foreign financial institutions and

individuals with whom they hope to place public and private offerings of U.S. issuers. As indicated above, U.S. firms presently maintain 252 offices abroad. The center of underwriting arrangements and syndications is in London (which is considered a "switchboard" market, in that the securities are not purchased by local U.K. residents and the dealers in the U.K. represent foreign purchasers) and to a lesser extent in Zurich.

(iii) Secondary trading for foreign persons in U.S. securities

Issuers. U.S. securities are bought and sold by investors from many parts of the world. Total foreign portfolio investment in the U.S. was $98.5 billion as of September 30, 1976, consisting of $39.8 billion in stocks, $11.6 billion in corporate bonds (including issues of Federal agencies and of state and municipal governments), $10.5 billion in other private debt (notes, loans and long-term certificates of deposit), and $36.6 billion in U.S. Treasury debt. This total portfolio investment was up $12.5 billion since December 31, 1975. According to the New York Stock Exchange, in 1975 total purchases and sales of U.S. securities by foreign persons amounted to $25.7 billion. This consisted of purchases of $14.3 billion, and sales of $11.4 billion, for net foreign purchases of $2.9 billion. The principal foreign countries involved were Switzerland ($1.0 billion net purchases), U.K. ($0.5 billion net purchases), and Canada ($0.5 billion net purchases). In 1975 foreign transactions on the NYSE contributed nearly 7.6% of total NYSE commissions, in addition, foreign entities often make tender offers for U.S. securities. Foreign firms made 26 tender offers for U.S. securities in 1975 and 14 tender offers between January and mid-August, 1976.

Brokers. In order to deal with foreign customers interested in U.S. securities, U.S. securities firms maintain offices in foreign jurisdictions. NYSE member firms now maintain 252 foreign offices. One firm alone maintains 61 offices abroad. In addition, foreign firms maintain operations in the U.S. in order to carry on purchases and sales of U.S. securities for their customers. There are presently estimated to be 31 brokerage firms with U.S. offices or stock exchange memberships owned by 61 foreign financial institutions. Certain of these firms hold one or more memberships on the U.S. regional stock exchanges, particularly on the Boston Stock Exchange (18), the Midwest Stock Exchange (15), and the Pacific Coast Stock Exchange (13). In light of open access provisions embodied in recent U.S. securities legislation, it is anticipated that foreign affiliated firms will apply to become members of other exchanges. There is talk at present that 6 or 7 foreign firms are considering making investments in U.S. brokerage firms.

(iv) Secondary trading for U.S. persons in foreign securities traded in foreign markets

The fourth element of "internationalization of the securities markets" is purchase and sale by U.S. persons of foreign securities traded exclusively in foreign markets. According to the NYSE, in 1975 total purchases and sales of foreign securities in foreign markets by U.S. persons amounted to $14.3 billion. This consisted of purchases of $10.4 billion, and sales of $3.9 billion, for net purchases of $6.5 billion. The principal countries involved were Canada ($3.2 billion net purchases), Israel ($0.4 billion net purchases), and Japan ($0.3 billion net purchases).

These transactions are carried on by the U.S. customer dealing directly with foreign brokers or dealing with U.S. brokers who pass along the orders to foreign brokers. Generally, U.S. brokers are not granted access to the stock exchanges of foreign countries, with a few exceptions. [Footnote: See discussion in footnote 4, page 3-25, and the accompanying text.]

<u>(2) Should the Commission encourage the "internationalization" of the securities markets?</u>

With a few exceptions, no special mandate has been provided to the Commission for treatment of international securities transactions. Traditionally, the Commission has been concerned with domestic U.S. securities transactions, and it has not undertaken any special treatment or mandate concerning foreign securities or international securities transactions. The Commission's primary goal has been the protection of investors through disclosure of material information by securities issuers, and the maintenance of orderly and competitive securities markets through regulation of market arrangements and the conduct of securities professionals. The Commission's involvement in international securities activities has usually been limited to dealing with specific issues arising in its normal workload. Over the recent past, specific issues involving international aspects have been arising with increasing frequency. These issues have principally concerned the following matters:

(i) What should be the scope of disclosure required of foreign issuers whose securities are distributed in U.S. markets or whose securities find their way into U.S. markets in secondary trading without a distribution by the issuer?

(ii) Should the Commission provide exemptions from registration under the Securities Act for securities distributions by U.S. issuers in foreign markets, and exemptions from regulations under the Exchange Act for underwriters and brokers which participate in such foreign distributions?

(iii) Should foreign mutual funds be permitted to offer their shares in the U.S., and should foreign investment advisers be allowed to offer their services in the U.S., and how should such foreign funds and advisers be regulated, and how should the Commission apply its disclosure requirements to U.S. mutual funds which sell their shares in foreign markets?

(iv) Should foreign brokers and financial institutions, including banks and their affiliates, be admitted to membership on U.S. securities exchanges, and, if so, how should they be regulated, and how should the Commission regulate the foreign activities of U.S. brokers and financial institutions engaged in securities transactions abroad?

(v) How should the Commission pursue enforcement of U.S. securities laws in international transactions which involve U.S. markets, U.S. persons, or substantial conduct in the U.S.?

The Commission's involvement in these questions having international aspects has increased greatly over the recent past. This reflects the fact that international securities transactions have increased tremendously. At the same time, the U.S. Government has followed a policy of encouraging the free flow of capital and the removal of barriers to such free flow, thereby encouraging "internationalization." In addition, international organizations such as the European Economic Community and the Organization for Economic Co-Operation and Development have undertaken proposals to liberalize restrictions on capital movements and to develop minimum standards in regulation of international securities transactions. As these international securities activities increase, and as questions having international aspects arise with increasing frequency in the Commission's work, the Commission must concern itself with the question of whether it has a role to encourage the "internationalization" of the securities markets. Is the role of the Commission limited to questions of investor protection and maintenance of orderly and competitive markets without regard to whether this encourages or discourages "internationalization" of the securities markets, or does the Commission have the authority to, and should it as a matter of policy, encourage such "internationalization"?

In addition to continuing to focus on its goal of investor protection and orderly markets, the Commission must determine whether it should be seriously concerned with the following questions and considerations:

(i) If there is to be a shortfall in capital formation in the future, is the Commission interested in the ability of U.S. issuers to raise capital in other markets of the world, and of foreign issuers to raise capital in U.S. markets?

(ii) Is the Commission interested in maintenance of the reputation of U.S. issuers in foreign markets?

(iii) Is the Commission interested in having U.S. investors become more familiar with foreign securities and thus increase their interest in purchasing such securities?

(iv) Is the Commission interested in the ability of less developed country issuers to raise capital in U.S. markets?

(v) Is the Commission interested in protection of non-U.S. investors in foreign capital markets when they purchase U.S. securities?

(vi) Is the Commission concerned with development of the capital markets of foreign countries?

(vii) Is the Commission interested in establishing closer relationships with agencies of foreign governments and with international organizations which deal with capital market matters and securities regulation, and should the Commission take an active part in efforts to establish minimum international standards for disclosure, for regulation of mutual funds and for improvement and harmonization of accounting standards and practices worldwide?

If the Commission is to be seriously interested in such questions, how do they fit within the mandate and authority of the Commission to seek investor protection and the maintenance of orderly markets? How do these questions and considerations fit within the normal workload of the Commission, and what resources, in terms of budget and staff and Commission time, should be devoted to the pursuit of these matters? To what extent should the Commission be willing to take innovative steps to encourage "internationalization"?

The phrasing of the principal question for this Discussion Paper suggests that the Commission perhaps should take a more positive stance to encourage international capital flows. This assumption could be viewed as a departure from the traditional neutral and passive role played by the Commission in connection with the determination and pursuit of national policy and national interests as they concern securities transactions. The participants at the Conference are urged to consider as an overriding issue in itself, and also in connection with each of the specific issues (disclosure, mutual fund and investment adviser regulation, broker regulation, and enforcement matters) to be discussed in the remaining sections of this paper, whether or not the Commission as an independent regulatory and enforcement agency should as a matter of policy assume the role of sponsor or promoter of a particular economic interest.

Sub-group discussions will likely focus on the overall role of the Commission concerning "internationalization," and an analysis of what alternatives are available to the Commission in terms of its role. In addition, the participants may express their views on how the Commission could go about blending in a practical manner the pursuit of the role that the participants suggest concerning "internationalization" with the necessity that the Commission spend the vast majority of its time dealing with specific questions and issues that arise under the statutes and rules administered by the Commission.

(3) How should the Commission apply the disclosure requirements of the Securities Act, and the Exchange Act to foreign private issuers whose securities are distributed in U.S. markets or traded in U.S. secondary markets?

The philosophy embodied in the Securities Act of 1933 (the "Securities Act") and the Securities and Exchange Act of 1934 (the "Exchange Act") is that U.S. investors, are best protected by full and fair disclosure of all material information about issuers of securities which are publicly distributed in the U.S. or are traded in U.S. secondary markets. The disclosure required in the distribution process is accomplished through registration with the

Commission under the Securities Act and filing of the appropriate registration statement and prospectus, and the continuing disclosure required in post-distribution and secondary trading is accomplished under the Exchange Act through filing with the Commission of interim, periodic and annual disclosure reports. In dealing with foreign issuers in the U.S. markets, whether it be in public distributions or in secondary trading, the Commission's policy has been to provide U.S. investors with protections as equal as reasonably and practicably possible to the protections provided to them when they deal in securities of domestic U.S. issuers.

This policy of seeking to apply to foreign issuers the same standards as those applied to domestic issuers is more simply stated than carried out. Difficult questions of compliance with U.S. standards are created by differences in national laws, business practices and accounting principles, jurisdictional problems, and respect for national sovereignties. When necessary, the Commission has made accommodations to foreign issuers. This section of the Discussion Paper describes the accommodations that have been made in applying the disclosure requirements of the Securities Act and the Exchange Act to foreign private issuers in the U.S.

(a) Accommodations for foreign private issuers under the Securities Act

Initially, it should be noted that neither the Congress nor the Commission has favored, as a matter of policy, a double standard of disclosure for foreign issuers under the Securities Act. Neither the Securities Act, the rules adopted thereunder, nor the various registration forms differentiate between domestic and foreign private issuers. Foreign issuers are required to comply substantially with all of the disclosure standards. They may also be required to provide disclosures on economic, political and legal matters in their home country, including taxation, expropriation risks, shareholder rights, currency devaluation risks and the like.

Notwithstanding, the Commission has made some practical accommodations to foreign issuers. In the narrative portions of the prospectus, that is everything except the financial statements, accommodations for the most part have been limited to the disclosure of remuneration and benefits for individual directors and officers. As a general rule, such information is not required to be disclosed in foreign jurisdictions. Because of the potential harm to a particular company which such disclosures might entail, the staff has and will continue to accept aggregate figures for benefits for management as a group rather than requiring disclosures of benefits for particular individuals.

The Commission's traditional insistence that foreign issuers provide substantially the same disclosures as domestic issuers is based on the relative unfamiliarity of U.S. investors with foreign operations and customs, the lack of effective redress by such investors against foreign issuers, and the recognition that lowering its standards could possibly impede and not promote fuller disclosures in foreign jurisdictions. In the area of narrative, non-financial disclosure the staff believes that this policy has not caused any significant problems for foreign issuers.

The participants will likely consider and re-evaluate this policy. It has been asserted that the registration process itself and our required disclosures are too costly and time-consuming. What are the views of the participants on whether the Commission can and should grant additional disclosure accommodations to foreign issuers? Does the Commission in fact have authority to grant such accommodations?

(b) Accommodations for foreign issuers under the Exchange Act

The Exchange Act extends the disclosure approach of the Securities Act to the post-distribution trading markets. Its purpose is to provide current information on issuers of securities traded in the secondary market, through the filing and publication of current disclosure documents about the issuer.

Contrary to the policy and practice under the Securities Act to limit accommodations available to foreign issuers engaged in "distributions" of securities, over the years since the enactment of the Exchange Act in 1934 the Commission has granted substantial accommodations to foreign issuers in connection with the disclosure requirements of the Exchange Act. The different approach derives from the fact that the Exchange Act gives the Commission greater latitude to relate practices and customs of foreign issuers to the interests of U.S. investors. The accommodations that have been granted are based upon a number of factors: historical precedents adopted early in the history of the Exchange Act and the work of the Commission; the balancing of administrative burden and expense of attempting to compel compliance by foreign companies against the benefits to be received; the very real difficulties of enforcing U.S. civil and penal liabilities on foreign issuers and persons; the weighing of available enforcement remedies against the possible injury to the existing U.S. securityholders; notions of comity among nations, and questions under international law as to whether the Commission had authority to impose sanctions on foreign issuers and persons located and operating abroad; and the relatively minor impact that foreign securities have in the past had on U.S. markets.

There are a number of questions and considerations that the participants at the Conference should keep in mind in discussing the accommodations to be made for foreign issuers from the continuing disclosure requirements under the Exchange Act. In light of the increasing impact of foreign issuers on U.S. securities markets and the trend in foreign countries toward increased requirements of continuing disclosure, do the existing accommodations to foreign issuers in disclosure of current information continue to be justified, should existing accommodations be limited and curtailed, or should additional accommodations be made? Would the limitation or removal of accommodations have a material impact on foreign issuers and deter them from using U.S. markets? Does the interest, or potential interest, of U.S. investors in foreign securities justify the continuance or require the expansion of accommodations for foreign issuers from the continuing disclosure requirements of the Exchange Act? Is it fair to U.S. domestic issuers to impose less demanding continuing disclosure requirements on foreign issuers? Would increased continuing disclosure requirements on foreign issuers increase the familiarity of U.S. investors in foreign securities, and therefore promote the U.S. market for foreign securities? Are there any steps that the Commission could take to promote, either directly or indirectly, increased disclosure by foreign issuers in their own national jurisdictions without imposing complete U. S. requirements?

The accommodations for foreign issuers under the Exchange Act are described and discussed below.

(i) Exemption for foreign issuers from Exchange Act proxy rules and insider trading rules

Registration under the Exchange Act automatically triggers the proxy rules of Section 14 and the insider trading rules of Section 16. Section 14 generally regulates the solicitation of proxies and the nature and extent of information that must be furnished to shareholders in connection with meetings, whether or not solicitations are made. This information requirement also extends in certain respects to the annual reports furnished to shareholders. Section 16 requires disclosures of equity ownership by corporate insiders and prohibits short swing trading profits by such corporate insiders. Although no specific exemption for foreign issuers is contained in either Section 14 or 16, the Commission, pursuant to broad exemptive power otherwise provided, adopted Rule 3a12-3 in 1935. This rule, in effect, exempts issuers from most foreign jurisdictions from the provisions of Sections 14 and 16. This exemptive rule was adopted in recognition of the disclosure laws and customs of foreign jurisdictions, the prevalent use of bearer shares in such jurisdictions, the limited impact of foreign equity securities in our markets, and practical problems of enforcement.

(ii) Exemption for foreign over-the-counter securities from interim and periodic reporting requirements

Another significant accommodation provided for foreign issuers is in the registration requirements under Section 12(g) of the Exchange Act for equity securities trading in the over-the-counter market in the U.S. Because of the usual passive role of foreign issuers in the development of such trading markets and for practical enforcement reasons, the Commission has exempted by rule most foreign issuers from the registration and the attendant periodic reporting requirement. Rule 12g3-2, adopted in 1967, provides, basically, a two part exemption. First, it exempts the equity securities of foreign issuers if such class of securities is held by less than 300 persons resident in the U.S. rather than the 500 securityholder world-wide test of Section 12(g). Second, notwithstanding the number of total U.S. securityholders, paragraph (b) the Rule provides a complete exemption from the reporting requirements if the foreign issuer (or a foreign government official on its behalf) furnishes, not files, to the Commission whatever material information the issuer reports to its own government or to foreign stock exchanges, or otherwise makes public to its securityholders. Other miscellaneous exemptions in Rule 12g3-2 are for American

Depositary Receipts and temporary exemptions for most foreign issuers which are required to file periodic reports by reason of prior Securities Act or Exchange Act registrations. These exemptions are not available to essentially American companies although foreign formed or to certain North American companies. At the present time, approximately 150 foreign issuers are furnishing information under this Rule.

Although Rule l2g3-2(b) generally has worked satisfactorily and has resulted in the receipt by the Commission of information that might not otherwise be made available, the timing of the receipt of the information and the extent of the information furnished could be improved. The problem of differing accounting disclosures remains. However, the basic premise appears to remain valid that perhaps ultimately American investors will be furnished with information substantially similar to that which would be furnished if the securities were registered. In any event, a more practical solution to this problem may not be available. The Participant’s recommendations in this area would be helpful.

(iii) Accommodations for foreign listed or registered securities from interim and quarterly reporting requirements

Domestic issuers file with the Commission interim reports on Form 8-K and quarterly financial statements on Form 10-Q. Most foreign issuers have never been and are not now subject to the requirements to file these interim and quarterly reports. It can be assumed that this historical exemption was based on the absence of any similar requirements in foreign jurisdictions.

To fill the void left by this exemption, in 1967 the Commission adopted Form 6-K to be filed by foreign issuers registered under the Exchange Act. This was based on the recognition by the Commission that foreign jurisdiction were revising and increasing periodic disclosure requirements and therefore that same type of current reporting requirement was practicable. Pursuant to Form 6-K foreign issuers furnish to the Commission the same information required to be furnished under Rule 12g3-2(b) by foreign issuers not registered under the Exchange Act, i.e., whatever material investor information that is required to be made public in the foreign jurisdictions or which is distributed to shareholders. Form 6-K is not deemed “filed” for purposes of Section 18 liability. No foreign issuer furnishes under Form 6-K the detailed information required to be filed by domestic issuers on Form 10-Q. Form 6-K has substantially the same practicable merits and shortcomings of Rule l2g3-2(b), particularly the nature and extent of interim financial reporting.

(iv) Accommodations in initial registration and annual reports for listed or registered foreign securities

Corporate issuers domiciled outside of North America which list securities on national stock exchanges or any foreign issuer which, is subject to Section 12(g) of the Exchange Act and which is not eligible for or does not desire to take advantage of the exemption in

Rule l2g3-2, must register the applicable securities on Form 20. Those foreign issuers with securities registered on Form 20 must also file an annual report on Form 20-K. The financial statements required in these forms are the same as would be required in domestic forms, and any material differences in accounting principles must be reconciled to U.S. generally accepted accounting principles. (See discussion of accounting matters under (c)) The disclosure requirements imposed in the narrative portions of these foreign forms are not nearly as demanding as those specified for domestic issuers required to register and report on Forms 10 and 10-K respectively. Again, the Commission was concerned with the effect that disclosure requirements which were contrary to foreign customs, practices and requirements would have on the trading markets for foreign securities in the U.S. Accordingly, only general minimal non-financial disclosure requirements are specified in Form 20. The annual report form on 20-K is designed as an update of the Form 20 information, but, except for financial statements, requires disclosures of only changes in previously reported information regardless of when reported.

Forms 20 and 20-K were last amended in 1967. Since that time, the domestic counterparts, Forms 10 and 10-K, have undergone significant amendments. These amendments to the domestic forms have resulted in part from the Commission's continual efforts to improve disclosures to investors, the Commission's efforts to integrate the disclosure requirements of the Securities Act and the Exchange Act, and developing national economic problems and also in part as a consequence of non-securities legislation. The principal amendments to Forms 10 and 10-K have resulted in added or increased disclosures pertaining to sales and earnings by lines of business, competitive conditions, the five year summary of earnings, legal proceedings, including environmental matters, and background of and remuneration or other benefits paid to management.

There has been discussion recently at the Commission that perhaps foreign issuers should be required to disclose in their initial and annual reports on Forms 20 and 20-K substantially the same information that is made available by domestic issuers. (The financial statements would remain as at present.) The same policy considerations and questions raised in the discussion of the other accommodations afforded to foreign issuers under the Exchange Act (see above) are applicable here. Why should not foreign issuers be required to disclose the same information to enable informed comparable investment decisions? Are foreign issuers being given unfair and unjustified competitive advantages? On the other hand, given the differences in the legal, economic and business environments in which such foreign issuers operate, can or would foreign issuers comply with such increased disclosures? Would such increased disclosure requirements deter foreign issuers from using our capital markets and/or cause retaliation abroad? What would be the impact of any such requirement on the domestic markets for foreign securities? Are there other practicable alternatives to increasing the disclosure requirements of foreign issuers, or easing the compliance, burden on such issuers as a result of the adoption of increased disclosures requirements?

The views of the participants on the proposal to amend Forms 20 and 20-K are particularly solicited.

(c) How should the Commission apply its accounting requirements to foreign issuers?

The Commission understands that the principal problems faced by foreign private issuers relate basically to the accounting requirements that must be met in order to register their securities under the Securities Act or to file the appropriate reports under the Exchange Act. The Commission understands that foreign issuers are required to expend considerable effort in order to meet U.S. standards. However, the Commission believes that it is absolutely essential that financial statements published by foreign issuers should be as directly comparable as is practicably possible to the financial statements published by U.S. domestic issuers in order that U.S. investors may make informed investment decisions.

The Commission expects to make few, if any, concessions for foreign issuers with respect to the form and content of financial statements and the related disclosure. The financial, information is generally the most important part of any prospectus, and the Commission thinks that the information supplied should be comparable to that supplied by our own companies. However, some accounting accommodations have been made.

The Commission does not insist that the auditors certifying financial statements by foreign issuers be permitted to practice in the U.S. This is the case if the foreign accountants follow generally accepted auditing standards in the U.S. and are aware of and able to apply U.S. generally accepted accounting principles.

In seeking comparability in financial statements, the Commission permits, with certain exceptions, foreign issuers to prepare their financial statements in accordance with accounting principles which are generally accepted in their home country, provided that if there are any material differences between such principles and generally accepted accounting principles (GAAP) in the U.S., the financial statements must include a reconciliation by way of footnotes of such differences to U.S. GAAP. However, in the case of other foreign issuers, the practice has been different. For example, the Commission had uniformly required Japanese issuers to prepare consolidated financial statements according to U.S. GAAP, because Japanese financial statements are vastly different from U.S. financial statements, especially in that the Japanese statements usually are not consolidated and cover the parent only.

Some persons assert that the Commission's insistence that foreign issuer financial statements be reconciled with U.S. GAAP or be restated in conformity therewith causes undue problems for certain foreign issuers. For example, they assert that some foreign issuers are required to maintain two sets of books, one based upon generally accepted accounting principles in their own countries, and another based upon U.S. GAAP to be used for filings with the Commission. It would be useful for the participants to discuss the accounting requirements of the Commission as they apply to foreign issuers and to express their views on whether they feel that the requirements are too strict, or in fact should be stricter.

In another area of accounting requirements, the Commission permits foreign issuers to include in their filings “convenience translations” of amounts shown in foreign currencies into amounts shown in U.S. dollars. The purpose of this is merely to provide the reader with some general idea of magnitude: such “convenience translations” are not intended to be, and should not be, read to indicate that the foreign issuers actually earn U.S. dollars, and should not be used as a basis for projections of earnings in the future. There is some consideration at present as to whether the use of “convenience translations” should be discontinued because their use may imply direct comparability between foreign and U.S. issuers, and may lead the reader away from considering the very significant fact that foreign issuers operate in a different legal, economic and political environment from U.S. issuers.

(d) What disclosure should be made by foreign issuers engaged in rights offerings to U.S. shareholders?

Some persons argue that foreign issuers engaged in rights offerings (for example, U.K. issuers), and which provide substantial disclosure under their home country laws, should not be required to file a separate U.S. registration statement in order to make the rights offering to their U.S. shareholders. These persons assert that the Commission should be able to determine whether the disclosure standards applicable in the home jurisdiction are acceptable for protection of U.S. investors. On the other hand, some argue that the foreign issuer should make available the same information that domestic issuers provide so that the investor may have comparable information. They argue that there is no reason to permit foreign issuers to raise capital by sales to U.S. investors without complying fully with the same disclosure requirements applied to U.S. issuers.

Should it make a difference whether the foreign issuer has shareholders in the U.S. because it took affirmative action to use the U.S. markets, such as a public offering or a listing, or that the foreign issuer took no affirmative action and its securities found their way to the U.S. in secondary trading? Is a short form Securities Act registration feasible for these offerings? Should such offerings be permitted without at least minimum information concerning the offering and the issuer being available in the U.S.?

(4) How should the Commission deal with foreign mutual funds and foreign investment advisers?

Under the Investment Company Act of 1940 and the Investment Advisers Act of 1940 the Commission is charged with extensive regulatory and supervisory responsibilities over investment companies and investment advisers.

(a) Foreign mutual funds

Unlike other Federal securities laws, which emphasize disclosure, the Investment Company Act provides a regulatory framework within which investment companies must operate, Among other things, the Act: (1) prohibits changes in the nature of an investment company's business or its investment policies without shareholder approval; (2) protects against management self-dealing, embezzlement or abuse of trust; (3) provides specific controls to eliminate or mitigate inequitable capital structure; (4) requires that an investment company disclose its financial conditions and investment policies; (5) provides that management contracts be submitted to shareholders for approval and that provision be made for the safekeeping of assets; and (6) establishes controls to protect against unfair transactions between an investment company and its affiliates.

Foreign mutual funds are prohibited from selling their securities in the U.S. in connection with a public offering; however, Section 7(d) of the Investment Company Act authorizes the Commission, by order upon application, to permit a foreign company to register and to make a public offering if the Commission makes a finding that "by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of [the Investment Company Act] against such company and that the issuance of such order is otherwise consistent with the public interest and the protection of investors." In December 1974 the Commission solicited public comments on several basic issues regarding foreign investment company sales in the U.S., and in September 1975 the Commission announced that it would consider, on an ad hoc basis, applications for permission to register filed by foreign investment companies, which applications addressed certain issues outlined in the Commission release. During the past several years varying degrees of interest in registering under the Investment Company Act have been expressed by foreign mutual funds. While certain German, Dutch and Japanese money managers have preliminarily investigated the possibility of selling fund shares in the U.S., thus far none has filed with the Commission the necessary application for permission.

Under what circumstances, if any, could the Commission accept the regulatory system of a foreign country, such as Germany or Japan, as providing alternative and adequate protection for U.S. investors? How can the Commission determine the adequacy of the regulatory environment in a foreign country? Under what circumstances, if any, should the Commission exempt a foreign fund from provisions of the Investment Company Act to which a domestic mutual fund would be subject? How can the Commission ensure that it and U.S. investors could enforce effectively the provisions of the Investment Company Act against a foreign fund? Is there any overriding public policy reason for permitting foreign money managers to offer fund securities in the U.S. -- would U.S. investors have significantly improved investment opportunities, and would such sales significantly further the internationalization of the capital markets? Would a policy of reciprocity be in the public interest?

(b) Foreign investment advisers

Persons who, for compensation, engage in the business of advising others as to the value of securities, or the advisability of purchasing or selling securities, or who as a part of a regular business promulgate analyses or reports concerning securities, must register with the Commission under the Investment Advisers Act. The Advisers Act, among other things, prohibits fraudulent, deceptive or manipulative practices, performance fee contracts, except in certain cases, and advertising not complying with certain restrictions.

Foreign investment advisers with U.S. operations are required to register under the Investment Advisers Act. To what extent, if any, should the Commission exempt foreign advisers from the provisions of the Act? Under what circumstances, if any, should the Commission exempt from any provisions of the Advisers Act the foreign activities of foreign advisers or the foreign activities of all registered advisers? How can the Commission ensure that it and U.S. investors could effectively enforce the provisions of the Advisers Act against foreign advisers? When a foreign investment adviser operates in the U.S. through a U.S. subsidiary engaged in rendering investment advice, should the foreign parent also be regulated under the Act, and if so, to what extent?

<u>(5) How should the Commission regulate brokers engaged in international securities transactions?</u>

In addition to the disclosure and regulation provisions discussed in the preceding sections of this Discussion Paper, the Securities Exchange Act of 1934 assigns to the Commission broad regulatory responsibilities for securities markets and persons in the securities business. The Exchange Act, among other things, requires the Commission to develop and enforce a comprehensive scheme of regulation over securities transactions effected on U.S. markets, and to impose requirements necessary to make that regulation reasonably complete and effective. Securities exchanges are required to register with the Commission. The Exchange Act provides for Commission supervision of the self-regulatory activities of registered exchanges, and permits registration of associations of brokers and dealers exercising self-regulatory functions under Commission supervision. The Exchange Act also requires registration of brokers and dealers doing a business in securities and prohibits fraudulent, deceptive and manipulative acts and practices on the exchanges and in the over-the-counter markets.

(a) Foreign brokers activities abroad with U.S. customers.

The question has arisen as to when a “broker” or “dealer” (which terms under the Exchange Act would cover most financial intermediaries, including banks) located abroad should be deemed to be engaged in a securities business within the jurisdiction of the U.S. and thus be required to register with the Commission and to comply with U.S. rules and regulations applicable to registered brokers and dealers. [Footnote: The application of the anti-fraud provisions of the securities laws, on the other hand, does not depend on a finding that a particular person is conducting a business within the U.S., and accordingly such provisions apply where there is a requisite effect on the U.S. securities markets, violative acts occur in the U.S., or U.S. jurisdictional means are used in connection with such violations.] Traditionally, the Commission's staff has taken the position that a broker or dealer is deemed to be transacting a business in securities within the jurisdiction of the U.S. if, among other things, its customers are either nationals or residents of the U.S. This is so even if the transactions effected by the broker or dealer originate outside of the U.S.

With the growing "internationalization" of securities markets, this interpretation by the Commission's staff could create problems. For example, a foreign broker which regularly deals abroad with U.S. customers may be deemed to be transacting a business in securities within the jurisdiction of the U.S., and thus be required to register with the Commission and to comply with U.S. rules and regulations. In addition, an increasing number of U.S. financial institutions, including both brokers and Edge Act subsidiaries of U.S. commercial banks, have established offices outside the U.S. Through those foreign operations they deal with financial institutions, including U.S. institutions, often in transactions in U.S. securities and on U.S. markets. Under the above interpretation, those foreign operations would require broker-dealer registration and compliance with U.S. rules and regulations.

It would be useful for the participants to discuss the extent to which the Commission should regulate the activities of brokers outside of the U.S. dealing with U.S. customers, and how the Commission could enforce any such regulation.

(b) Foreign brokers' activities in the U.S.

Additional issues arise when foreign brokers physically come into the U.S. Securities regulation in the U.S. has traditionally depended to a substantial degree on the concept of self-regulation, with Commission oversight; that is to say, the securities industry regulates itself through organizations such as securities exchanges and the National Association of Securities Dealers, which are subject to oversight jurisdiction of the Commission. The Commission recently determined that under the Exchange Act exchanges cannot predicate denial of membership on foreign ownership or affiliation, and that it is no longer in the province of the exchanges to adopt "most favored nation" or "mutual non-discrimination" policies for access by foreign firms, pursuant to which foreign firms could be admitted only if U.S. firms could be admitted to the comparable organizations in their home countries. At the same time, the Commission does recognize that many foreign countries, either directly or indirectly, exclude participation by U.S. firms in their markets. [Footnote: The Commission is engaged in a study of impediments that exist in foreign countries to access to capital markets by non-nationals, including rules prohibiting membership on local stock exchanges. The Commission is cooperating with the Department of the Treasury in its proposal that the OECD undertake an examination of impediments, and recently participated in a meeting of the OECD Committee on Financial Markets at which this proposal was adopted. OECD member countries will be asked to identify any impediments that they perceive in other countries and any impediments that may exist in their own countries. The Commission’s study on this subject will serve as the basis for the U.S. response to the inquiry.]

It would be useful for the participants to discuss ways in which the Commission can foster increased access to U.S. markets in order to attract more capital and increase the competitive edge of U.S. markets over the markets abroad that remain closed to brokers and intermediaries other than those for the home country.

Another aspect of regulation of foreign brokers active in the U.S. is that foreign brokers may claim that they should receive special treatment in the form of limitation of or exemption from certain U.S. regulations because foreign secrecy laws may prevent them from disclosure of certain information. For example, they may claim that they are not able to disclose fully the information about their customers that is required by U.S. regulation. It would be useful for the participants to discuss whether foreign brokers should be afforded any special treatment because of such problems.

<u>(6) How should the Commission pursue enforcement of U.S. laws in connection with international securities transactions?</u>

The tremendous increase in the internationalization of securities markets in recent years raises many difficult enforcement problems for the Commission. Some of the activities in the international field requiring enforcement efforts by the Commission are as follows: (i) unregistered distributions in the U.S. by foreign issuers; (ii) foreign distributions by U.S. issuers followed by apparent “secondary” sales in U.S. markets, raising the question whether the original foreign distribution should have been registered with the Commission; (iii) manipulative activities and trading on inside information in U.S. markets (and in U.S. securities traded abroad) carried out through foreign financial institutions; (iv) acquisition by foreign interests of substantial percentages and possible control of U.S. issuers without making the required reports to the Commission; (v) extension of credit by foreign financial institutions to U.S. citizens or residents in excess of amounts allowed (50%) by U.S. credit regulations; and (vi) use of foreign financial institutions to facilitate bribery and other questionable payments by U.S. corporations.

The principal difficulties the Commission faces in carrying out its enforcement responsibilities in the international field are: (1) obtaining information about international transactions, and obtaining evidence about suspected violations of U.S. securities laws; and (2) effecting service of process on persons outside the U.S., and enforcing any judgments obtained.

(a) Obtaining information

The Commission encounters severe difficulties in obtaining information concerning international securities transactions. Secrecy laws in a number of countries prevent the disclosure of information about customers of banks and other financial institutions. This means that the Commission is often unable to pursue its routine market surveillance enquiries into possible trading on inside information when the trading has originated through a foreign institution.

The Commission presently has pending several proposals which it hopes will help in dealing with this problem. Proposed amendments to Exchange Act Rule 17a-3(a)(9) would require users of omnibus (undisclosed) accounts to undertake to furnish, at the request of the Commission, the name and address of each beneficial owner of the account.

The Commission has requested that legislation be enacted to affirm the power of Federal courts to grant ancillary relief in cases of refusal to comply with Commission requests for information. This would permit a court, in cases of such refusal, for example, to restrict transfer of shares, revoke or suspend the right to vote shares, prohibit payment of or impound dividends, or require public sale of the securities involved. The availability of these sanctions would provide a significant incentive for non-resident owners of U.S. securities to comply with requests for information from the Commission.

(b) Enforcement actions against foreign persons

The Commission has increasingly found it appropriate to bring enforcement actions in the U.S. against foreign financial institutions and individuals. This generally has been in the form of civil actions in U.S. courts seeking to enjoin such foreign institutions and individuals from claimed violations of U.S. securities laws. The Commission has faced great difficulties in such suits in effecting service of process over foreign persons. A number of countries refuse to honor requests from the Commission for the issuance of letters rogatory to assist the Commission to effect service of process. In these cases, the Commission has frequently bad to resort to obtaining a court order under Rule 4(i)(E) of the Federal Rules of Civil Procedure authorizing service of process by the international mails. Some of the countries which refuse to honor Commission requests for letter rogatory also object to service on their citizens by international mail.

The Commission has undertaken to improve its enforcement capability through participation in treaty negotiations. In January of 1977, a U.S.-Swiss Treaty on Mutual Assistance in Criminal Matters will go into effect. The aim of this treaty is to provide for mutual assistance between the two countries in connection with a wide range of criminal matters, including some financial crimes and business frauds. The Commission hopes that this treaty will assist it in the investigation of major international securities frauds.

Over the years the Commission has taken steps to establish informal working relationships with other countries in order to obtain the information it seeks and to carry out appropriate enforcement actions. The most dramatic example of such an informal working relationship is the Inter-Governmental Committee formed to deal with the IOS/Vesco debacle. When the 10S empire came tumbling down, it had more than one half billion dollars in assets located in a number of countries, including Luxembourg, Canada, Netherlands Antilles, and the Bahamas. There was no pre-existing international structure or organization to deal with the claims against these widely dispersed assets. As a result of Commission action instituted in the Southern District of New York, other interested governments took action to freeze assets, and receivers and liquidators appointed in the U.S. and elsewhere pressed suits in several countries and sought to lock up all assets which could be located. However, the need for separate actions in various national courts resulted in some instances in the assets being removed before they could be blocked, and in lengthy delays and conflicts. As a result of meetings among responsible persons in the countries involved, an informal Inter-Governmental Committee was formed to coordinate the activities of receivers and liquidators.

During the past three years the Inter-Governmental Committee has obtained control over hundreds of millions of dollars that were in danger of complete loss, and over most of the significant IOS entities. It has held meetings with liquidators of the principal IOS entities and funds. As a result of the work of this informal Inter-Governmental Committee, compromises and other practical working arrangements in the international securities area have been developed, and coordinated procedures for administration and distribution of the IOS funds have been established.

It would be useful for the participants to discuss their views on the international enforcement efforts of the Commission and the problems that are faced. How should the Commission deal with the problems of obtaining information about foreign transactions and carrying out enforcement actions in connection with such transactions? How can the Commission carry out its mandate to assure that U.S. investors are protected?

(c) “Extraterritorial” reach of U.S. securities laws

Another matter of importance in the international enforcement field is the question of what transactions should the Commission assert jurisdiction over. To the extent that there is uncertainty as to the extraterritorial reach of U.S. securities laws, there may be uncertainty in international securities transactions, and this may deter such transactions. Recent cases have shown that the courts are struggling over the question of the proper reach of U.S. securities laws.

To what extent should the Commission seek to establish more certainty in this area?

Agenda Topic 4

What should be the relationship between the Commission and the private sector with respect to the setting of accounting and auditing standards?

1. Do generally accepted accounting principles provide an appropriate framework for the fair presentation of a registrant's financial position and results of operations?

2. Should the Commission withdraw or modify its statement of policy on the establishment and improvement of accounting principles and standards issued in Accounting Series Release No. 150?

3. Should the Commission prescribe by rule auditing standards to be followed by independent accountants who certify financial reports filed with the Commission?

4. If the Commission determined to prescribe accounting and/or auditing standards, what resources would it require?

Introduction

An integral part of the disclosure process envisioned by the securities laws is the disclosure, on a periodic basis, of the financial position and results of an enterprise's operations. Historically, the Commission has followed a policy of looking to the private sector for leadership in the establishment of the accounting principles which are designed to assure that there is fair presentation of the financial data to be included in the reports filed with the Commission. Similarly, the Commission has looked to the private sector for the articulation of auditing standards which will provide the necessary guidance to the auditors who must report upon the results of their examinations of issuers' financial statements.

The role of accounting in the disclosure process has become more visible during the past ten years. Through the medium of public debate and litigation, the role of the accounting profession, the manner by which accounting principles and auditing standards are established, and the extent of protection that examinations by independent auditors give to the public, increasingly are being questioned. Recently, in a report entitled Federal Regulation and Regulator Reform, issued by the Subcommittee on Oversight and Investigations of the Committee on Interstate and Foreign Commerce of the U.S. House of Representatives, the following recommendations were made:

1. Independent accountants and auditors should become neutral corporate financial reporters. Thus, to the maximum extent practicable, the SEC should prescribe by rule a framework of uniform accounting principles. In instances where uniformity is not practicable, the SEC should require the independent auditor to attest that the accounting principles selected by management represent financial data most fairly. He should also prescribe supplemental data to permit a translation from one set of assumptions to another, thereby permitting comparability among companies in a particular industry.

2. The SEC should prescribe by rule auditing standards to be followed by independent accountants who certify financial reports filed with the SEC.

Implementation of the recommendations of the Subcommittee's report would be a significant change in the direction of the Commission's historic policy. The purpose of this paper is to outline some of the considerations which affect such a policy determination. For the purposes of this paper, it is assumed that the Commission's historic policy is permissible under the securities laws. [Footnote: On July 29, 1976 the public accounting firm of Arthur Andersen & Co. filed a lawsuit against the Commission seeking a declaratory judgment that, among other things, the Commission's statement of policy set forth an Accounting Series Release No 150 that it would consider that the principles, standards and practices promulgated by the Financial Accounting Standards Board in its statements and interpretations have substantial authoritative support and those contrary to such FASB promulgations would be considered to have no such support, was unlawful. Following the denial by the Court of Andersen's motions for a temporary restraining order and a preliminary injunction, the Commission filed a motion for summary judgment and/or dismissal. The Commission's motion is currently pending.]

<u>Background -- Accounting Principles</u>

The events leading to the Securities Act of 1933 (Securities Act), and the subsequent federal securities laws, are well known. In considering the appropriate remedy for the debacles of the 1920's, Congress considered, among other alternatives, a corps of federal auditors to conduct examination of companies seeking to obtain money from the public. However, in response to testimony from the accounting profession, Congress chose reliance on the certification of an independent public or certified accountant. Broad authority was given to the Federal Trade Commission (the first administrator of the Securities Act) to define accounting terms and to prescribe the form and details by which financial information was to be shown.

In 1934, administration of the Securities Act was transferred to the newly created Securities and Exchange Commission. Again, the role of the independent accountant was recognized as was the Commission's authority to define accounting terms and to prescribe the forms, detail and the methods to be followed in the presentation of financial statements included in filings with the Commission.

<u>Accounting Series Release No.4</u>

Following a period of internal debate concerning the Commission's role in the establishment of accounting principles, the Commission issued a statement of its policy. Accounting Series Release No. 4, issued on April 25, 1938, was an expression of the Commission's administrative policy. It stated that the Commission would presume that financial statements prepared in accordance with accounting principles for which there was no substantial authoritative support were misleading notwithstanding disclosure of the principles used. If there was a difference in view with the Commission, the Commission would accept disclosure in lieu of a change in the financial statements only when there was substantial authoritative support for the proposed accounting principle and the Commission had not expressed a contrary view in an official release.

Regulation S-X:

On February 21, 1940, the Commission adopted Regulation S-X, which contained the rules and requirements as to form, content and detail of financial statements and schedules filed under the Securities Act and the Securities Exchange Act.

Regulation S-X did not purport to establish accounting principles; it was limited to securing consistency in the form and structure of financial statements. Accounting principles continued to evolve in the private sector and as a result of the Commission's informal review procedures. In recent years, some have suggested that the Commission .has changed this policy and is now setting accounting standards through amendments to Regulation S-X. The Commission does not acknowledge that it is establishing new accounting standards through these amendments; rather, it views the amendments as providing important supplemental disclosure.

Accounting Series Release No. 96

In ASR No. 96, issued in January, 1963, the Commission explained that its policy "is intended to support the development of accounting principles and methods of presentation by the profession but to leave the Commission free to obtain the information and disclosure contemplated by the securities laws and to require conformance with accounting principles which have gained general acceptance."

The Financial Accounting Standards Board

From 1959 to 1973, the Accounting Principles Board, a committee of the AICPA, was responsible for the establishment of accounting principles. The members of the APB served on a part time basis without compensation. In response to criticism of the APB, the American Institute of Certified Public Accountants (AICPA) in 1971 authorized a study of how accounting principles should be established. Following an extensive inquiry, a seven person committee recommended establishment of a Financial Accounting Standards Board. The Committee's report was well received, and at the urging of many, including the SEC, the FASB was established and began operations in April of 1973.

The FASB was the first independent, full-time body designated by the accounting profession to formulate and issue accounting standards. It has seven full-time salaried members who have no other business affiliations. It is assisted in its work by a full-time technical and research staff of approximately 80 professional and administrative employees.

Before the FASB issues a new Statement of Financial Accounting Standards or Interpretation of an existing authoritative pronouncement an elaborate procedure involving notice to the public and an opportunity for comment is typically followed. First, a discussion memorandum is prepared and circulated to approximately 25,000 persons. The FASB then holds public hearings to receive comments on issues raised in the discussion memorandum. After consideration of the oral and written comments, an exposure draft setting forth the proposed financial and reporting standards is issued for broad public comment. After consideration of the comments received, the FASB deliberates further and prepares a final statement for issuance.

Accounting Series Release No. 150

With the establishment of the FASB, which it had supported, the Commission believed that it should publicly reaffirm its historic policy. On December 20, 1973, the Commission issued ASR 150 in which it reaffirmed its policy of deferring to the private sector for the establishment of accounting principles. ASR No. 150 states that with respect to the Commission's administrative policy first stated in ASR No. 4, "principles, standards and practices promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support."

* * *

As indicated by the recommendations of the Subcommittee on Oversight and Investigations, Congress is once again focusing its attention on the performance of the accounting profession. It is possible that some Congressional Committees may examine the role and performance of the accounting profession during the coming session of Congress. And, within the accounting profession, a debate has surfaced regarding the adequacy of the FASB's performance. The discussions and conclusions from this meeting are a part of the Commission's continuing evaluation of the efficacy of its past policies.

Question 1

Do generally accepted accounting principles provide an appropriate framework for the fair presentation of a registrant's financial position and results of operations?

Definition

The accounting and auditing literature describes the phrase "generally accepted accounting principles" as "a technical accounting term which encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application but also detailed practices and procedures. Those conventions, rules and procedures provide a standard by which to measure financial presentations."

Discussion

There is no one document which purports to describe all accounting principles or practices that exist or are employed in the preparation of financial statements. Nor does a broad framework presently exist which is the basis for all accounting principles or practices (however, the FASB has recently issued an extensive discussion memorandum as a part of a project leading to the development of a conceptual framework for financial reporting).

The accounting principles and practices in the United States represent a collection of conventions which can result in differing financial presentations for similar transactions. Although certain accounting alternatives have been eliminated (for instance, all research and development costs now must be charged to expense) others continue:

-- many companies use the FIFO method of costing inventories while others employ FIFO; in fact, many companies employ FIFO for domestic inventories and FIFO for foreign inventories even though the inventories are very much the same.

-- in the oil and gas industry some companies capitalize and others expense unsuccessful exploration costs (the FASB has a project underway which will consider this question).

-- although industrial companies generally value marketable securities at the lower of cost or market, insurance and investment company frequently value such securities at market.

In addition to its permitting alternatives, GAAP has also been criticized by some who believe it does not permit presentations which portray “economic reality.” For example, it has been recommended that:

-- financial statements should reflect the effects of the changing purchasing power of the dollar;

-- fixed assets should be carried at current value or current replacement cost rather than historical cost;

-- periodically, interest expense on long-term debt should be adjusted to reflect currently existing rates.

Some critics of existing GAAP believe all accounting alternatives should be eliminated through the development of a single, uniform framework which would apply to all companies in all industries. Others might not go quite this far but would seek uniformity for companies in similar circumstances. To many individuals, comparability of financial reporting among companies is paramount and anything significantly different results in chaotic reporting.

Critics of this view believe rigid uniformity can result in less meaningful financial reporting. In their opinion, even companies in the same industry do not necessarily operate in a similar manner and managements should be allowed considerable flexibility so that they can convey what they believe to be the "fairest presentation" of their financial position and operations (which differs from the "fair presentation" that is now required).

Thus, as we look at GAAP today we see it criticized from all corners -- to some it is too loose, to others it is too constraining, and finally, to some it does not produce the most meaningful presentation of financial results.

Question 2

Should the Commission withdraw or modify its statement of policy on the establishment and improvement of accounting principles and standards issued in Accounting Series Release No. 150?

Introduction

ASR No. 150 restates the Commission's historic policy of looking to the private sector to provide leadership in the establishment of accounting standards in recognition of the establishment of the FASB. Withdrawal or modification of that policy to any significant extent could be perceived as a reversal. Thus, the fundamental policy question would seem to involve a choice between standard setting in the public or private sector.

Arguments for standard setting in the public sector

Reporting of financial data directly or indirectly affects almost all segments of society. A primary goal of accounting should be fairness -- fairness in the sense that the reporting of economic events will be consistent for similar events and will reflect reality. Consistency in application and elimination of alternative principles to reflect the same types of events helps foster the efficient allocation of capital.

Good public policy would dictate that these broad objectives be achieved by the representative, of that public interest, with the force of law to ensure compliance with the established standards. The private sector lacks this "public" mandate and does not have the authority to insist that its standards, no matter how sound, are enforced.

Standard setting in the public sector is not unusual. For example, standards for air safety are set by the Federal Aviation Administration, for automobile safety by the National Highway Traffic Safety Administration, for foods and drugs by the Food and Drug Administration, for atmospheric and water pollution by the Environmental Protection Agency and by state governments. Cost accounting standards for government defense procurement contracts are established by the Cost Accounting Standards Board, created by legislation in 1970 and headed by the Comptroller General of the United States. It should be noted, however, that the government is a major party to the transactions for which the Cost Accounting Standards Board sets standards.

Regardless of ones views regarding the desirability of governmental standard setting, the fact remains that the Commission's policy of allowing accounting principles to evolve in the private sector has not worked. Alternative methods of reporting similar events still exist. The public interest requires that the Commission act to establish a rational set of accounting principles that will eliminate unnecessary alternatives. Although the private sector has and is making progress in establishing a broad "conceptual framework," this project has been slow in development with no success guaranteed. Additionally, the private sector has been unable, or unwilling, to react on a timely basis to specific industry or other emerging problems which have developed.

Thus, both because standard setting in the private sector has not worked and because of the need for governmental involvement in establishing accounting principles which have the force of law, the Commission should establish accounting principles.

Argument for Standard Setting in the Private Sector

The following arguments for establishing accounting standards in the private sector are taken from the report of the Study on Establishing Accounting Standards which led to the creation of the FASB:

"There are distinct disadvantages to transferring the standard-setting function to the public sector. One very real concern is that government agencies may be more susceptible to political pressures than private bodies. This could lead to accounting standards being designed to accomplish the self-serving objectives of private interest groups rather than solely to meet the needs of those who use financial statements in making economic decisions. The political pressures evident in 1971 when Congressional action was taken to regulate the accounting treatment of the investment tax credit reinforce this concern.

"A second concern is that where government agencies have laid their hands on accounting, the result has too often been a tendency toward inflexibility and a lack of responsiveness to the needs of investors. The failure of the Interstate Commerce Commission to take action to modernize railroad accounting is hardly a triumph for government regulation. State regulation of insurance accounting has not been responsive to the needs of shareholders for information relevant to investment decision-making. Other examples could, of course, be given. While the SEC's record in accounting matters has been generally well regarded, many believe it has held the clock back by consistently opposing the recognition of values as distinct from costs in accounting.

"A third argument against transferring standard setting to a government agency is the belief that such a development would inevitably sap the vitality of the accounting profession. To an increasing degree, through their participation in the work of the APB and in other ways, leaders of the profession have given unstintingly of their time and talent in the search for better accounting standards. We doubt that such men would be willing to contribute to a similar degree if the basic responsibility for accounting standards were shifted to government auspices. On the contrary, it seems likely that practicing public accountants might be largely reduced to the role of advocates on behalf of their clients. This would constitute a serious loss to the public at large."

These arguments are at least as sound today as when originally stated in 1973. Additionally, and as a counter to the arguments raised for the public sector, it should be remembered that government does not necessarily always work in the broad public interest, nor is the private sector insensitive to the expressed needs of the public.

Background -- Auditing Standards

The impetus for the formation of auditing standards, as they are known today, was the McKesson & Robbins case of the 1930's. McKesson & Robbins involved a massive management fraud which received wide public exposure and resulted in an SEC investigation into the character and scope of the examination by the company's independent public accountants, whether the examination conformed to the then generally accepted auditing standards, and whether generally accepted auditing standards were adequate to assure the reliability of financial statements. Before the Commission completed its investigation, the AICPA moved to rectify the deficiencies in auditing standards highlighted by this case. In 1939, the Institute's membership adopted "Extensions of Auditing Procedures," later known as Statement on Auditing Procedure (SAP) No. 1, initiating a series of such statements which extend to today, but which are now known as Statements on Auditing Standards.

SAP No. 1 addressed the audit procedures of physical observation of inventories and confirmation of receivables, specific problem areas evidenced by the McKesson & Robbins case. The AICPA's actions in this regard were noted by the Commission in the report on its investigation into the case. The Commission stated, "We have no reason to believe at this time that these extensions will not be maintained or that further extensions of auditing procedures along the lines suggested (by the Commission) in this report will not be made." The AICPA's by-laws were amended to create a standing Committee on Auditing Procedure, later replaced by the Auditing Standards Executive Committee, to issue additional technical pronouncements on auditing issues.

When the Commission adopted a requirement that a representation as to compliance with generally accepted auditing standards be included in the reports of independent accountants on financial statements filed with the Commission, a need for a pronouncement defining these standards became apparent. Accordingly, the AICPA's Committee on Auditing Procedures undertook a special study on auditing standards, differing from the Committee's previous activities which involved detailed auditing procedures. The AICPA's members subsequently adopted the nine standards developed by the Committee and they, together with a tenth standard which encompassed a longstanding audit principle, form today's "Generally Accepted Auditing Standards," as listed below:

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

I. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion can not be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

The fifty-four individual statements issued by the AICPA's Committee on Auditing Procedure were codified in 1973 in Statement on Auditing Standard No. 1, which with the statements issued subsequently form the comprehensive authoritative literature on auditing standards.

SEC Requirements

Rule 2-02(b) of Regulation S-X states:

"Representations as to the audit -- The accountant's report (1) shall state whether the audit was made in accordance with generally accepted auditing standards; and (2) shall designate any auditing procedures deemed necessary by the accountant under the circumstances of the particular case, which have been omitted, and the reasons for their omission. Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this rule."

As previously stated, with certain exceptions, the Commission does not prescribe the auditing procedures to be followed by independent accountants in examining and reporting on financial statements filed with the Commission. The Commission generally has recognized the role of the public accounting profession in providing leadership in developing auditing standards and procedures. However, the Commission and its staff do meet regularly with the AICPA's senior technical committee on auditing matters and their views are given careful consideration by that committee during the course of its deliberations. Moreover, the Commission has over the years commented on existing auditing practices in its opinions relating to examinations conducted by independent accountants involving deficiencies in adherence to existing standards and other matters of inadequate performance of audit examinations.

Question 3

Should the Commission prescribe by rule auditing standards to be followed by independent accountants who certify financial reports filed with the Commission?

Argument For:

We live in a litigious society. Multi-million dollar lawsuits involving accountants were rare ten years ago; today they are commonplace. In part, this explosion may be explained by an apparent gap between the performance of independent auditors and the expectations of the users of the auditor's reports. The report issued by the Subcommittee on Oversight and Investigations concluded:

"In this era of complex corporate structure, conglomerates, and multinational corporations, the SEC's reliance on the private accounting profession alone to assure that corporate records are examined by independent auditors has been insufficient to protect public investors and accomplish the objectives of the federal securities laws." [Footnote: Federal Regulation and Regulatory Reform, Subcommittee on Oversight and Regulations, House Committee on Interstate and Foreign Commerce, at 38 (1976).]

In general, the courts have measured an auditor's performance against the standards expected of a reasonable person within the profession. In other words, compliance with generally accepted auditing standards developed by the accounting profession will generally insulate an auditor from liability for deficient financial statements. If the Commission were to prescribe auditing standards through rulemaking, auditors would be provided a statutory defense premised on the sections of the securities acts which provide immunity from liability for those who in good faith rely on the Commission's rules.

The public interest requires that the standards by which liability for such a vital function as an audit is measured be determined by a method which includes public participation. Only through a government agency such as the SEC, following the procedures prescribed in the Administrative Procedure Act, can auditing standards be established in a manner that is fair to both the auditors and the users of their reports. With the specter of liability so clear, it is asking too much of the accounting profession to expect that they will act in the public interest without regard to their own self-interest. In 1969, John L. Carey, in his history of the accounting profession, wrote:

"Thus, as the legal liabilities of professional accountants in the United States have seemed to be extended by court decisions and legislation, the [American] Institute [of Certified Public Accountants] has become increasingly aware that pronouncements and rules which encourage higher standards of performance might he used against its members unfairly in the courts." [Footnote: Carey, John L., The Rise of the Accounting Profession, vol. 1 (New York, American Institute of Certified Public Accountants, 1969) pp. 248-9.]

An examination of the output of the Auditing Standards Executive Committee of the AICPA since its formation in 1972 indicates that its output is directed to developments that threaten auditors with increased responsibility and concurrent liability. To a large extent, they appear to create standards that will provide protection for their activities rather than to provide initiative in improving auditors' performance in the public interest. The accounting profession's attempts at defining their responsibility for the detection of fraud are illustrative. The authoritative accounting literature states:

"The ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result. The responsibility of the independent auditor for failure to detect fraud (which responsibility differs as to clients and others) arises only when such failure clearly results from failure to comply with generally accepted auditing standards."

The profession's recognition of this responsibility was acknowledged, to a limited extent, in the recent auditing standard on material errors and irregularities. However, even that document places its emphasis on the limitation of auditors' liabilities. The profession has still not clearly stated that it will fulfill the objective most expected by the public -- detection of material fraud. [Footnote: A survey conducted for a major accounting firm indicated that 66% of the investing public believe that "the most important function of the public accounting firm's audit of a corporation is to detect fraud." Public Accounting in Transition, Opinion Research Corporation, 1974, p. 48.]

Other differences between the perceptions or expectations of the public and the performance by the accounting profession include the areas of "independence," and "fairness" of presentation of financial information.

The definition of the auditor's responsibilities is too important to be left to those whose judgment, in appearance if not in fact, is clouded by self-interest. Instead, the SEC should prescribe auditing standards through rulemaking procedures.

Argument For or Against

Introduction

The following description of the work of the Commission, on Auditors' Responsibilities is presented for use by those on each side of the question. On one hand, these statements indicate the recognition by the accounting profession of the serious questions it faces. On the other hand, it is argued that the profession has been too slow in recognizing its responsibilities and is only now investigating and defining what it should be doing.

The profession, through the AICPA, has appointed a seven-person commission to study auditors' responsibilities. The charge to this Commission (known as the Cohen Commission) issued by the AICPA indicates the scope of their mandate;

"In the broadest sense, the function of independent auditors is to enhance the reliability of information used in financial decisions of a wide range of individuals and organizations. This role is an important aspect of the process of efficient allocation of resources in the economy. Therefore, it is vital to the economy that users of information have confidence in auditors. Such confidence is dependent on a mutual understanding as to the appropriate responsibilities of auditors and a belief by users that such responsibilities are being fulfilled.

"In view of the growing demands by investors, creditors, management, government, and the general public for auditors to assure a wider scope of responsibility, the American

Institute of Certified Public Accountants has concluded that a full-scale study should be made of the future function of independent auditors.

“The main purpose of the study is to develop conclusions and recommendations regarding the appropriate responsibilities of independent auditors. It should consider whether a gap may exist between what the public expects or needs and what auditors can and should reasonably expect to accomplish. If such a gap does exist, it needs to be explored to determine how the disparity can be resolved.

“Some of the specific questions being asked by the public are, What responsibility should an auditor have for detecting fraud? Should auditors monitor all financial information released to the public and if so, what should be the extent of their responsibilities? Should the auditor’s standard report, particularly the phrase “present fairly,” be changed to express better the responsibilities of auditors? What mechanisms should be adopted to strengthen the function of auditors? Is the mechanism for developing auditing standards adequate? What should the profession do to reduce the risks of misunderstanding about its role?

“In considering such questions, the study should recognize that the responsibilities of auditors may be constrained by the nature of the information presented, the evidence that exists to support that information, the effectiveness of the methods of acquiring that evidence, and the costs of collecting and analyzing the information. In developing the feasible responsibilities of auditors, responsibilities should not be confused with results. Recognizing a responsibility does not necessarily imply infallibility in execution.

“The study should obtain the views of as many interested and knowledgeable parties as is possible and should assure that the views obtained are representative of users and providers of independent audits as well as providers of financial information. One or more public hearings should be held. A public record should be maintained of significant proceedings of the study and of comments received.”

<u>Argument Against</u>

There is no evidence that would support a conclusion that the auditing standards established by the accounting profession have been inadequate to properly define the extent of an auditor’s responsibility. To the contrary, the fact that the Commission and the courts have generally accepted the profession’s standards is an indication of the appropriateness of these standards. The few instances of failures by auditors have resulted more from a breach of standards than from weaknesses in the standards themselves.

Additionally, there is no reason to believe that establishment of auditing standards by the government will necessarily narrow the gap between public expectations and realistic acknowledgement of the limitations of the audit process. Further, standards promulgated by the government could very easily become detailed checklists or rules that would be inflexible and not easily adaptable to rapidly changing situations.

As with the arguments against the public sector establishing accounting principles, many argue that establishing auditing standards by government would destroy the auditing profession. Standards of conduct, performance and ethics are hallmarks of a profession. To remove from the auditor the ability to establish his own standards, and be held accountable to them, would relegate the auditor to a subservient "examiner."

The policy of the SEC allowing auditing standards to be established in the private sector has implicitly recognized the ability of the accounting profession to act in the public interest. Any changes in that policy should await the report of the Commission on Auditors' Responsibilities.

Question 5 [*sic*]

If the Commission determined to prescribe accounting and/or auditing standards, what resources would it require?

Discussion

The Office of the Chief Accountant has 16 employees. The FASB has approximately 80 employees. The budget of the Chief Accountant's office is approximately $500,000 while the budget of the FASB is approximately $4 million per year and the AICPA spends approximately $600,000 per year on activities related to the establishment of auditing standards, not including the substantial expenses of the members of AudSec which are absorbed by their respective firms.

A decision that the SEC should involve itself to a greater extent in the setting of accounting or auditing standards must necessarily consider whether the Commission could reasonably expect to approximate the resources currently available in the private sector. The ability of the Commission to attract and retain qualified professionals to meet a changed mandate is a critical area of concern if the Commission were to assume a leadership role in the establishment of accounting or auditing standards. Recent audit experience, for example, is important if the Commission becomes active in establishing auditing standards. Would the Commission be able to secure the assistance of sufficient numbers of qualified persons?

CORPORATE DISCLOSURE PANEL TOPICS

I. Integration of the Securities Act of 1933 and the Securities Exchange Act of 1934

a. Should the Commission put more emphasis on the continuous reporting obligations of companies under the Exchange Act so that when a security offering is made under the

Securities Act, the registration statement would incorporate by reference all documents on file with the Commission and contain only data regarding the particular offering and such other information as is necessary to make the documents incorporated by reference not misleading?

b. Is it appropriate that there are different standards for liability with respect to filed and non-filed disclosures?

II. Projections and Soft Information

a. Should the Commission permit, or even require, items of soft information -- opinions, predictions, analyses and other subjective evaluations -- in company filings?

b. Should a broad safe harbor provision, comparable to the replacement cost data safe harbor rule promulgated by the Commission on December 9, 1976, be enacted for items of soft information?

(1) Is such a safe harbor provision needed if companies are to be expected to voluntarily disclose items of soft information in Commission filings?

(2) Are the present liability provisions of the federal securities laws particularly suited to "hard" historical data rather than "soft" evaluative information?

III. Differential Disclosure

a. Should the Commission implement a multi-level system of investor protection which utilizes the concept of "differential disclosure" and recognizes a significant variation in the needs and interests of different types of investors?

(1) Is it appropriate as a matter of policy, to assume that different levels of disclosure will satisfy the information needs of different types of investors?

(2) Is differential disclosure viable as a matter of law?

(3) Should the SEC adopt safe harbor rules to protect issuers who comply in good faith with the SEC rules which incorporate a differential disclosure approach?

(4) In what other areas would differential disclosure be appropriate?

IV. Disclosure of Socially Significant Issues

a. Should the Commission require corporate filings to contain more information regarding environmental and other socially-significant matters not traditionally considered of direct relevance to investment or shareholder voting decisions? (Please consider what criteria should be utilized by the Commission in determining which such information to require in corporate filings.)

V. Proxy Statement Revisions

a. Should information regarding director standards for selecting management and for evaluating management performance be required?

b. Should disclosure of the criteria utilized for selecting nominees to the board of directors be required?

c.. Should the shareholder proposal rules be amended to permit shareholders to nominate persons to the board of directors via management's proxy soliciting materials?

VI. Revision of Commission Disclosure Requirements

a. Should there be a different set of disclosure requirements for "large" companies and "small" companies?

b. Should the Commission require information other than that which is meaningful for investment analysis purposes, i.e., should the Commission require the disclosure of information solely to deter "undesirable" corporate conduct?

VII. Monitoring the Effects of Commission Disclosure Policy

a. Should the Commission monitor the effects of the statutes, rules and regulations administered by it? If so, how should such monitoring be effected?

b. Should the Commission undertake to report the results of any such monitoring program to Congress on a periodic basis?