1998 Annual Report

United States
Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

The Honorable Albert Gore, Jr.
Vice President of the United States and
President of the Senate
Washington, D.C. 20510

The Honorable J. Dennis Hastert
Speaker of the House of Representatives
Washington, D.C. 20515

Gentlemen:

I am pleased to send you the annual report of the Securities and Exchange Commission (SEC or Commission) for fiscal year 1998. The activities and accomplishments identified in the annual report continue the Commission's long tradition of effective enforcement in and regulation of our nation's capital markets. I have highlighted some of the Commission's achievements below.

Enhancing Investor Protections

The Commission remains vigilant in pursuing its law enforcement responsibilities. This past year, in an undercover investigation in the over-the-counter market, the Commission filed enforcement actions against 58 defendants. Of the 58 defendants, 14 are or have been

the subject of parallel criminal proceedings involving conduct related to that alleged in our complaints.

The Commission sanctioned a broker-dealer and four individuals for more than $5 million in fines for fraudulent sales practices. The Commission determined that the broker-dealer's compensation, production, hiring, and training policies created an environment that enabled the firm's brokers to engage in abusive sales practices such as churning, unauthorized and unsuitable trading, and lying to customers. This action makes clear that brokerage firms must place the interests of their clients first, and must avoid practices that put the firm and its brokers in conflict with the interests of their clients.

We also kept up our focus of coordinating examinations with foreign, federal, and state regulators and self-regulatory organizations to enhance cooperation. During the year, Commission staff conducted examinations with the Hong Kong, China Securities and Futures Commission; the United Kingdom's Financial Services Authority acting as the Investment Management Regulatory Organization; the Australia Securities Authority; and the Bundesaufsichtsamt Fur Das Kreditwesen.

To motivate Americans to get the facts they need to save and invest wisely, the Commission and a coalition of other government agencies, businesses, and consumer organizations launched a “Facts on Saving and Investing Campaign”. As part of this campaign, the Commission released a brochure entitled *Get the Facts on Saving and Investing,* which explains the basics of saving and investing, and conducted the first-ever national town meeting on saving and investing.

Disclosure Developments

For the past several years, the Commission has been actively reevaluating the current securities registration system. In November 1998, we published proposals that would modernize the regulation of capital formation and provide significant benefits to public investors, issuers of securities, and securities professionals.. The proposals are based on the recognition that these benefits will be recognized only if the registration system is flexible enough to adapt to changes in the capital markets of today and the future. The proposals also would update and simplify the regulations applicable to takeover transactions to address changes in deal structure and advances in technology.

We also overhauled the prospectus disclosure requirements for mutual funds in order to provide investors with clearer and more understandable information about funds. At the same time, we permitted a mutual fund to offer investors a new disclosure document, called the “Profile,” that summarizes key information about the fund.

Technology

One of the most significant areas we have been focusing on is automation and the many technological challenges facing the industry. First among them is preparing for the year 2000. This past year, our Compliance Inspections and Examination staff conducted nationwide examinations that were dedicated to obtaining information on the year 2000 problem. We also announced a moratorium on the implementation of new Commission rules that would require major reprogramming of computer systems by securities industry participants. As we approach the millennium, the Commission will continue its year 2000 program, taking any actions we believe will help ensure that the securities industry is prepared for the year 2000.

In light of the important role of technology, and the increasing competition in today's securities markets, we adopted a new regulatory framework for alternative trading systems. The new framework allows alternative trading systems to choose to register as exchanges *or* to register as broker-dealers and comply with additional requirements specifically designed to address their unique role in the market. It also better integrates alternative trading systems into the regulatory framework for markets, and is flexible enough to accommodate the business objectives of, and the benefits provided by, alternative trading systems.

We awarded a three-year contract for the modernization of our Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system. While EDGAR is one of the government's most successful large information system initiatives, the dramatic changes in technology over the past few years necessitate its modernization. EDGAR modernization will improve substantially the presentation quality and structure of SEC filings. The EDGAR architecture will be converted to an Internet-based system and will support the attachment of graphical files. This modernization will greatly benefit issuers, investors, SEC staff, and other data users.

International Listings

We continued our efforts to widen the range of choices available to U.S. investors by promoting the internationalization of our markets. In 1990, 434 foreign companies were reporting in the U.S.; today, there are over 1,100 foreign companies from 56 countries. We will continue to do all we can to encourage more companies to list here to afford U.S. investors the protections of U.S. securities laws.

Accounting

An area of great concern to the Commission is inappropriate earnings management. While this is not a new problem, it has risen in a market unforgiving of companies that miss Wall Street's estimates. During the year, our staff issued guidance on various issues relating to the presentation of earnings per share

* * *

The markets today are very different from the ones that existed just a few years ago. Over the last five years, the markets have experienced phenomenal growth and technological advances that have made our markets more accessible to more people. Change has always been the hallmark of our markets, and the SEC has succeeded by recognizing that fact and responding to it. I have every confidence that the Commission will continue to perform its responsibilities with the professionalism and dedication that all of us have come to expect.

Sincerely,
Arthur Leavitt,
Chairman

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Commission Members and Principal Staff Officers

(As of November 5, 1998)

Commissioners	Term Expires
Arthur Levitt, *Chairman*	2003
Norman S. Johnson, *Commissioner*	1999
Isaac C. Hunt, Jr., *Commissioner*	2000
Laura S. Unger, *Commissioner*	2001
Paul R. Carey, *Commissioner*	2002

Principal Staff Officers

Jennifer Scardino, *Chief of Staff*

Brian J. Lane, Director, *Division of Corporation Finance*

- **Vacant,** *Deputy Director*
- **Martin Dunn,** *Senior Associate Director*
- **William E. Morley,** *Senior Associate Director*
- **Robert A. Bayless,** *Associate Director*
- **Mauri Osheroff,** *Associate Director*
- **Shelley E. Parratt,** *Associate Director*
- **David A. Sirignano,** *Associate Director*
- **Vacant,** *Associate Director*

Richard Walker, *Director, Division of Enforcement*

- **Vacant,** *Deputy Director*
- **William Baker,** *Associate Director*
- **Paul V. Gerlach,** *Associate Director*
- **Thomas C. Newkirk,** *Associate Director*

Joan E. McKown, *Chief Counsel*
Christian J. Mixter, *Chief Litigation Counsel*
Stephen J. Crimmins, *Deputy Chief Litigation Counsel*
Walter Schuetze, *Chief Accountant*
James A. Clarkson, III, *Director of Regional Office Operations*

Vacant, *Director, Division of Investment Management* [Paul Roye joined the Commission as Director of the Division of Investment Management on November 22, 1998.]
Kenneth J. Berman, *Associate Director*
Barry Miller, *Associate Director*
Robert Plaze, *Associate Director*
Douglas Sheidt, *Associate Director*

Richard Lindsey, *Director, Division of Market Regulation*
Robert L.D. Colby, *Deputy Director*
Larry E. Bergmann, *Associate Director*
Belinda Blaine, *Associate Director*
Michael A. Macchiaroli, *Associate Director*
Catherine McGuire, *Associate Director*

Harvey Goldschmid, *General Counsel, Office of General Counsel*
Paul Gonson, *Solicitor and Deputy General Counsel*
David M. Becker, *Deputy General Counsel*
Karen Burgess, *Associate General Counsel*
Anne E. Chafer, *Associate General Counsel*
Richard M. Humes, *Associate General Counsel*
Diane Sanger, *Associate General Counsel*
Jacob H. Stillman, *Associate General Counsel*

Lori A. Richards, *Director, Office of Compliance Inspections and Examinations*

Mary Ann Gadziala, *Associate Director*
Gene Gohlke, *Associate Director*
C. Gladwyn Goins, *Associate Director*

Lynn E. Turner, *Chief Accountant, Office of the Chief Accountant*

Brenda Murray, *Chief Administrative Law Judge, Office of the Administrative Law Judges*

Erik R. Sirri, *Chief Economist, Office of Economic Analysis*

Deborah Balducchi, *Director, Office of Equal Employment Opportunity*

James M. McConnell, *Executive Director, Office of the Executive Director*
Michael Bartell, *Associate Executive Director*
Wilson A. Butler, Jr., *Associate Executive Director*
Margaret Carpenter, *Associate Executive Director*
Jayne Seidman, *Associate Executive Director*

Marisa Lago, *Director, Office of International Affairs*

Nancy M. Smith, *Director, Office of Investor Education and Assistance*

Susan Ochs, *Director, Office of Legislative Affairs*

Paul S. Maco, *Director, Office of Municipal Securities*

Christopher Ullman, *Director, Office of Public Affairs, Policy Evaluation and Research*

Jonathan G. Katz, *Secretary to the Commission*

Biographies of Commission Members

Arthur Levitt, *Chairman*

Arthur Levitt is the 25th Chairman of the United States Securities and Exchange Commission. First appointed by President Clinton in July 1993, the President reappointed Chairman Levitt to a second five-year term in May 1998. His term expires on June 5, 2003.

As SEC Chairman, Arthur Levitt's top priority is investor protection, which is reflected by the key successes of his first term: reforming the debt markets; improving broker sales and pay practices; promoting the use of plain English in investment literature as well as in SEC communications with the public; preserving the independence of the private sector standard setting process, ensuring the independence of accountants; and encouraging foreign companies to list on U.S. markets.

Chairman Levitt created the Office of Investor Education and Assistance and has held a series of investor town meetings to educate investors about how to safely and confidently participate in the securities markets. Under Chairman Levitt's leadership the Commission created a web site (www.sec.gov), which allows the public free and easy access to corporate filings, and an 800 number that enables the public to report problems and request educational documents.

Chairman Levitt has also worked to sever ties between political campaign contributions and the municipal underwriting business, as well as improving the disclosure and transparency of the municipal bond market. Chairman Levitt has sought to raise the industry's sales practice standards and eliminate the conflicts of interest in how brokers are compensated. In partnership with the securities industry,

Chairman Levitt developed the “Fund Profile” and other plain English guidelines for investment products to make disclosure documents easier to understand while maintaining the value of the information provided to investors.

In his second term, Chairman Levitt will maintain his focus on investor protection by: increasing cooperation with the criminal authorities to combat securities fraud; fighting fraud in the microcap stock market, working to ensure that the securities industry's computers are prepared for the year 2000 (Y2K); maintaining quality accounting standards; harmonizing international accounting standards; and creating a regulatory framework that embraces new technology.

Before joining the Commission, Mr. Levitt owned *Roll Call,* a newspaper that covers Capitol Hill. From 1989 to 1993, he served as the Chairman of the New York City Economic Development Corporation, and from 1978 to 1989 he was the Chairman of the American Stock Exchange. Prior to joining the AMEX, Mr. Levitt worked for 16 years on Wall Street. He graduated Phi Beta Kappa from Williams College in 1952 before serving two years in the Air Force.

Norman S. Johnson, *Commissioner*

Following his appointment by President Clinton, and his confirmation by the Senate, Norman S. Johnson was sworn in as a United States Commissioner on February 13, 1996 in a ceremony presided over by the Chief Federal District Judge in Salt Lake City, Utah.

Prior to his nomination, Commissioner Johnson was a senior partner in the firm Van Cott, Bagley, Cornwall & McCarthy and had a long and illustrious legal career focusing on federal and state securities law. Commissioner Johnson commenced his career in the private

practice after serving as a staff member of the SEC from 1965 through 1967. In addition, Commissioner Johnson served as an Assistant Attorney General in the Office of the Utah Attorney General from 1959 to 1965 and also served as a law clerk to the Chief Justice of the Utah Supreme Court.

During his career, Commissioner Johnson served as President of the Utah State Bar Association, was chosen as a State Delegate, House of Delegates, American Bar Association, and was named Chairman of The Governor's Advisory Board on Securities Matters, State of Utah. In addition, Commissioner Johnson served on the Governor's Task Force on Officer and Director Liability, State of Utah and numerous other committees and groups concerned with the application of federal and state securities laws

Commissioner Johnson has received numerous honors and awards in recognition of the outstanding contributions he has made to the Securities Practice in the Rocky Mountain area. He has authored several articles published in legal periodicals, one of which is much cited, “The Dynamics of SEC Rule 2(e). A Crisis for the Bar.”

Commissioner Johnson has involved himself in many community groups, including the Utah Supreme Court Committee on Gender and Justice. Married since 1956 to the former Carol Groshell, Commissioner Johnson has three grown daughters, Kelly, Catherine and Lisa, all whom reside in Utah.

Isaac C. Hunt, Jr., *Commissioner*

Isaac C. Hunt, Jr. was nominated to the Securities and Exchange Commission by President Bill Clinton in August 1995 and confirmed by the Senate on January 26, 1996. He was sworn in as a Commissioner on February 29, 1996

Prior to being nominated to the Commission, Mr. Hunt was Dean and Professor of Law at the University of Akron School of Law, a position he held from 1987 to 1995. He taught securities law for seven of the eight years he served as Dean. Previously, he was Dean of the Antioch School of Law in Washington, D.C. where he also taught securities law. In addition, Mr. Hunt served during the Carter and Reagan administrations at the Department of the Army in the Office of the General Counsel as Principal Deputy General Counsel and as Acting General Counsel. As an associate at the law firm of Jones, Day, Reavis and Pogue, Mr. Hunt practiced in the fields of corporate and securities law, government procurement litigation, administrative law, and international trade. In addition, Mr. Hunt commenced his career at the SEC as a staff attorney from 1962 to 1967.

Mr. Hunt was born on August 1, 1937 in Danville, Virginia. He earned his B.A from Fisk University in Nashville, Tennessee in 1957 and his LL.B. from the University of Virginia School of Law in 1962.

Laura S. Unger, *Commissioner*

Laura S. Unger was sworn in on November 5, 1997 as a member of the Securities and Exchange Commission, for a term expiring June 2001. Before being appointed to the Commission, Ms. Unger served as Counsel to the United States Senate Committee on Banking, Housing and Urban Affairs where she advised the Chairman, Senator Alfonse M. D'Amato (R-NY). As counsel, Ms. Unger followed legislative issues relating to banking and securities.

Prior to working for the Senate Banking Committee, Ms. Unger was a Congressional Fellow for Banking and Securities matters in the office of Senator D'Amato. Before coming to work on Capitol Hill, Ms. Unger

was an attorney in the Enforcement Division of the Securities and Exchange Commission in Washington, D.C.

Ms. Unger received a B.A. in Rhetoric from the University of California at Berkeley and a J.D. from New York Law School.

Paul R. Carey, *Commissioner*

Paul R. Carey was nominated to the Securities and Exchange Commission by President Bill Clinton and confirmed by the Senate on October 21, 1997 for a term which expires June 5, 2002.

Prior to being nominated to the Commission, Mr. Carey served as Special Assistant to the President for Legislative Affairs at the White House where he had been since February of 1993. Mr. Carey was the liaison to the United States Senate for the President, handling banking, financial services, housing, securities, and other related issues. Prior to joining the Administration, Mr. Carey worked in the securities industry focusing on equity investments for institutional clients.

Mr. Carey received his B.A. in Economics from Colgate University. Mr. Carey was born in Brooklyn, New York on October 18, 1962.

SEC Regional and District Offices

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Daniel F. Shea, Regional Director
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Randall J. Fons, Regional Director
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Richard P. Wessel, District Administrator
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Enforcement

The SEC's enforcement program seeks to protect investors and foster confidence by preserving the integrity and efficiency of the markets.

Key 1998 Results

In 1998, the SEC obtained judicial and administrative orders requiring securities law violators to disgorge illegal profits of approximately $426 million. Civil penalties authorized by the Enforcement Remedies and Penny Stock Reform Act of 1990, the Insider Trading Sanctions Act of 1984, and the Insider Trading and Securities Fraud Enforcement Act of 1988 totaled more than $51 million.

In SEC-related cases, criminal authorities obtained 74 indictments or informations and 61 convictions during 1998. The SEC granted access to its files to domestic and foreign prosecutorial authorities in 286 instances

Significant Enforcement Actions

Most of the SEC's enforcement actions were resolved by settlement with the defendants or respondents, who generally consented to the entry of judicial or administrative orders without admitting or denying the factual allegations made against them. The following is a sampling of the year's significant actions.

Internet-Related Cases

- The Commission filed a complaint against Steven Samblis, a self-styled stock picker, and his corporation New Stock, Inc., for failing to disclose that Samblis was paid for the companies he hyped in the magazine he published, “New Stock” *(SEC v. Steven Samblis, et al.*[1]). The SEC alleged that Samblis enthusiastically recommended the securities of certain publicly-traded companies without disclosing that he had been paid at least $20,000 to make these recommendations. The SEC also alleged that Samblis was paid to issue thousands of e-mails over the Internet regarding these same securities. In addition to a preliminary injunction, the SEC seeks a permanent injunction, disgorgement, and civil money penalties.

- The SEC filed a complaint against a radio talk show host, Jerome M. Wenger, who promoted the stock of a company on his radio program, “The Next Super Stock,” without disclosing that he was being paid by the company to do so *(SEC v. Jerome M. Wenger*[2]*).* Wenger received $4,000 in cash and stock that he sold for approximately $71,000. The SEC's complaint seeks a final judgment permanently enjoining Wenger and ordering him to disgorge his ill-gotten gains plus prejudgment interest and to pay civil penalties. Wenger was arrested and charged criminally by the U.S. Attorney's Office with securities fraud.

Broker-Dealer Cases

- The SEC filed an action against Michael R. Milken and MC Group, a firm owned and controlled by Milken *(SEC v. Michael R. Milken and MC Group*[3]*).* MC Group, through

Milken and others, acted as a broker in connection with two transactions in which it introduced companies; proposed business arrangements involving the purchase, sale, or exchange of securities; and participated in negotiations regarding the structure of the transactions and securities to be issued. As a result of these activities, MC Group received $42 million in transaction-based compensation. The SEC alleged that Milken violated the 1991 SEC order barring him from associating with a broker, and that MC Group failed to register as a broker, conduct for which Milken was responsible. Milken and MC Group consented to the entry of injunctions and to orders requiring them to pay disgorgement of $42 million plus prejudgment interest of $5 million.

- The SEC charged a broker-dealer, Olde Discount Corp., with creating an environment which encouraged its registered representatives to engage in churning, unauthorized trading, misrepresentations and omission of material facts, and unsuitable recommendations *(In the Matter of Olde Discount Corp,, et al*.[4]). In an order issued by consent, the Commission made findings against the firm and three of its senior executives. The Commission held Olde Discount directly liable for fraudulent sales practices flowing from the firm's compensation, production, hiring, and training practices. The Commission also found that the firm's founder, Ernest Olde, failed to supervise and caused the violations and that two former sales executives willfully induced and caused those violations and failed to supervise. The Commission imposed remedial relief, censures, cease-and-desist orders, and a total of $5.15 million in penalties against the firm and four individuals.

Microcap Cases

- The SEC filed 5 federal civil enforcement actions against 58 defendants resulting from an undercover investigation into illegal manipulation of the over-the-counter markets for "penny stock" or "microcap" securities *(SEC v. Szur, et al.*[5]*).* Of the 58 defendants 14 are, or have been, the subject of parallel criminal proceedings involving conduct related to that alleged in the SEC's complaints. The fraudulent schemes alleged in the 5 actions filed include: payments of undisclosed bribes totaling approximately $3.3 million to brokers who, in turn, induced their customers to purchase microcap securities; manipulation of the prices set by market makers for purchase and sale of those microcap stocks; and material misrepresentations about the issuers of microcap securities. The SEC is seeking permanent injunctions, court orders prohibiting the defendants from future participation in offerings of penny stocks, and disgorgement and prejudgment interest. These cases were pending at the end of the fiscal year.

- The SEC filed an emergency lawsuit in federal district court to halt the unregistered and fraudulent sale and manipulation of the stock of Electro-Optical Systems Corporation (EOSC) by Thomas Cavanagh and other defendants *(SEC v. Thomas Edward Cavanagh, et al.*[6]*).* The court ordered the defendants to immediately cease their fraudulent activity and froze their assets pending further litigation. The SEC also temporarily suspended trading in the securities of EOSC for a ten-day period because of questions regarding the accuracy of statements and material omissions concerning the company. The complaint alleged, among other things,

that defendants were conducting a fraudulent scheme to create a controlled market for the stock of EOSC in order to artificially inflate the price of the stock which they sold to unsuspecting investors, including numerous small investors purchasing over the Internet. The complaint alleged that defendants and relief defendants had made at least $5 million on sales of EOSC stock, and the fraud was continuing. As a result of defendants' actions, the complaint alleged, the price of EOSC stock rose more than 1000% in one day and was maintained by defendants at that level for several months through control of the supply of the stock and issuance of false and misleading information about the company and its potential product. The court entered a temporary restraining order prohibiting violations of the securities laws.

Investment Adviser and Investment Company Cases

- The SEC instituted administrative and cease-and-desist proceedings against Monetta Financial Services, Inc. (Monetta), a registered investment adviser; Robert Bacarella, Monetta's president; and William Valiant, Paul Henry, and Richard Russo—each of whom is a director of one of two mutual funds advised by Monetta *(In the Matter of Monetta Financial Services, Inc., et al.*[7]*).* The SEC alleged that Monetta received profitable short-term trading opportunities in certain “hot” initial public offerings (IPOs) from broker-dealers underwriting those offerings to whom Monetta had directed brokerage business generated by the funds. At Bacarella's direction, Monetta directed the hot IPOs to the personal accounts of Valiant, Henry, and Russo who accepted them without disclosing the practice to the funds' shareholders and obtaining the consent of disinterested

representatives of the Funds. Valiant, Henry, and Russo then “flipped” or sold the hot IPO shares for profits totaling more than $51,000. This is a process called “spinning.” The SEC further alleged that Monetta's allocation of the shares resulted in conflicts of interest because the receipt of the shares by Valiant, Henry, and Russo placed them in a position where their judgment and exercise of their responsibilities to the funds in general could be influenced by considerations of personal gain dispensed by Monetta. Monetta's IPO allocations constituted material information that was relevant to the operation of the funds because of these serious conflicts of interest. The SEC is seeking disgorgement and civil penalties. The case was pending at the end of the fiscal year.

- The SEC filed an injunctive action against Sweeney Capital Management, Inc. (SCM), a registered investment adviser; Timothy Sweeney, its owner; and Susan Gorski, a portfolio manager, for misappropriating more than $109,000 in client-owned soft dollar credits and for failing to disclose SCM's use of soft dollar credits for a variety of defendants' business and personal expenses *(SEC* v. *Sweeney Capital Management Inc., et al.*[8]*}.* The complaint alleged that during the fiscal year ended December 31,1994, SCM paid approximately 70% of its operating expenses with soft dollars misappropriated from its advisory clients and a hedge fund whose assets SCM managed. The defendants engaged in other fraudulent soft dollar practices, including submitting false invoices to soft dollar brokers for non-existent consulting work to pay for Gorski's salary, SCM's rent, and personal loans to Sweeney and submitting multiple invoices for the same goods and services. The SEC also alleged that defendants filed false forms with the SEC, distributed

misleading marketing materials to the public, made false claims to investors about the competitiveness of SCM's advisory fees, misused client assets in its custody, and misappropriated an elderly client's funds. The SEC is seeking permanent injunctions, disgorgement, and civil penalties. This case was pending at the end of the fiscal year.

Offering Violations

- The SEC obtained a temporary restraining order in its action against International Heritage Incorporated (Heritage Incorporated), International Heritage, Inc. (IHI), and other individuals associated with these two entities for a fraudulent pyramid scheme *(SEC v. International Heritage, Inc., et al.*[9]*).* The SEC alleged that IHI raised more than $150 million from over 155,000 investors through a pyramid scheme. In addition to selling interests in the pyramid scheme, the defendants sold $5 million in notes convertible into shares of IHI common stock. The defendants knowingly misrepresented IHI's financial condition to investors and concealed the fact that IHI was operating a pyramid scheme. The Court also appointed a receiver for IHI. This matter was pending at the end of the fiscal year.

- The court in *SEC v. American Automation, Inc., et al.*[10] entered a preliminary injunction against American Automation, Inc., Kendyll R. Horton, Hazel A. Horton, and Merle B. Gross. In addition, the court ordered the continuation of an asset freeze, previously granted in connection with a temporary restraining order against all defendants, including five relief defendants.

The court also appointed a receiver to take possession of the assets of American Automation. The SEC's complaint alleged that the defendants raised over $4.5 million through the fraudulent offer and sale of American Automation stock to over 1,400 investors in several states. The complaint also alleged that the defendants told investors that American Automation would develop and place automated insurance vending machines in high traffic areas and that projected profits would be almost $100 million by the end of its third year of operation; however, no automated vending machines have been sold and American Automation's only source of revenue has come from investors' funds. Additionally, the defendants allegedly used investor funds to pay for their personal expenses and for business expenses unrelated to American Automation's operations. This matter was pending at the end of the fiscal year.

Financial Disclosure Cases

- The SEC instituted administrative proceedings in which it alleged that KPMG Peat Marwick LLP engaged in improper professional conduct and issued an unqualified report on the 1995 year-end financial statements of a client from which it lacked independence *(In The Matter of KPMG Peat Marwick LLP*[11]*).* Peat Marwick organized and capitalized KPMG BayMark, a firm owned by Edward R. Olson and three others, as a vehicle for new lines of business, including the “corporate turnaround” business. As part of a turnaround engagement, KPMG BayMark installed Olson as president and chief operating officer of Porta Systems Corp., a financially troubled audit client of Peat Marwick's Long Island office. When Peat Marwick audited Porta's 1995 year-end financial statements and prepared its audit report, its

financial and business relationships with Porta and KPMG BayMark impaired Peat Marwick's independence. This case was pending at the end of the fiscal year.

- The Commission issued a settled cease-and-desist order against Sony Corporation and Sumio Sano *(In the Matter of Sony Corp. and Sumio Sano*[12]) and filed a related settled complaint against Sony in the U.S. District Court for the District of Columbia for violations of the federal securities laws based on Sony's inadequate disclosures concerning the performance of its subsidiary, Sony Pictures *(SEC v. Sony Corp.*[13]*).* Without admitting or denying the matters set forth therein, Sony consented to the issuing of a cease-and-desist order in which the Commission found, among other things, that Sony, a Japanese corporation whose securities trade on the New York Stock Exchange in the form of American Depositary Receipts, violated the periodic reporting provisions applicable to foreign private issuers. Specifically, the Commission found that during the four months preceding Sony's November 1994 writedown of approximately $2.7 billion of goodwill associated with the acquisition of its Sony Pictures subsidiary, Sony made inadequate disclosures about the nature and extent of Sony Pictures' net losses and their impact on the consolidated results Sony was reporting. The Commission also noted that during the relevant period, Sony did not report the results of Sony Pictures as a separate industry segment, but instead reported the combined results of Sony Pictures and Sony's profitable music business as a single “entertainment” segment, which had the effect of obscuring the losses sustained by Sony Pictures. The Commission ordered Sony to cease and desist from committing or causing violations of the periodic reporting provisions of the Exchange Act and to comply with

various undertakings. Without admitting or denying the allegations in the Commission's complaint, Sony consented to the entry of a final judgment imposing a $1 million civil penalty.

Insider Trading Cases

- The SEC obtained a temporary restraining order against unknown purchasers who traded just before the September 2, 1998 announcement that DST Systems, Inc. intended to acquire USCS International, Inc. *(SEC* v. *One or More Unknown Purchasers of Call Options and Common Stock of USCS International, Inc.*[14]). The SEC alleged that the unknown persons purchased 200 out-of-the-money USCS call options and 61,800 shares of USCS common stock for more than $1.6 million through an account in Zurich, Switzerland. The buyers sold the option contracts on September 3, obtaining profits of nearly $70,000, and transferred the proceeds to Switzerland. The SEC also alleged that on September 3 the unknown persons sold all 61,800 shares of USCS common stock for profits of as much as $500,000. This action was pending at the end of the fiscal year.

Municipal Securities Cases

As part of the SEC's initiative to address unfair practices in the municipal securities industry, the SEC recently brought two “yield-burning” cases:

- One was filed against Rauscher Pierce Refsnes, Inc. and its former Senior Vice President, James R. Feltham, in connection with the issuance of $129 million of Series 1992B

Refunding Certificates of Participation by their financial advisory client, the State of Arizona Department of Administration (DOA) *(SEC v. Rauscher Pierce Refsnes, Inc. and James R, Feltham*[15]*}.* The SEC alleged that Rauscher and Feltham sold certain United States Treasury securities (escrow securities) to DOA at above-market prices, which reduced the yields on those securities. According to the SEC's complaint, that practice allowed Rauscher to make illegal, undisclosed profits of $707,037 at the expense of the federal government, while purporting to comply with the federal tax laws governing the certificates offering The complaint also alleged, among other things, that Rauscher and Feltham charged DOA a fraudulent and excessive undisclosed markup on the escrow securities and that Rauscher's profit was unreasonable in light of the circumstances surrounding the sale. The matter was pending at the end of the fiscal year. The settlement preserved the tax-exempt status of the bonds issued, thereby protecting investors. The case against Snyder was pending at the end of the fiscal year.

International Affairs

The SEC operates in a global marketplace. Our international affairs staff promotes international cooperation among regulators and encourages the adoption of high regulatory standards by negotiating information-sharing arrangements for enforcement and regulatory matters, conducting technical assistance programs, and furthering the SEC's interests m international organizations

Key 1998 Results

The SEC develops global regulatory initiatives to better protect U S investors. This year, the Asian financial crisis highlighted the importance of high regulatory standards and the need for disclosure and transparency. We devoted substantial resources to respond to the Asia crisis, in addition to implementing international enforcement and technical assistance programs.

Regulatory Initiatives

In 1998, the importance of cross-border and cross-sector regulatory cooperation in promoting financial stability was noted by the Group of Seven (G-7) countries (Canada, France, Germany, Italy, Japan, the U K , and the U.S) The SEC worked closely with the U S Treasury Department on initiatives of the G-7 and the Group of Twenty-Two Finance Ministers and Central Bank Governors (G-22).

Work on Financial Stability

G-7 Summit

Our staff helped shape the G-7 Finance Ministers Summit Report, which called for improved international cooperation among regulators and law enforcement authorities, and compliance with Ten Key Principles of Information Sharing.

G-22

In response to the Asian financial crisis, the G-22 issued reports on transparency and accountability, and strengthening the international financial architecture. We played an active role in the development of these reports.

Core Principles of Securities Regulation

In 1998, the International Organization of Securities Commissions (IOSCO) adopted the “Objectives and Principles of Securities Regulation” (the Core Principles), which represent consensus on sound practices for regulating securities markets. Our staff worked within IOSCO to develop the Core Principles. The principles will guide securities regulators and assist international organizations in assessing securities regulation in emerging markets.

International Disclosure Standards

In 1998, IOSCO adopted non-financial statement disclosure standards that will allow issuers to prepare a single disclosure document for capital raising and listing in multiple jurisdictions.

International Accounting Standards

The SEC chairs IOSCO's working party on multinational disclosure and accounting. In early 1999, the International Accounting Standards Committee expects to finalize a core set of standards. The SEC and other IOSCO members will then consider whether to allow foreign issuers to use these standards for cross-border securities offerings.

Responses to Changes in Technology

Our staff contributed to lOSCO's development of a complementary international regulatory approach to the Internet, including the issuance of a 1998 report entitled “Securities Activity on the Internet.”

Year 2000 Preparedness

Through its work with IOSCO and other international organizations, the SEC is promoting Y2K preparedness internationally, including testing and contingency planning.

International Organizations

The SEC promotes its views on the U.S. securities markets and develops international consensus on regulatory and market oversight issues in various international forums.

International Organization of Securities Commissions

IOSCO is the predominant international forum for collaboration in the securities regulatory community. Its membership includes 90 countries, covering most of the world's securities regulators.

Council of Securities Regulators of the Americas (COSRA)

COSRA is a regional organization whose membership includes the SEC as well as securities regulators from 25 nations in North, Central and South America, and the Caribbean. In 1998, COSRA's key initiatives included (1) launching an innovative, hemisphere-wide "Facts on Saving and Investing Campaign," including town meetings, radio and television shows, and seminars, and (2) producing a report on collective investment schemes that provides information about the mechanisms used to oversee a variety of investment vehicles.

Organization for Economic Cooperation and Development (OECD)

Our staffs expertise on disclosure resulted in the inclusion of strict accounting and auditing guidelines for companies in the OECD's treaty criminalizing foreign bribery. The treaty will go into effect in early 1999.

Enforcement Cooperation

The SEC needs assistance from foreign authorities to protect U.S. investors from cross-border fraud. We have entered into over 30 formal information-sharing arrangements with foreign counterparts.

The following cases illustrate the effectiveness and importance of the SEC's international enforcement program.

SEC v. Euro Security Fund, et al.. In this insider trading matter, the SEC identified substantial purchases in the United States, through European banks, of Elsag Bailey's options and equities immediately prior to an announcement of a tender offer for Elsag Bailey by a Swiss-Swedish company. The SEC simultaneously obtained a U.S.

court order freezing $6.6 million in potential profits and requested information about the identity of traders from European securities authorities. With this assistance, the SEC identified one of the foreign traders as a company insider and obtained information to support a preliminary injunction.

SEC v. *Cavanaugh, et al* In this microcap fraud case, several Spanish entities controlled accounts involved in a manipulative trading scheme. The SEC's counterpart in Spain was instrumental in helping the SEC locate $5 million in proceeds at a bank in Spain. The money was then frozen to permit its return to defrauded U.S. investors.

Technical Assistance

The SEC's technical assistance program helps emerging securities markets develop regulatory structures that promote investor confidence The program is multifaceted and includes training, reviewing foreign securities laws, and responding to detailed requests The cornerstone of the SEC's technical assistance program is the International Institute for Securities Market Development, a two-week, management-level training program covering the development and oversight of securities markets. In addition, the SEC conducts a week-long International Institute for Securities Enforcement and Market Oversight.

Our staff participated in a range of training initiatives in conjunction with the China Securities Regulatory Commission, including a program on accessing the U.S. capital markets, and commented on Chinese draft securities legislation.

Investor Education and Assistance

Our Investor Education and Assistance staff serves investors who complain to the SEC about investment fraud or the mishandling of their investments by securities professionals. The staff responds to a broad range of investor inquiries, produces and distributes educational materials, and organizes town meetings and seminars.

Key 1998 Results

During the year, the investor assistance specialists analyzed and responded to 51,311 complaints and inquiries from the public. Our actions helped investors recover approximately $1.2 million. We launched the *Facts on Saving and Investing Campaign,* an unprecedented campaign to help Americans become financially fit. As part of the campaign, we conducted the first-ever National Town Meeting on Saving and Investing,

The SEC participated in 6 investors' town meetings and organized 32 educational seminars on investing wisely. In addition, we released three new publications, *A Plain English Handbook: How to Create Clear SEC Disclosure Documents, Get the Facts on Saving and Investing,* and *Investment Clubs.* We also compiled the *Financial Facts Tool Kit,* a collection of educational brochures from the campaign's partners.

Investor Complaints and Inquiries

Rising Volume of Investor Requests for Assistance

In 1998, our investor assistance specialists analyzed and responded to 51,311 complaints and inquiries, an increase of more than 7% over 1997. The volume of investor contacts agencywide has increased more than 45% since 1993. About 30% of the investor complaints and inquiries are received through our Investor Education and Assistance electronic mailbox (help@sec.gov).

Complaint Trends

The most common investor inquiries we received in 1998 involved (1) questions about the laws governing the securities industry, (2) questions concerning the filing status of companies, and (3) requests for SEC publications.

The most common complaints received were

- misrepresentation in selling a product,
- unauthorized transactions;
- delays in transfers of accounts or transfer problems,
- failure to follow an investor's instructions;
- about the way a corporation conducts its ordinary business;
- failure to process or delays in handling orders;
- failure to distribute money to investors;
- problems concerning 401K plans or pension plans;
- failure to send stock certificates to investors, and

- harassing cold calls from broker-dealers.

Referrals

When a complaint contains allegations of serious misconduct or suggests a pattern of widespread abuses, the investor assistance staff refers the complaint to the Division of Enforcement or the Office of Compliance Inspections and Examinations. In 1998, investor assistance specialists referred over 1,700 complaints to SEC divisions and offices or to other regulatory agencies

Investor Outreach

Because a well educated investor provides one of the most important defenses against securities fraud, we have a number of programs to educate investors

The Facts on Saving and Investing Campaign.

The Facts on Saving and Investing Campaign is an ongoing educational effort to motivate individuals throughout the Western Hemisphere to get the facts about saving and investing. During the kick-off week of March 29 to April 4, 1998, 21 countries throughout the Americas participated in the campaign. In the United States, campaign partners—including federal agencies, 46 states, consumer organizations, and financial industry associations—held educational events and distributed information. Key campaign events during the year included:

- National Town Meeting on Saving and Investing. The National Town Meeting was held in Washington, D.C. and transmitted by satellite to 34 cities throughout the United States. The audio

portion was simulcast over the Internet through the Alliance for Investor Education's Web site.

- Widespread Distribution of the "Ballpark Estimate." The "Ballpark Estimate" is a single-page worksheet created to help individuals calculate how much they will need to save each year for retirement.

Investors' Town Meetings and Seminars

We participated in town meetings in Bangor, Maine, Des Moines, Iowa; Los Angeles, California; Minneapolis, Minnesota; Palo Alto, California; and Washington, D.C. In coordination with the securities industry, we held 32 educational seminars as part of the town meeting program.

New Publications

Our investor assistance staff has prepared and distributes over a dozen brochures that explain in plain English how the securities industry works, how to invest wisely, and what to do if something goes wrong. This year we published:

- *Get the Facts on Saving and Investing*—an introduction to the basics of saving and investing.

- *A Plain English Handbook: How to Create Clear SEC Disclosure Documents*—a guide for writing in plain English.

- *Financial Facts Tool Kit*—a collection of educational brochures from campaign partners to help individuals save and invest wisely. In August 1998, we unveiled an on-line version of the tool kit at **www.sec.gov/consumer/toolkit.htm.** Within two

weeks of its release, the on-line toolkit received more than 16,000 hits.

- *Investment Clubs*—a new brochure on investment clubs, which have been popular with individual investors.

Toll-Free Information Service

Our toll-free information service (800-SEC-0330) provides investor protection information and allows investors to order educational materials. During the year, we received over 65,000 calls to this service.

Internet Site

Investors who access the SEC's Web site can read and download the agency's educational publications and see our latest investor alerts. During 1998, the investor assistance and complaints section was viewed by over 250,000 users from around the world.

Regulation of Securities Markets

The Division of Market Regulation oversees the operations of the nation's securities markets and market participants. In 1998, the SEC supervised approximately 8,300 registered broker-dealers with over 70,000 branch offices and over 591,000 registered representatives. In addition, the SEC oversaw 8 active registered securities exchanges, the National Association of Securities Dealers and the over-the-counter securities market, 16 registered clearing agencies, 1,210 transfer agents, the Municipal Securities Rulemaking Board, and the Securities Investor Protection Corporation.

Broker-dealers filing FOCUS reports with the Commission had approximately $2,4 trillion in total assets and $145 billion in total capital for fiscal year 1998. Average daily trading volume reach 666 million shares on the New York Stock Exchange and 786 million shares on the Nasdaq Stock Market in calendar year 1998.

Key 1998 Results

The Commission proposed and adopted important rules to revise the regulation of exchanges and give alternative trading systems the option of registering as an exchange or a broker-dealer subject to enhanced regulation relating to transparency, fair access, and systems capacity. These rules are part of our efforts to ensure that the SEC's regulatory framework responds to change in the U.S. securities markets due to technological advances.

We adopted an alternative regulatory structure for over-the-counter (OTC) derivatives dealers. These dealers, which must be affiliated

with fully regulated securities firms, will operate subject to exemptions that permit them to compete more effectively in the global market place.

We also approved the rule filing implementing the merger of the American Stock Exchange (AMEX) and the National Association of Securities Dealers, Inc (NASD) on October 30, 1998.

Our staff conducted an extensive review of the debt securities markets in the United States, with particular emphasis on price transparency. As a result of the staffs efforts, the NASD has agreed to pursue measures that should improve price transparency in the corporate bond market.

The Commission continues to monitor industry progress in preparing for the year 2000. The Commission adopted rules requiring certain broker-dealers and non-bank transfer agents to report on the status of their year 2000 preparations, including a report prepared by an independent public accountant regarding their processes for preparing for year 2000.

Securities Markets, Trading, and Significant Regulatory Issues

Corporate Debt Transparency

During 1998, the staff reviewed the debt securities market in the United States, with particular emphasis on price transparency. This review found that, as a whole, the market for government securities is characterized by reasonably good quality pricing information for investors. It also found that GovPX, a private information vendor formed by a consortium of interdealer brokers and primary dealers in the U.S. Treasury market, currently distributes quotation and transaction information provided by five of the six interdealer brokers

in Treasury bills, bonds, and notes.[17] The staff found improvement in price transparency in the municipal securities market, but determined that price transparency is deficient in the corporate bond market. Accordingly, Chairman Levitt announced on September 9, 1998 that the Commission had requested that the NASD act on certain recommendations of the staff to improve price transparency in the corporate bond market.[18]

The NASD specifically agreed to:

- adopt rules requiring dealers to report transactions in U S. corporate bonds and preferred stocks to the NASD and to develop systems to receive and redistribute transaction prices,

- create a database of transactions in corporate bonds and preferred stocks, and

- create a surveillance program to better detect fraud in these markets Alternative Trading Systems

In April 1998, the Commission published two releases to address changes in the securities markets due to technological developments. First, we proposed a new regulatory framework for alternative trading systems, which was adopted—largely as proposed—in December 1998. The new framework allows alternative trading systems to choose to register as exchanges *or* broker-dealers and comply with additional requirements specifically designed to address their unique role in the market. Most of the rule amendments and new rules composing this framework become effective on April 21, 1999, with the remainder becoming effective on August 30, 1999.

Second, we proposed allowing registered exchanges to be for-profit and proposed certain deregulatory measures to provide registered

exchanges, and other markets operated by self-regulatory organizations (SROs), opportunities to better compete. These measures were adopted in December 1998. Specifically, we adopted a streamlined procedure to allow SROs to quickly begin trading new derivative securities products. In addition, SROs may operate pilot trading systems for up to two years without filing for approval of the system by the Commission. During this trial two-year period, the pilot trading system is subject to strict volume limitations. Finally, we made clear that we will work to accommodate, within the existing requirements for exchange registration, exchanges wishing to operate under a proprietary structure.

Automation Initiatives

Rule 17a-23 under the Exchange Act establishes recordkeeping and reporting requirements for registered broker-dealers that operate broker-dealer trading systems. In 1998, our staff reviewed 34 initial operation reports, 25 notices of proposed material change, 155 quarterly activity reports, and 7 reports of cessation of operations.

Order Handling Rules

The staff issued several no-action letters to electronic communications networks (ECNs) regarding their compliance with the provisions in the order handling rules applicable to the ECN Display Alternative. In 1998, letters were issued for the Instinct Real-Time Trading Service, the Island System, the Bloomberg Tradebook System, the TONTO System, the Routing and Execution DOT Interface Electronic Communications Network, the ATTAIN System, BRUT, the Strike System, and the PIM Global Equities Trading System.[19]

Matching Services

The Commission issued an interpretive release concluding that entities that provide trade matching services for transactions in institutional securities are clearing agencies and must be registered with the SEC. The release requested comment on ways to encourage entities to provide matching services through modified regulation as clearing agencies or conditional exemption from registration.[20]

Merger of Depository Trust Company and Participants Trust Company

The Commission approved proposals relating to a merger between The Depository Trust Company (DTC) and Participants Trust Company (PTC). In addition, we approved a proposed rule change filed by DTC that incorporated the rules and procedures of PTC, with certain modifications, into DTC's rules and procedures and increased the size of DTC's Board of Directors.[22]

Reduction of Clearing Services

The Commission approved a series of proposals relating to the Philadelphia Stock Exchange's (PHLX) withdrawal from the securities depository business that was offered through its wholly-owned subsidiary, Philadelphia Depository Trust Company (Philadep) and to its restructuring and limiting its clearance and settlement business offered though its wholly-owned subsidiary, Stock Clearing Corporation of Philadelphia (SCCP).[23]

Trading Reconstruction

Trading Analysis of October 27 and 28, 1997

On September 14, 1998, the staff issued a report entitled *Trading Analysis of October 27 and 28, 1997.* The report analyzes the impact of the cross-market trading halt circuit breaker procedures that were triggered for the first time on October 27, 1997 when the Dow Jones Industrial Average declined 554 points (7%). The report's findings were reflected in the SRO revisions of circuit breaker procedures that became effective on April 15, 1998.[24]

Staff Legal Bulletin—Circuit Breakers

The staff's trading analysis of October 27 and 28, 1997 also resulted in the publication of a staff legal bulletin on September 9, 1998.[25] The bulletin provides guidance to broker-dealers on handling customer orders and notifying customers when marketwide circuit breakers halt trading. It also reminds broker-dealers about their responsibility to maintain adequate internal systems capacity.

The Year 2000

The Commission continues to monitor industry progress in preparing for the year 2000 and work with the SROs and industry groups on a range of year 2000 issues, including testing and contingency planning. The purpose of these coordinated actions is to promote remediation of industry systems, so that the consequences of any year 2000-related failures can be minimized

Surveys of SROs

Since 1996, our staff has conducted five surveys of the exchanges, clearing agencies, and NASD regarding their year 2000 efforts. As part of these surveys, they ask the SROs to report the progress made in moving their mission critical systems through the various phases towards achieving year 2000 compliance. They also request that the SROs report on any problems meeting time schedules and their contingency planning efforts.

Moratorium on Rules

As part of its efforts to support market participants' efforts to remediate and test systems that are critical to the operation of the nation's capital markets, the Commission announced a moratorium on the implementation of new Commission rules that require major reprogramming of computer systems by SEC-regulated entities between June 1, 1999 and March 31, 2000. This moratorium further facilitates participants' efforts to allocate significant time and resources to addressing potential problems caused by the year 2000 problem.

Broker-Dealer and Transfer Agents Reporting Requirements

In July 1998, we amended rule 17a-5 under the Exchange Act to require certain broker-dealers to file new Form BD-Y2K with the Commission and with their designated examining authority. We also adopted new rule 17Ad-18 under the Exchange Act to require non-bank transfer agents to file new Form TA-Y2K with the Commission.. The first forms were filed on August 31,1998, reflecting broker-dealer and transfer agents' year 2000 efforts as of July 15, 1998. The second and final forms are required to be filed no later than April 30, 1999, reflecting the broker-dealers' and the transfer agents' efforts to

prepare for the year 2000 as of March 15, 1999. In addition, in October 1998, we amended rule 17a-5 and rule 17Ad-18 to require certain broker-dealers and certain non-bank transfer agents to file with their second Y2K form a report prepared by an independent public accountant regarding their processes for preparing for the year 2000.[28] By the end of 1998, over 6,700 reports had been received.

AMEX/NASD Merger

On April 8, 1998, the AMEX and the NASD Boards unanimously approved the terms of a Transaction Agreement that would result in AMEX becoming a subsidiary of the NASD. At a Special Meeting of Members on June 25, 1998, the AMEX Membership ratified the Transaction Agreement. Our staff discussed the proposed merger extensively with the NASD and AMEX and reviewed the Transaction Agreement and the overall terms of the merger. The NASD submitted two rule filings and AMEX submitted one rule filing relating to the merger, which the Commission published for notice and comment and approved on October 30, 1998.[29]

International Securities Exchange

On November 10, 1998, the International Securities Exchange (ISE) announced its intention to register with the SEC as a for-profit all electronic options exchange.[30] Our staff held extensive discussions with the ISE regarding its structure during the preceding months. To fund the formation of this new exchange, memberships have been sold to a consortium of broker-dealers,

Intermarket Trading Systems

The Commission published on July 24, 1998 a proposal to amend the Intermarket Trading System (ITS) Plan to expand the inter-market

linkage to include all listed securities and to change the requirement for approving Plan amendments from a unanimous vote to a two-thirds majority vote.[31] We also published a proposal on July 15, 1998 to amend the ITS Plan to link Pacific Stock Exchange's (PCX) OptiMark System to ITS.[32]

Derivatives

The Commission also approved several SRO proposals that strengthened market stability and integrity while facilitating the use of exchange-traded derivatives for risk management purposes

Foreign Debt Obligations

On June 8, 1998, the Commission proposed an amendment to rule 3a12-8 under the Exchange Act to add Belgium to the list of countries whose debt obligations are exempted by the rule, thereby permitting the sale of futures on those debt obligations in the United States.

Hedge Funds

On September 23, 1998, 14 commercial and investment banks announced a private-sector acquisition of Long Term Capital Management (LTCM), a large hedge fund that had relied heavily on the use of leverage to implement its investment strategies. Our staff testified before a Congressional subcommittee on the issues arising from the financial turmoil surrounding LTCM.[34] We are also working with other members of the President's Working Group on Financial Markets on a study of hedge funds.

Trading Practice Developments

Rule 15c2-11

The Commission proposed amendments to rule 15c2-11 that, among other things, would require all broker-dealers to: (1) review information about the issuer when they first publish or resume publishing a quotation for a security subject to the rule, (2) document that review, (3) annually update the information if they publish priced quotations, and (4) make the information available to other persons upon request.[35]

An exemption was issued to Nasdaq and NASD Regulation (NASDR) to permit broker-dealers that had been publishing quotations for unregistered foreign equity securities and American Depositary Receipts (ADRs) in the over-the-counter Bulletin Board (OTCBB) to initiate quotations for those securities in the Pink Sheets.[36] The exemption related to an NASD rule change prohibiting the quotation in the OTCBB of unregistered foreign equity securities and ADRs after March 30, 1998.[37]

Rule 10b-13

Our staff granted exemption letters from rule 10b-13 to United Kingdom (U.K.) market makers and principal traders to continue their U.K. market activities during cross-border tender and exchange offers subject to the City Code.[38]

Regulation M

Our staff granted an exemption from rule 101 of Regulation M that permits broker-dealers effecting block transactions through the facilities of the NYSE and AMEX to make bids or purchases required by NYSE or AMEX rules in conjunction with the block transactions.[39]

Broker-Dealer Issues

OTC Derivatives Dealers

On October 23, 1998, the Commission approved an alternative regulatory structure for a class of registered dealers that are active in the OTC derivatives markets. This structure permits a U.S. securities firm to establish a separately capitalized entity, called an OTC derivatives dealer. Among the rules amended was the net capital rule that will allow OTC derivatives dealers to use Value-at-Risk models to calculate market risk capital. The rule changes will permit these dealers to compete more effectively against banks and foreign dealers in global OTC derivatives markets. The rules become effective on January 4, 1999.[40]

Internet Issues

The staff issued two no-action letters dealing with Internet dividend reinvestment plans. The first letter conditionally grants relief from the section 15 (a) broker-dealer registration requirements to StockPower, Inc. Among other things, StockPower represented that it would pass through to participating bank transfer agents certain charges imposed by third parties, but would not otherwise receive transaction-related compensation.[41]

The second letter conditionally grants relief from the section 15(a) broker-dealer registration requirements to issuers and their directors, officers, and employees. Under this letter, an issuer may (1) use StockPower software to offer issuer dividend reinvestment and stock purchase plans (DRSPP) related materials on the Internet, (2) allow investors to communicate directly with bank transfer agents operating those DRSPPs, and (3) place “tombstone” ads on the Web site without those ads being considered selling efforts or methods.[42]

Extension of Credit

In 1998, the Commission began to issue orders exempting broker-dealers from Exchange Act section 11(d). We issued these orders using our general exemptive authority under section 36 of the Exchange Act. In all cases, the relief is based on specified representations.

We granted relief from section 11(d) for the installment sale of a large global offering [43] In addition, we permitted for the first time the installment sale of securities in a non-privatization offering to the U S public at large [44]

We also permitted the acceptance of payment by credit card for the purchase of shares in a venture capital fund. The credit cards had to be issued by financial institutions unaffiliated with the broker-dealer selling the shares.[45] Finally, we permitted the margining of mutual fund shares offered through a wrap fee mutual fund asset allocation program. The mutual fund shares were acquired in exchange for shares that were also acquired through the program and sold to a customer more than 30 days prior to the extension of credit. Some of the exchanged shares offered through the program were in mutual funds managed and advised by an unaffiliated broker-dealer.[46]

Transaction Confirmations

Our staff confirmed that in transactions effected as agent, the yield to maturity (YTM) required to be disclosed by rule 10b-10 under the Exchange Act must take into account sales commissions charged by broker-dealers. They also clarified that, under rule 10b-10, YTM calculations in agency transactions do not have to include incidental transaction fees and miscellaneous charges. In addition, they granted

temporary no-action relief, for six months, to permit broker-dealers not currently in compliance with that requirement to make the systems changes necessary to comply with the rule.[47]

Floor Trading

On August 21, 1998, in response to a request from the Intermarket Surveillance Group, staff clarified that any compensation arrangement that results in an exchange member sharing in the trading profits or trading losses of a customer account, however structured, would constitute an interest in the account for purposes of section 11(a)(1) of the Exchange Act and rule 11a-1. Because some compensation arrangements may give rise to violations of section 11(a)(1) or other securities laws, the staff stated that a SRO cannot fulfill its obligation under section 19(g) of the Exchange Act to determine if violations exist unless it surveils and investigates its members' compensation arrangements. They also clarified that an SRO is not fixing commission rates by prohibiting a compensation arrangement that results in a violation of applicable securities laws [48]

Net Capital

In a no-action letter to the NYSE and the NASD Regulation, staff stated that an introducing broker may include its proprietary assets held at a clearing firm (PAIB Assets) as allowable assets in its net capital computation so long as the introducing and clearing brokers follow the guidance described in the letter. Because introducing and clearing brokers must make operational changes to comply with the terms of the letter, introducing firms may continue their current practice of treating PAIB Assets as allowable until June 1, 1999.[49]

Additionally, our staff issued a no-action letter to the Government Securities Clearing Corporation (GSCC) regarding deficit charges for

repurchase transactions. When computing net capital, GSCC netting members may exclude certain outstanding repurchase deficits from their calculations when they meet the conditions discussed in the letter.[50]

Books and Records

In October 1998, the Commission reproposed for comment amendments to the Commission's books and records rules for broker-dealers [51] The reproposed amendments incorporate comments received in response to the original proposal and are designed to clarify and expand broker-dealer recordkeeping requirements with respect to purchase and sale documents, customer records, associated person records, customer complaints, and certain other matters. In addition, the reproposed amendments specify the books and records that broker-dealers would have to make available at their local offices. The reproposed amendments are specifically designed to assist securities regulators in conducting sales practice examinations.

Arbitration

The Commission approved several significant rule proposals that affect the way securities industry disputes are resolved. On June 22, 1998, we approved an NASD rule change that ended the NASD's requirement for securities industry employees to arbitrate their statutory discrimination claims. Securities firms and employees, however, may still voluntarily enter into agreements to arbitrate these claims.[52] We also published for public comment a proposal by the NYSE that would make its arbitration forum unavailable for the arbitration of statutory employment discrimination claims unless the agreement to arbitrate the claims was entered into after the dispute arose.[53] In addition, on October 15, 1998, we approved two NASD

rule proposals that provide for the list selection of arbitrators by parties for both investor and intra-industry arbitration cases, giving parties a greater role in choosing who will decide their cases.[54]

Lost and Stolen Securities

As of December 31, 1997, 25,436 institutions were registered in the program, a 1% increase of 1996. The number of securities certificates reported as lost, stolen, missing or counterfeit decreased 4% from 2,093,233 in 1996 to 2,007,611 in 1997. The aggregate dollar value of these reported certificates decreased 78% from $56,177,860,398 in 1996 to $11,809,945,634 in 1997. The total number of lost and stolen recovery reports received increased 16% from 162,076 in 1996 to 192,586 in 1997. The dollar value of recovery reports received increased 178% from $7,000,530,298 in 1996 to $19,468,888,875 in 1997. The total number of certificates inquired about by institutions participating in the program increased .03% from 8,538,192 in 1996 to 8,565,639 in 1997. In 1997, the dollar value of certificate inquires that matched previous reports of lost, stolen, missing, or counterfeit securities certificates decreased 4% from $5,164,280,780 to $4,961,362,068.

Oversight of Self-Regulatory Organizations

National Securities Exchanges

As of September 30, 1998, there were eight active securities exchanges registered with the SEC as national securities exchanges: AMEX, Boston Stock Exchange (BSE), Chicago Board Options Exchange (CBOE), Cincinnati Stock Exchange (CSE), Chicago Stock Exchange (CHX), New York Stock Exchange (NYSE), Philadelphia Stock Exchange (PHLX), and PCX. We granted exchange applications to delist 123 debt and equity issues, and granted

applications by issuers requesting withdrawal from listing and registration for 55 issues. The exchanges submitted 313 proposed rule changes during 1998. We approved 243 pending and new filings, and 26 were withdrawn. Approved rule filings included:

- amendments to revise the circuit breaker rules to increase the trading halt levels from declines of 350 and 550 points to declines of 10%, 20%, and 30% of the Dow Jones Industrial Average,[55] and

- a proposal by the NYSE to modify its margin requirements to accommodate changes to the federal margin requirements.[56]

National Association of Securities Dealers, Inc.

The NASD is the only national securities association registered with the SEC and includes more than 5,500 member firms. The NASD owns and operates The Nasdaq Stock Market as a wholly-owned subsidiary. The NASD submitted 98 proposed rule changes to the SEC during the year. We approved 83 proposed rule changes, including some pending from the previous year, and the NASD withdrew 7. Among the significant changes we approved or that were effective upon filing were:

- rules adopting the Order Audit Trail System to track orders in Nasdaq equity securities from the point of origination or receipt through execution;[57]

- an NASD proposal requiring each registered representative who engages in proprietary or agency trades in equities, preferred securities, or convertible debt securities, or who directly supervises such activities, to register as a limited representative-equity trader;

- amendments to NASD rule 3010 to require tape recording of conversations when a certain percentage, varying from 40% of a small firm to 20% of a larger firm, of a member firm's sales force is comprised of registered persons who were employed within the last three years by a firm that has been expelled from membership in a securities industry SRO that has had its registration as a broker-dealer revoked by the SEC;[59] and

- amendments to the NASD rules on continuing education to establish a supervisors' program, separate from the registered representatives' continuing education program.[60]

At Congressman Dingell's request, the staff also prepared a report discussing changes made by the NASD in response to the Commission's 1996 21 (a) report. They noted that, although the changes are ongoing, the NASD has made significant improvements to its policies and procedures.

Letters to the Commodity Futures Trading Commission

Our staff responded to requests from the Commodity Futures Trading Commission (CFTC) for our views regarding various proposals to trade financial products. In addition, they issued a letter to the CFTC on December 4, 1997 objecting to the designation of the Chicago Board of Trade (CBOT) as a contract market for futures and futures options on the CBOT Dow Jones Utilities Average Index (DJUA) and the Dow Jones Transportation Average (DJTA).[61] On July 16, 1998, the Commission issued an order upholding the staff's position,[62] concluding that neither the DJUA or the DJTA satisfies the substantial segment requirement of the law.[63] The CBOT appealed the Commission's decision to the Seventh Circuit Court of Appeals, where it is pending.

Self-Regulatory Organization Corporate Governance

The Commission approved several SRO proposals in 1998 enhancing public and non-industry participation in the SRO governing processes Specifically, we approved proposals ensuring that the public and non-industry members of the NASD, PHLX, and CHX governing boards equal or exceed the number of industry members.[64] The public governors include senators, representatives, professors, and distinguished individuals who have no connection with the securities industry. The non-industry governors include representatives from both large and small companies who are not directly involved in the securities business. Similar changes to the membership of many important SRO committees, including those that involve SRO oversight responsibilities and policymaking, have been proposed or instituted.[65]

Municipal Securities Rulemaking Board

The Municipal Securities Rulemaking Board (MSRB) is the primary rulemaking authority for municipal securities dealers. In 1998, we received 23 new proposed rule changes from the MSRB. A total of 19 new and pending proposed rule changes were approved, and one was withdrawn. Approved proposals included interpretations of rules concerning consultants, transaction reporting procedures, continuing education requirements for registered persons, and political contributions.[66] The MSRB also focused on strengthening the underwriting process by addressing syndicate practices and disclosure requirements. In this regard, we approved an amendment to rule G-32 that strengthened the provisions relating to dissemination of official statements among dealers and incorporated a long-standing interpretation relating to disclosures required to be made to

customers in connection with negotiated sales of new issue municipal securities.[67]

We also approved an amendment to rule G-38 concerning consultants that clarified the definition of payment and whether bank affiliates and their employees may be deemed consultants under the rule.[68] In addition, we approved the MSRB's commencement of a service to provide daily reports from the MSRB Transaction Reporting Program.[69] This service will summarize information about customer and interdealer transactions in municipal securities that are reported to the MSRB.

Tradepoint

On November 20, 1997, Tradepoint filed an application for exemption from registration as a national securities exchange under section 6 of the Exchange Act. Tradepoint, a Recognised Investment Exchange under the U.K. Financial Services Act of 1986, is a screen-based electronic market for the trading of securities listed on the London Stock Exchange. Tradepoint wishes to make its system available in the United States, primarily to institutional investors. We solicited comments on the filing on July 2, 1998.[70]

Clearing Agencies

Sixteen clearing agencies were registered with the Commission at the end of 1998. On February 13, 1998, we registered the Emerging Markets Clearing Corporation (EMCC) as a clearing agency to clear and settle Brady bonds.[71] We also exempted Euroclear from registration as a clearing agency. Registered clearing agencies submitted 98 proposed rule changes to us, and we processed 96 new and pending proposed rule changes.

Applications for Re-entry

Rule 19h-1 under the Exchange Act prescribes how the Commission reviews proposals submitted by SROs to allow persons subject to a statutory disqualification to become or remain associated with member firms. In 1998, we received 22 filings or notices from SROs recommending that certain persons be permitted to become or remain associated with member firms notwithstanding a statutory disqualification: 15 from the NASD, 5 from the NYSE, 1 from the AMEX, and 1 from the CBOE. One filing was withdrawn.

Investment Management Regulation

The Division of Investment Management regulates investment companies (which include mutual funds) and investment advisers under two companion statutes, the Investment Company Act of 1940 and the Investment Advisers Act of 1940. The Division also administers the Public Utility Holding Company Act of 1935.

Key 1998 Results

During 1998, the Commission adopted major changes to the primary disclosure form used by mutual funds. We also adopted a rule permitting the use of a “profile,” which is a new disclosure document intended to provide investors with a summary of key information about a mutual Hind. These initiatives are part of the SEC's continuing efforts to increase the effectiveness of disclosure provided to investors. In addition, we continued implementing provisions of the National Securities Markets Improvement Act of 1996 (NSMIA) and issued no-action and interpretive letters addressing numerous changes in the investment company and investment advisory industries.

Significant Investment Company Act Developments

Rulemaking

Mutual Fund Disclosure Initiatives

- *Amendments to Mutual Fund Registration Form.* The Commission adopted amendments to Form N-1 A, the mutual

fund registration form, to improve prospectus disclosure [72] The amendments. (1) minimize prospectus disclosure about organizational and legal matters that do not help investors evaluate mutual funds and (2) focus disclosure on essential information about a fund that investors need to know before investing. In recognition of the importance of risk disclosure to investors, the amendments require a new risk/return summary at the beginning of a mutual fund prospectus (and the new profile). This risk/return summary includes a concise narrative description of a mutual fund's overall risks, a bar chart of a fund's annual returns for 10 years that illustrates performance fluctuations from year to year, and a table that compares a fund's performance to that of a broad-based securities market index.

- *Fund Profiles.* The Commission adopted rule 498, which permits funds to use a short-form disclosure document called a "profile."[73] The profile summarizes key information about a mutual fund in a standardized format designed to facilitate comparison among funds If a fund uses a profile, an investor can purchase the fund's shares based on the profile, or request and review the fund's prospectus and other information before making an investment decision. All investors would receive a prospectus no later than confirmation of purchase.

Money Market Funds

The Commission adopted technical amendments to rule 2a-7, the rule that regulates money market funds.[74] The amendments revise the rule's terminology and its treatment of certain instruments to reflect market usage. The amendments also resolve certain interpretive issues, including the application of other amendments adopted in 1996 concerning tax-exempt money market funds and

investments in asset-backed securities. We also amended our advertising rules to clarify the formula used to calculate yield for money market funds and reduce the potential for investors to be misled or confused by the presentation of the money market fund's short term total return.

Delivery of Disclosure Documents to Households

The Commission proposed a new rule 154 under the Securities Act that enables issuers and broker-dealers to satisfy prospectus delivery requirements by sending a single prospectus to two or more investors sharing the same address.[75] We also proposed similar amendments to rules 30d-1 and 30d-2 under the Investment Company Act, and to rules 14a-3, 14c-3 and 14c-7 under the Exchange Act, which govern the delivery of annual or semi-annual reports to shareholders. The proposed rule and rule amendments would provide greater convenience for investors and cost savings for issuers by reducing the amount of duplicative information that investors receive.

Advisory Contracts

The Commission proposed amendments to rule 15a-4, the rule that permits an investment adviser, in certain circumstances, to advise temporarily an investment company under a contract that the investment company's shareholders have not approved.[76] The proposed amendments would (1) expand the exemption provided by the rule to include temporary advisory contracts entered into after a merger or similar business combination involving the fund's adviser or a controlling person of the adviser and (2) lengthen the period during which the adviser may serve under a contract without shareholder approval.

Disclosure

Filings Reviewed

In 1998, the staff reviewed 80% of the 2,100 new portfolios filed with the SEC, including 96% of newly-filed open-end and closed-end portfolios. The staff also reviewed 91% of the 645 proxy statements filed, 20 % of the 18,715 post-effective amendments filed, and 100% of the 200 insurance contract filings.

Exemptive Orders

The Commission issued 320 exemptive orders to investment companies (other than insurance company separate accounts) seeking relief from various provisions of the Investment Company Act. We also issued 53 exemptive orders to investment companies that are insurance company separate accounts. Over 13% of all exemptive orders issued in 1998 (other than orders issued to insurance company separate accounts) concerned mergers involving investment advisory firms or funds. The number of these types of orders nearly doubled from the previous year, reflecting the trend toward consolidation in the financial services industry. Some of the other significant developments with regard to exemptive orders in 1998 are discussed below

Open-End Interval Fund

The Commission issued an order permitting a registered closed-end fund to convert into an open-end fund that would redeem its shares at monthly intervals rather than daily. The fund invests in equity securities of issuers in developing countries, and sought relief in order to provide its shareholders with greater liquidity while maintaining a relatively illiquid portfolio. Under the terms of the order,

the fund's new investors will be limited to “qualified purchasers,” as defined by section 2(a)(51) of the Investment Company Act.[77]

Mutual Insurance Company

The Commission issued an order permitting certain registered and unregistered funds to enter into insurance agreements with an affiliated mutual insurance company. The agreements would provide limited insurance coverage for certain money market assets held by the funds. *Denial of a Request for a Hearing*

The Commission denied a request for a hearing on an application concerning the foreign custody arrangements of certain unit investment trusts. The Commission's order, among other things, reiterated the standard for determining whether a person requesting a hearing is an “interested person” with respect to an application for purposes of rule 0-5(c) under the Investment Company Act. The Commission denied the hearing request because the person was not an interested person and failed to demonstrate that a hearing was necessary or appropriate in the public interest or for the protection of investors.[79]

Interested Director Status

The Commission issued an order finding that a director of a fund complex, who also is an outside director for the parent company of a broker-dealer firm that provides de minimis distribution services to the fund complex, should be deemed an independent director under the Investment Company Act.[80]

Interpretive and No-Action Letters

The Division's Office of Chief Counsel, which handles most requests for guidance directed to the Division, responded to 888 formal and informal requests for guidance during 1998. Some of the more significant interpretive and no-action letters are discussed below,

Termination of Investment Advisory Contract

The Commission stated that it may consider pursuing enforcement action against a closed-end fund if the fund excluded a shareholder proposal seeking termination of the fund's investment advisory contract. The fund contended that under applicable state law only its directors could terminate the contract. The Commission concluded, however, that section 15(a)(3) of the Investment Company Act provided the fund's shareholders with independent authority to terminate the contract. Due to the novelty of this request, the Commission and not our staff considered this matter.[81]

Fund Supermarkets

Our staff provided interpretive guidance regarding certain legal issues under rule 12b-1 of the Investment Company Act arising from the participation of mutual funds in fund supermarkets. The staff concluded that whether a fund's payment of all or part of a supermarket fee must be made pursuant to a rule 12b-1 plan depends on an analysis by the board of directors of the purpose for which the payment is made.

Reorganization of Investment Advisers

Our staff concluded that if a reorganization does not result in a change of actual control or management of an investment adviser, the adviser may rely on rule 202(a)(1)-1 under the Investment Advisers Act and rule 2a-6 under the Investment Company Act to

conclude that no assignment of the adviser's contracts will occur as a result of the reorganization. Whether there is a change of actual control or management, however, is a factual issue to which the staff will not respond.[83]

Our staff agreed that the acquisition by J.P, Morgan & Co. Incorporated (JPM) of 45% of the outstanding equity interest of American Century Companies, Inc. (ACC), amounting to 10.83% of the voting power in ACC, along with certain minority stockholder protections, would not result in an assignment of the advisory contracts of the mutual funds advised by a subsidiary of ACC. The staff based its position on representations that, among other things, JPM would not have a controlling influence over the management or policies of ACC.[84]

Delayed Offerings of Securities by Closed-End Funds

Our staff took the position that a closed-end fund may conduct a delayed at-the-market shelf offering of equity securities to the general public in reliance on rule 415(a)(1)(x) under the Securities Act to take advantage of opportunities when its shares are trading at a premium to its net asset value. The fund must meet the substantive requirements of the rule (including those that do not apply to funds), file quarterly reports with the Commission, register the offering on Form N-2, and make sure that the gross proceeds to the fund less the underwriting commission equal or exceed net asset value.[85]

Section 13(f) Confidential Treatment Filings

Our staff issued a letter providing general guidance to investment managers with section 13(f) reporting obligations and reminding filers of the Commission's long-standing position that confidential treatment

may be accorded to Form 13F information only in limited circumstances.

Deferred Compensation Plans for Investment Company Directors

Our staff clarified its position regarding the status of deferred compensation plans for investment company directors under the Investment Company Act. They stated that investment companies that wish to implement deferred compensation plans are not required to seek orders from the Commission covering the plans.[87]

Investment Adviser Advertisements

Our staff stated that it would not recommend enforcement action under section 206(4) of the Investment Advisers Act or rule 206(4)-l(a)(1) thereunder, if DALBAR, Inc. advertises certain numerical ratings of unaffiliated investment advisers, notwithstanding the staffs position that the numerical ratings, based on DALBAR's surveys of investment advisory clients, are testimonials by DALBAR and the advisory clients. The staff based its position on representations that, among other things, a DALBAR rating does not emphasize the favorable client responses or ignore the unfavorable responses. The staff also provided guidance regarding some of the factors that advisers should consider when determining whether any advertisements containing a DALBAR rating would be false or misleading [88]

Private Investment Companies

Our staff took the position that the securities of an investment company that relies on the exclusion from the definition of investment company provided by section 3(c)(1) or section 3(c)(7) of the Investment Company Act (Investing Pool), which are held by the

Investing Pool's “knowledgeable employees,” may be excluded when determining whether all of the beneficial owners of the Investing Pool's securities are qualified purchasers for purposes of rule 2a51-3(b). They also took the position that those securities owned by “knowledgeable employees” may not be excluded for purposes of rule 2a51-3(a),[89]

Foreign Investment Companies

Our staff stated that a foreign fund generally would not be deemed to be making a public offering for purposes of section 7(d) of the Investment Company Act if certain functions (known as the “ten commandments” activities) that, for U S. tax purposes, previously had been performed offshore by or on behalf of the foreign fund, are performed in the U.S [90]

Our staff also confirmed that as long as a foreign fund is conducting only a global private offering, a foreign investor who is temporarily in the U S. may meet with the fund's personnel, and purchase an interest in the fund, without causing the fund to be deemed to be making a public offering for purposes of section 7(d) of the Investment Company Act or to have to count or qualify the foreign investor under section 3(c)(1) of 3(c)(7) of the Act.[91]

Interpretive Releases *Offshore Internet Offers*

The Commission provided interpretive guidance concerning the application of the registration requirements of the U.S. securities laws to offshore offers of securities or investment services made on Internet Web sites by foreign investment companies and investment advisers. The release indicates that offshore offers and solicitation activities would not be considered to be made “in the US.” if the Internet offer is not targeted to the U.S. The release suggests non-

exclusive measures, such as the use of disclaimers that state that the offer is not being made in the U.S., or screening mechanisms designed to ensure that offering materials or other communications are not sent to U.S. persons, as a means of indicating that offers are not targeted to the U.S [92]

Principal and Agency Transactions by Investment Advisers

The Commission provided interpretive guidance concerning section 206(3) of the Investment Advisers Act. This section generally prohibits an adviser from engaging in or effecting principal or agency transactions with an advisory client unless the adviser discloses certain information and obtains the client's consent prior to the completion of the transaction. This guidance (1) supersedes a prior position taken by the Commission and permits investment advisers to make required disclosures and obtain client consent after execution but before settlement of a principal or agency transaction and (2) clarifies that if an investment adviser receives no compensation for effecting an agency transaction between advisory clients, the transaction is not subject to section 206(3).[93]

Insurance Products *Form N-6*

The Commission proposed a new Form N-6 for insurance company separate accounts that are registered as unit investment trusts and that offer variable life insurance policies. The form would register these separate accounts under the Investment Company Act and register their securities under the Securities Act. It would focus prospectus disclosure on essential information to assist investors in deciding whether to invest in a particular variable life insurance policy. In addition, it would minimize prospectus disclosure about technical and legal matters, improve disclosure of fees and charges, and streamline the registration process by replacing two forms that

were not specifically designed for variable life insurance policies with a single form tailored to these products.[94]

Separate Account Conversions

Our staff took the position that the conversion of a managed separate account into a unit investment trust with an underlying fund could proceed, without registering interests in the separate account or the shares of the underlying fund on Form N-14 under the Securities Act, where the restructuring involved a change in legal form only that would not materially change a contract holder's interest in the contract, the underlying portfolio assets, or the separate account. This position applies only to reorganizations of managed separate accounts that are similar in all material respects to the reorganization described in the letter.[95]

State and Local Government Deferred Compensation Plans

Our staff took the position that an insurance company that offers and sells group annuity contracts and interests in separate investment accounts funding the group annuity contracts to state and local government deferred compensation plans qualifying under section 457 of the Internal Revenue Code of 1986, as amended, is not required to register the group annuity contracts or the separate investment accounts under the federal securities laws. They had previously taken the position that registration was not required in these cases subject to certain conditions restricting the ability of an employer to withdraw assets from the plan,[96] but modified their position in light of the amendment of section 457 by the Small Business Job Protection Act of 1996 that extended an “exclusive benefit” requirement to section 457 state and local government plans.[97]

Significant Investment Advisers Act Developments

Rulemaking

Rule Amendments Under NSMIA

Under NSMIA, the Commission is primarily responsible for regulating investment advisers with more than $25 million of assets under management; smaller investment advisers must register with state securities regulators and generally are prohibited from SEC registration During 1998, the Commission adopted amendments to rules governing this jurisdictional division.

- *Multi-State Advisers.* The Commission amended rule 203 A-2 to permit investment advisers required to register in 30 or more states, but that do not have $25 million of assets under management or otherwise meet the criteria for SEC registration, to register with the SEC.[98]

- *Investment Adviser Representatives..* The Commission amended rule 203A-3(a) to revise the definition of investment adviser representative to permit certain supervised persons employed by or associated with SEC-registered investment advisers to provide advisory services to one or a few institutional business clients without being subject to state qualification requirements. Under the revised rule, supervised persons may have the greater of 5 natural person clients or a number of natural person clients equal to 10% of all their clients before being subject to state qualification requirements."

Performance Fees

The Commission liberalized rule 205-3 to give investment advisers and eligible clients greater flexibility in negotiating the terms of a performance fee arrangement. The amendments eliminate requirements for specific contractual terms and disclosures when advisers charge a performance fee, and raise the financial thresholds for client eligibility. They also expand client eligibility to include certain qualified purchasers, such as high net worth individuals and "knowledgeable employees" of the investment adviser.[100]

Year 2000

In January 1998, our staff issued a Legal Bulletin describing investment advisers' obligations under the Investment Advisers Act regarding their preparedness for the year 2000 computer problem. Advisers that are unprepared or uncertain about their year 2000 readiness must disclose this fact to their clients if the failure to address the year 2000 issue could have a material effect on their clients.[101]

The Commission also adopted a new rule 204-5, and accompanying Form ADV-Y2K, to require most registered investment advisers to file reports with the SEC on their readiness for year 2000. Under the rule, advisers must report on their year 2000 preparedness with respect to all clients, and those advisers that are sponsors or administrators of a fund complex must report on the readiness of the investment companies they advise.[102]

Significant Public Utility Holding Company Act Developments

Developments in Holding Company Regulation

As a result of the current trend toward consolidation, the Commission considered a number of proposed utility combinations, including

several involving companies that owned gas properties with companies that owned electric properties. Three of these proposals resulted in the creation of new registered holding companies. Registered holding companies also continued to demonstrate their interest in nonutility activities, both in the U.S and abroad. As a result, the complexity of applications and requests for interpretive advice continued to increase. The Commission expects these trends to continue in 1999, as the restructuring of the industry continues.

Registered Holding Companies

As of September 30, 1998, there were 19 public holding companies registered under the Public Utility Holding Company Act. The registered holding companies systems' were comprised of 101 public utility subsidiaries, 37 exempt wholesale generators (EWGs), 114 foreign utility companies (FUCOs), 498 nonutility subsidiaries, and 87 inactive subsidiaries, for a total of 856 companies and systems with utility operations in 31 states. These holding company systems had aggregate assets of approximately $188 billion and operating revenues of approximately $73 billion for the period ended September 30, 1998.

Financing Authorizations

The Commission authorized registered holding company systems to issue approximately $19.5 billion of securities, an increase of less than 1% from last year. The total financing authorizations included $3.9 billion for investments in EWGs and FUCOs.

Examinations

The staff examined three service companies, three parent holding companies, and nine special purpose corporations. The examinations

focused on: (1) the methods of allocating costs of services and goods shared by associate companies, (2) internal controls, (3) cost determination procedures, (4) accounting and billing policies, and (5) quarterly and annual reports of the registered holding company systems. By uncovering misallocated expenses and inefficiencies through the examination process, consumers saved approximately $9.9 million.

Applications and Interpretations

The Commission issued various orders under the Public Utility Holding Company Act. Some of the more significant orders included:

Sempra Energy

The Commission authorized the acquisition by Sempra Energy, a company not previously subject to the Holding Company Act, of (1) Pacific Enterprises, a California public utility holding company exempt from all provisions of the Holding Company Act except section 9(a)(2), and, through this acquisition, Southern California Gas Company; and (2) Enova Corporation, a California public utility holding company exempt from all provisions of the Holding Company Act except section 9(a)(2), and through this acquisition, San Diego Gas & Electric Company.[103] The Commission also granted Sempra Energy an order under section 3(a)(1) exempting it from all provisions of the Holding Company Act, except section 9(a)(2), following the acquisition. In approving the transaction, the Commission determined that a holding company may acquire utility assets that will not, when combined with the acquired company's utility assets, make up an integrated system, provided that there is *de facto* integration of contiguous utility properties and that the holding company will be exempt from registration under section 3 of the Holding Company Act following the acquisition.

WPL Holdings, Inc.

The Commission authorized the acquisition by WPL Holdings, Inc. (WPL), a public utility holding company exempt from registration by order of the Commission under section 3(a)(1) of the Holding Company Act, of IES Industries, Inc., a public utility holding company exempt from registration by rule 2 under section 3(a)(1) of the Holding Company Act, with the surviving entity to be renamed Interstate Energy Corporation (Interstate).[104] The Commission also authorized the acquisition by WPL Acquisition Co., a wholly-owned subsidiary of WPL, of Interstate Power company, a public utility company. As a result of these transactions, Interstate will own, directly and indirectly, four electric and gas utility companies. In finding that the transactions satisfied the Holding Company Act's standards for having more than one integrated system, the Commission evaluated several factors, including the loss of economies associated with divesting existing gas and electric operations. Interstate has registered as a holding company under section 5 of the Holding Company Act.

Financing Orders

The Commission authorized two regulated holding companies, American Electric Power Company (AEP) and Cinergy Corporation, to use financing proceeds to invest in EWGs and FUCOs, and to guarantee the obligations of EWGs and FUCOs, in amounts that, together with all other investments in EWGs and FUCOs, do not exceed 100% of each holding company's consolidated retained earnings.[105] The orders require AEP and Cinergy to provide quarterly information to facilitate the monitoring of their respective investments in EWGs and FUCOs and their effects on the holding company systems.

Compliance Inspections and Examinations

The Office of Compliance Inspections and Examinations manages the SEC's examination program. Inspections and examinations are authorized by the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. Entities subject to this oversight include brokers, dealers, municipal securities dealers, self-regulatory organizations, transfer agents, clearing agencies, investment companies, and investment advisers.

Key 1998 Results

During 1998, the staff conducted examinations concentrating on the areas of greatest compliance risk *(i.e., Smart Exams').* The examinations included an assessment of risk factors, identification of areas to be covered, and the refinement of the appropriate inspection techniques. The areas the staff covered and the inspection techniques they used varied because of the diverse population of registrants, risk assessment results, market conditions, and/or other industry developments. The staff considered the unique characteristics of each registrant and, in particular, the presence or lack of effective internal controls and compliance procedures.

We continued to increase cooperation among SEC examiners responsible for different types of regulated entities to increase effectiveness and productivity and enhance investor protection. For example, when appropriate, SEC examinations of firms with broker-dealer and investment advisory activities were conducted by multi-disciplinary examination teams.

Our staff also enhanced cooperation with foreign, federal, and state regulators, as well as with self-regulatory organizations (SROs). The

staff conducted coordinated examinations with staff from the Hong Kong Securities and Futures Commission, the United Kingdom's Financial Services Authority acting as the Investment Management Regulatory Organization, the Australia Securities Authority, and the Bundesaufsichtsamt Fur Das Kreditwesen.

We issued a report on soft dollar practices based on 355 examinations of broker-dealers and money managers. The report described the current state of soft dollar practices and made recommendations for regulatory action and industry compliance practices.

The staff conducted approximately 4,350 special reviews of registrants' programs for dealing with the year 2000 computer problem. The staff discussed the year 2000 problem with registrants and gathered selected information about their remediation programs. In approximately 9% of these reviews, the staff brought significant deficiencies to registrants' attention. The most commonly noted deficiencies were failing to plan for external testing and lagging significantly behind the Commission's guidance that corrections should be completed by December 31, 1998.

Investment Company and Investment Adviser Inspections

Investment Companies

Our examiners inspected 259 investment company complexes, including 17 fund administrators discussed below. Excluding special inspections and year 2000 reviews, this number resulted in an average frequency of inspection for the 1,128 investment company complexes of once every 4.7 years. The complexes inspected had total assets of $1.1 trillion in 2,636 portfolios, which represented approximately 37% of the mutual fund and closed-end fund portfolios

in existence at the beginning of 1998. The complexes inspected represented a mix of large and small complexes. Twenty of the inspections were done on a “for cause” basis, which means the staff had some reason to believe that a problem existed.

Serious violations found during 11 examinations warranted referrals for further investigation by the Division of Enforcement. The most common violations resulting in referrals involved fraud, the role of the fund's Board of Directors, registration and Commission filings, and books and records.

Investment Advisers

The staff completed 1,280 inspections of investment advisers, not including the year 2000 reviews, achieving an average inspection frequency of once every 5 years. The non-investment company assets managed by the advisers inspected totaled $1.7 trillion. The staff inspected 78 investment advisers for cause.

Serious violations warranting enforcement referrals were uncovered in 52 of the examinations. The most common violations resulting in referrals involved fraud, Form ADV or brochure disclosure or delivery, books and records, and conflicts of interest.

Mutual Fund Administrators

Many mutual fund complexes use third party administrators to perform their accounting and administrative functions. During 1998, examiners inspected 17 fund administrators. One of the examinations resulted in an enforcement referral.

Variable Insurance Products

In response to the rapid growth in variable insurance product assets and the emergence of new channels of distribution, specialized insurance product teams conducted examinations in this area. These teams identified and examined variable life and annuity contract separate accounts. Special emphasis was placed on examining branch offices of broker/dealers selling these products to determine patterns of sales practice abuses. A total of 31 insurance company complexes were examined, representing 25% of all the insurance sponsors as of the beginning of 1998. This maintains a five-year inspection cycle for insurance sponsors. None of these examinations resulted in an enforcement referral.

Broker-Dealer and Transfer Agent Examinations

Broker-Dealers

A total of 338 oversight and 308 cause and surveillance examinations of broker-dealers, government securities broker-dealers, and municipal securities dealers were conducted in 1998. Of these examinations, 123 took place in broker-dealers' branch offices, reflecting an emphasis on examining the adequacy of supervision over the activities of salespersons in branch offices. Serious violations in 139 examinations warranted referrals for further investigation by Enforcement staff. Findings in an additional 55 examinations were referred to SROs for appropriate action. The most common violations and deficiencies found were record keeping deficiencies, misrepresentations and unsuitable recommendations to customers, and unauthorized trading in customers' accounts.

The broker-dealer examination program devoted significant attention to abuses in the underwriting, trading, and retail selling of low-priced, speculative securities, frequently referred to as “microcaps.” Examinations also emphasized the supervision of registered representatives classified as independent contractors operating in franchised branch offices, the adequacy of broker-dealers' internal controls and risk management activities, and retail sales of variable annuities and mutual funds. The office also completed a review of clearing firm policies and procedures.

During 1998, our staff continued initiatives to enhance cooperation with foreign, federal, and state regulators, as well as with SROs. Examiners worked with SRO and state regulators to achieve maximum coordination with other broker-dealer regulatory programs. They also coordinated overlapping examinations of broker-dealers, clearing agencies, and transfer agents with bank regulators.

Transfer Agents

In 1998, our staff conducted 191 examinations of registered transfer agents, including 20 federally regulated banks. This program resulted in 143 deficiency letters, 68 cancellations or withdrawals of registrations, 8 referrals to the Division of Enforcement, 20 referrals to bank regulators, and 4 staff conferences with delinquent registrants. In addition, the staff conducted year 2000 reviews of transfer agents, and completed 4 routine inspections of clearing agencies

Self-Regulatory Organizations Inspections

In 1998, the staff inspected at least one program at the following SROs. American Stock Exchange, Boston Stock Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, Cincinnati Stock Exchange, National Association of Securities Dealers, New York

Stock Exchange, Pacific Stock Exchange, and Philadelphia Stock Exchange. The SRO inspections focused on:

- arbitration programs;
- listing, maintenance, and unlisted trading practices programs;
- financial and operational examination programs;
- market surveillance, investigatory, and disciplinary programs;
- customer communication review programs;
- programs for detecting and sanctioning sales practice abuses; and
- ethics and conflicts of interest.

The inspections resulted in recommendations to improve the programs' effectiveness and efficiency.

Our staff also conducted inspections of the regulatory programs administered by the NASD's 13 district offices. These inspections included reviews of NASD district offices' broker-dealer examination, financial surveillance, and formal disciplinary programs. The staff also reviewed the district offices' investigations of customer complaints and terminations of registered representatives for cause.

SRO Final Disciplinary Actions

Section 19(d)(1) of the Securities Exchange Act of 1934 and Rule 19d-1 require all SROs to file reports with the Commission of all final

disciplinary actions. In 1998, a total of 1,358 reports were filed with the SEC, as reflected in the following table.

SRO Reports of Final Disciplinary Action

American Stock Exchange	14
Boston Stock Exchange	0
Chicago Board Options Exchange	100
Chicago Stock Exchange	4
Cincinnati Stock Exchange	3
National Association of Securities Dealers	1,026
National Securities Clearing Corporation	0
New York Stock Exchange	171
Options Clearing Corporation	0
Philadelphia Stock Exchange	23
Pacific Exchange	17
Total Reports	1,358

Full Disclosure System

The fall disclosure system's goals are to foster investor confidence, provide investors with material information; contribute to the maintenance of fair and orderly markets; reduce the costs of capital raising; and inhibit fraud in the public offering, trading, voting, and tendering of securities. The Division of Corporation Finance tries to achieve this goal by reviewing the financial statements and business disclosure in periodic reports and transactional filings by corporate issuers and undertaking rulemaking that facilitates capital formation.

Key 1998 Results

Companies filed registration statements covering a record $2.55 trillion in proposed securities offerings during the year, a 76% increase over the $1.45 trillion in 1997. An increase in overall market activity, including merger transactions, resulted in $1.45 trillion in common stock offerings filed for registration in 1998 compared to nearly $800 billion in 1997. Offerings filed by first time registrants (IPOs) were a record, totaling approximately $257 billion, 55% more than the $166 billion filed in 1997.

In November 1998, we published proposals that would modernize the regulation of capital formation. We also issued a release proposing to update and simplify the regulations applicable to takeover transactions These important releases are discussed in more detail under Recent Rulemaking, Interpretive, and Related Matters.

International Activities

Foreign companies' participation in the United States public markets continued to show strong growth in 1998. During the year, approximately 160 foreign companies from 34 countries entered the United States public markets for the first time. At year-end, there were over 1,100 foreign companies from 56 countries riling reports with us Public offerings filed by foreign companies in 1998 totaled over $ 170 billion—a new record for an amount registered in a single year.

Review of Filings

In 1998, our Division of Corporation Finance reviewed 2,828, or nearly 21%, of the reporting issuers, along with 1,320 Securities Act IPOs, 338 registration statements under the Securities Exchange Act and 81 Regulation A exemptive filings. The following table summarizes the principal filings reviewed during the last five years. Because the staff reviews all new issuer filings (including IPOs), third party tender offers, contested solicitations, and going private transactions, the number of these filings that are reviewed reflects the increases and decreases in the number of filings received.

Recent Rulemaking, Interpretive, and Related Matters

Reform of Commission Rules Under the Securities Act

For the past several years, we have been actively reevaluating the registration system in response to the realities of the current marketplace and changes in technology. On November 13, 1998, we published proposals intended to create a more flexible system and provide significant benefits to public investors, issuers of securities, and securities professionals.[106] The proposed rules have the following objectives:

- to continue providing investors with the information they need when they make an investment decision;

- to better enable small businesses to meet their capital requirements in a changing market environment;

- to permit more communications to investors and the market around the time of an offering;

- to give analysts more flexibility to report about foreign government issuers and smaller, unseasoned companies;

- to make it easier for companies to turn a public offering into a private offering, and vice versa; and

- to provide issuers with incentives to offer securities publicly rather than privately.

The proposed rules, if adopted, also would result in more timely information being available to the marketplace, as companies would be required to:

- file annual and quarterly financial results sooner;

- make and update risk factors disclosure in their periodic reports;

- accelerate the due dates for some Form 8-K current reports; and

- expand the events that must be discussed in the current report Form 8-K

Regulation of Takeover and Security Holder Communications

On November 3, 1998, we issued a release proposing to update and simplify the regulations applicable to takeover transactions.[107] The goal is to conform the regulations with the realities of today's environment. The proposed rules, if adopted, would-

- permit significantly more communications with security holders and the markets before the filing of a registration statement involving a takeover transaction, a proxy solicitation, or a tender offer;

- put stock tender offers on a more equal regulatory footing with cash tender offers;

- integrate the forms and disclosure requirements for tender offers with going private transactions and consolidate the disclosure requirements in one location;

- permit security holders to tender their securities during a limited period after the successful completion of a tender offer;

- more closely align merger and tender offer disclosure requirements; and

- update the tender offer rules to clarify certain requirements and

- reduce compliance burdens where consistent with investor protection.

Plain English Initiative

During the year, we adopted the plain English rules to improve the readability of prospectuses.[108] Our original release proposing the rules was issued for public comment in January 1997.[109]

New Rule 421(d), the plain English rule, requires public companies to prepare the cover page, summary, and risk factors section of their prospectuses using the following basic principals:

- •short sentences;
- •definite, concrete, everyday language;
- •active voice;
- tabular presentation or bullet list for complex material, whenever possible;
- no legal jargon or highly technical business terms; and
- no multiple negatives.

Cross-Border Tender Offers, Business Combinations, and Rights Offerings

On November 13, 1998, we issued a release soliciting public comment on tender offer and registration exemptive rules for cross-border tender offers, business combinations, and rights offerings.[110] If adopted, these rules would make it easier for U.S. holders of foreign companies to participate in these types of transactions. Currently, offerers often exclude U.S. holders from these transactions because of the need to comply with U.S. securities regulations.

Amendments to Beneficial Ownership Reporting Under Exchange Act Section 13(d)

We adopted amendments to our beneficial ownership disclosure rules under Section 13(d) of the Exchange Act.[111] The amendments allow the use of the short-form Schedule 13G by:

- passive investors (those that do not have the purpose or effect of changing or influencing control of the issuer) if they do not own 20% or more of the outstanding securities; and

- more institutional investors.

Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore

We issued an interpretive release that provides guidance on when offers of securities or investment services made on Internet Web sites by foreign issuers, investment companies, investment advisers, broker-dealers, and exchanges would not be considered to be an offering "in the United States."[112]

The release also suggests measures that foreign Web site offerers could implement to guard against targeting their offers to the United States. For example, a foreign offerer could post an offer on its Web site without registering the offer, if:

- the offerer includes a meaningful disclaimer on the Web site that would specify intended offerees by identifying jurisdictions in which the offer is or is not being made; and

- the offerer takes steps reasonably designed to prevent sales to U.S. persons.

International Disclosure Standards

International disclosure standards are intended to facilitate cross border capital raising and listing by permitting companies to comply with one set of non-financial disclosure requirements for offerings in several jurisdictions. For several years we have been working with the International Organization of Securities Commissions (IOSCO) to develop a set of international standards for non-financial statement disclosures.

In May 1998, a draft of the standards was posted on the IOSCO Web site (www.iosco.org) as a consultation document. IOSCO approved the non-financial statement disclosures standards at its annual conference in September 1998. In February 1999, the Commission exposed for public comment amendments to its regulations in order to conform with these standards.

Amendments to Regulation S

We adopted Regulation S in 1990 to clarify the applicability of the Securities Act registration requirements to offshore transactions. Since its adoption, a number of abusive practices have developed involving unregistered sales of equity securities by U.S. companies purportedly in reliance upon the Regulation. These transactions have resulted in indirect distributions of those securities into the United States without the investor protection provided by registration. To address the continuing abuses, we adopted measures[113] designed to eliminate the abusive practices, while preserving many of the benefits of the Regulation for capital formation.

Small Business Proposals

Rule 701 provides an exemption from the registration requirements of the Securities Act for offers and sales of securities made to employees of private companies. The staff proposed rules that would raise the amount of securities that could be offered under the exemption.[114]

Rule 504 of Regulation D exempts public sales by private companies of up to $1 million of securities in a year from the registration requirements of the Securities Act.[115] The staff has proposed amendments to address concerns that the regulation may facilitate fraudulent securities transactions by microcap companies.

Shareholder Proposals

We issued a release adopting amendments to Rule 14a-8, the shareholder proposal rule, and related rules.[116] The proposals represented a package of reforms to address a range of concerns raised by both shareholder and corporate participants in the proposal process. The revisions:

- recast Rule 14a-8 into a plain English question and answer format;

- reverse the *Cracker Barrel* interpretive position so that employment-related shareholder proposals raising social policy issues are not automatically excludable on ordinary business grounds; and

- provide shareholders and companies with clearer guidance on companies' exercise of discretionary voting authority.

Year 2000 Interpretive Releases

We issued an interpretive release to elicit more meaningful year 2000 disclosure from public companies.[117] The release provides specific guidance on disclosure by companies with a year 2000 disclosure obligation, including;

- the company's state of readiness,
- the costs to address the company's Year 2000 issues,
- the risks of the company's Year 2000 issues, and
- the company's contingency plans.

In addition, we published guidance in the form of frequently asked questions to clarify some recurring issues raised by the Year 2000 interpretive release.[118]

Proposed Amendments to Form S-8

Form S-8 is the short-form Securities Act registration statement used primarily for legitimate employee benefit plans. Some companies, including microcap companies, have used Form S-8 improperly to compensate consultants whose primary service to the company is promotion and public sale of the company's securities. We issued a release proposing amendments to Form S-8 and related rules designed to deter this abuse.[119] The proposals also would facilitate tax and estate planning by permitting the form to be used to register options that would be exercised by family members of employees.

Paper Filings No Longer Accepted

We adopted a new electronic filing rule (Rule 14 of Regulation S-T) to make it clear that we will no longer accept filings made in paper that should have been filed electronically.[120]

Other Rulemaking Proposals During the year, we also proposed:

- amendments to Rule 135b to provide that an options disclosure

- document prepared in accordance with Rule 9b-1 under the Exchange Act is not a prospectus and accordingly is not subject to civil liability under Section 12(a)(2) of the Securities Act;[121] and

- technical amendments to require disclosure of a business enterprise's “operating segments,” rather than its “industry segments,” in conformity with the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 13.[122]

Staff Legal Bulletins

The Divisions of Corporation Finance, Market Regulation, and Investment Management published Staff Legal Bulletin No. 6 on July 22, 1998. The bulletin addresses disclosure obligations in connection with the January 1, 1999 conversion by 11 member states of the European Union to a common currency, the “euro.”

On September 4, 1998, the Division of Corporation Finance published Staff Legal Bulletin No. 7. The bulletin provides helpful information on the plain English rule that applies to companies filing registration statements under the Securities Act.

Conferences

Small Business Town Hall Meetings

Since 1996, several informal town hall meetings between our staff and small businesses have been conducted through the United States. These town hall meetings tell small businesses about the basic requirements for raising capital through the public sale of securities. They also provide us with information on the concerns and problems facing small businesses. During 1998, we held small business town hall meetings in Las Vegas, Nevada; Austin, Texas; and Salt Lake City, Utah.

SEC/NASAA Conference Under Section 19(c) of the Securities Act

The 15th annual federal/state uniformity conference was held in Washington, D.C. on May 4, 1998. Approximately 60 SEC officials met with approximately 60 representatives of the North American Securities Administrators Association, Inc. to discuss methods of achieving greater uniformity in federal and state securities matters. After the conference, a final report summarizing the discussions was prepared and distributed to interested persons and participants.

SEC Government-Business Forum on Small Business Capital Formation

The 17th annual Government-Business Forum on Small Business Capital Formation was held in Chicago, IL on September 24-25, 1998. This platform for small business is the only governmentally-sponsored national gathering for small business, which offers annually the opportunity for small businesses to let government officials know how the laws, rules, and regulations are affecting their ability to raise capital. Next year's Government-Business Forum will be in the Washington, D.C. area.

Accounting and Auditing Matters

The Chief Accountant is the principal advisor to the Commission on accounting and auditing matters arising from the administration of the federal securities laws. Activities designed to achieve compliance with the accounting and financial disclosure requirements of the securities laws include:

- *rulemaking and interpretation initiatives that supplement private-sector accounting standards and implement financial disclosure requirements;*

- *review and comment process for agency filings directed to improving disclosures in filings, identifying emerging accounting issues (which may result in rulemaking or private sector standard setting), and identifying problems that may warrant enforcement actions;*

- *enforcement actions that impose sanctions and serve to deter improper financial reporting by enhancing the care with which registrants and their accountants analyze accounting issues; and*

- *oversight of private sector efforts, principally by the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), the Independence Standards Board (ISB), and various international accounting bodies, which establish accounting, auditing, and independence standards designed to improve financial accounting and reporting and the quality of audit practice, including standards applicable to multinational offerings.*

Key 1998 Results

We adopted revised rules and the staff issued interpretive guidance to conform with the provisions of new FASB standards on segment reporting and earnings per share presentations. We also continued our involvement in initiatives directed toward reducing the disparities that currently exist between different countries' accounting and auditing standards. We issued a policy statement acknowledging the Independence Standards Board (ISB) as the private sector body to establish independence standards applicable to auditors of public companies.

Accounting-Related Rules and Interpretations

The Commission's accounting-related rules and interpretations supplement private sector accounting standards and implement financial disclosure requirements. Our principal accounting requirements are contained in Regulation S-X, which governs the form and content of financial statements filed with us.

Derivatives

During 1998, our accounting staff reviewed compliance by SEC registrants with recently adopted rules to require additional disclosures concerning derivatives and other financial instruments.[123] The required disclosures are designed to help investors better assess the market risk exposures of registrants involved with these instruments and better understand how those risks are managed. The rules clarify and expand existing requirements for financial statement footnote disclosures about accounting policies for derivatives and require disclosures outside the financial statements of qualitative and

quantitative information about the market risks inherent in derivatives and other financial instruments.

Segment Reporting

We issued revised rules for segment reporting to conform with changes made by the FASB in its new standard on segment disclosures.[124] The new standard was the result of a joint undertaking of the FASB and the Accounting Standards Board of the Canadian Institute of Chartered Accountants.

Earnings Per Share

During 1998, our staff issued an accounting bulletin to provide guidance on various issues relating to the presentation of earnings per share.[126] The bulletin responded to certain revisions to the requirements for presenting earnings per share adopted in a new FASB standard.[127]

Year 2000

We issued guidance to assist registrants in complying with their disclosure obligations involving year 2000 issues.

Oversight of Private Sector Standard Setting

FASB. The SEC monitors the structure, activity, and decisions of the private-sector standard-setting organizations, which include the FASB. The Commission and staff work closely with the FASB in an ongoing effort to improve the standard-setting process, including the need to respond to various regulatory, legislative, and business changes in a timely and appropriate manner. This close involvement

includes staff participation on all FASB task forces formed to consider major FASB projects.

A description of FASB activities in which the staff was involved is provided below.

To further its long-term project to address financial instruments and off-balance sheet financing issues, the FASB issued a final standard on accounting for derivative instruments and hedging activities.[128] The standard requires that an entity recognize all derivatives as either assets or liabilities on the balance sheet and measure those instruments at fair value. Certain derivative instruments may be specifically designated as a hedge if certain restrictive conditions are met. Under the standard, the recognition of gains and losses of a derivative depends on the intended use of the derivative and the resulting designation. Due to the complexities associated with derivative instruments, the FASB has formed a Derivatives Implementation Group to (1) identify issues related to the implementation of the new standard, and (2) develop recommendations for their resolution.

In a related action, the FASB published the first special report on the most frequently asked questions raised on its standard on reporting of securitizations and other financial transactions in which financial assets are transferred in exchange for cash and other assets.[129] The report is designed to aid understanding and implementing Statement 125 and represents the first of several reports on questions affecting a broad range of companies and financial institutions.[130]

The FASB continued its deliberations on the accounting for business combinations presently encompassed by Accounting Principles Board Opinion Nos. 16, *Business Combinations.,* and 17, *Intangible Assets.* They are considering whether two separate and distinct methods of

accounting for business combinations should continue. Commentators responded to a FASB special report, *Issues Associated with the FASB Project on Business Combinations.,* published to solicit comment about the scope, direction, and conduct of the project.

The FASB's discussions have focused primarily on accounting for goodwill arising from a purchase business combination. The FASB is not limiting its evaluation solely to accounting practices used in the United States, but also is evaluating practices in accounting for goodwill followed in other countries, such as the United Kingdom, which recently adopted a revised approach to accounting for goodwill. Comments will be solicited on a position paper prepared by the G4+1 to narrow significant differences in the existing business combination standards within the members' jurisdictions.[131]

The FASB began work on a research project on business reporting. This project evolved from previous recommendations made by the AICPA Special Committee on Financial Reporting and the Association for Investment Management and Research through its study, *Financial Reporting in the 1990s and Beyond.* Its objectives are to:

- develop recommendations for the voluntary and broad disclosure of certain types of nonfinancial information for all or selected industries that users of business reporting find helpful in making their investment decisions;

- develop recommendations for ways to coordinate generally accepted accounting principles and SEC disclosure requirements and to reduce redundancies; and

- study present systems for the electronic delivery of businessinformation and consider the implications of technology for business reporting in the future.

The FASB's Emerging Issues Task Force (EITF), in which our Chief Accountant participates, continued to identify and resolve accounting issues. During 1998, the EITF reached consensus on several significant issues, including questions relating to accounting for financial instruments, consolidation policies, and deferred compensation arrangements. The objective of the process is to narrow divergent reporting practices of public companies within the context of existing authoritative accounting standards.

AICPA. Our accounting staff oversaw various processes and activities conducted through the AICPA. These included (1) the Auditing Standards Board (ASB), which establishes generally accepted auditing standards; (2) the Accounting Standards Executive Committee (AcSEC), which provides guidance through its issuance of statements of position and practice bulletins; and (3) the SEC Practice Section (SECPS), which seeks to improve the quality of audit practice by member accounting firms that audit the financial statements of public companies.

ASB. During 1998, the ASB issued a standard to provide guidance to auditors when performing an attestation engagement with respect to management's discussion and analysis presentations of SEC registrants.[132] The ASB also issued guidance on agreed-upon procedures to be followed by auditors in reporting year 2000 readiness by broker-dealers and certain transfer agents subject to SEC reporting requirements.[133] The ASB issued a series of annual Audit Risk Alerts to provide auditors with an overview of recent economic, professional, and regulatory developments that may affect 1998 year-end audits.

AcSEC. The AcSEC issued a position statement on accounting for internal use computer software costs,[134] reducing diversity in accounting for such costs. A position statement also was issued on the reporting of start-up costs.[135] The AcSEC continued to address accounting issues involving specialized industries, dedicating resources in such areas as motion picture accounting, insurance accounting, and revenue recognition from software transactions.

SECPS. Two programs administered by the SECPS are designed to ensure that the financial statements of SEC registrants are audited by accounting firms that have adequate quality control systems. A peer review of member firms by other accountants is required every three years, and the Quality Control Inquiry Committee (QCIC) reviews on a timely basis the quality control implications of litigation against member firms that involves public company clients.

The Commission exercises oversight of the SECPS through frequent contacts with the Public Oversight Board (POB) and members of the Executive, SEC Regulations, Peer Review, and Quality Control Inquiry Committees of the SECPS. During the year, our accounting staff selected a random sample of peer reviews and evaluated selected working papers of the peer reviewers and the related POB files. The staff also reviewed QCIC closed case summaries and related POB oversight files. These reviews, together with discussions with the POB and QCIC staffs, provided us with information to assess the SECPS and QCIC processes. This oversight showed that the peer review and QCIC processes continue to result in member firms focusing on and achieving the important goal of maintaining and improving effective quality control systems. To help the profession continue to achieve that goal, the SEC staff requested the POB to study the audit process, including an assessment of the design and effectiveness of member firm's quality control systems. We will

cooperate with and monitor the Panel on Audit Effectiveness, which was appointed by the POB to undertake this study.

ISB. During 1998, we worked closely with the ISB, a new private sector body formed to establish independence standards applicable to audits of public entities. The standards are expected to promote investors' confidence in the audit process and in the securities markets. The ISB consists of eight members. Four are public members who are not affiliated with auditing firms, three are managing partners in auditing firms, and one is the president of the AICPA. The Chairman of the ISB is required to be one of the four public members. ISB standard-setting meetings are open to the public; draft ISB standards are published for public comment. We oversee the ISB process in the same manner as we oversee the FASB process.

In February 1998, we issued a policy statement acknowledging the ISB as the private sector body responsible for establishing independence standards for auditors of public entities.[136] However, as in the areas of accounting and auditing, we retain the authority to supplement or modify ISB standards and to pursue enforcement and disciplinary proceedings.

The ISB issued a rule proposal that would require auditors of public companies to disclose in writing to the company's audit committee all relationships with the company that could affect auditor independence. A final standard, *Independence Discussions with Audit Committees,* was adopted after year-end.

International Accounting and Auditing Standards

Requirements for listing or offering of securities vary from country to country. Issuers wishing to access capital markets in more than one

country may have to comply with requirements that differ in many respects, including accounting principles to be used in the preparation of financial statements. The differing requirements are believed to increase compliance costs for registrants and create inefficiencies in accessing multiple capital markets. Also, some countries' accounting principles are more comprehensive and result in financial statements that provide greater transparency of underlying transactions and events than others.

As a result, securities regulators around the world have been working on several projects to enhance the quality of reporting and disclosure requirements around the world.

For the past several years, the International Accounting Standards Committee (IASC) has been working to complete a core set of accounting standards for financial reporting in cross-border securities offerings. The International Organization of Securities Commissions (IOSCO), of which we are a member, will assess the completed set of standards to determine whether they should be endorsed for cross-border listings and offerings of securities.

Our accounting staff will assess the completed core standards in 1999, to determine whether we should propose changing the current reconciliation requirements for foreign issuers that file financial statements prepared using IASC standards.

During 1998, the SEC staff began parallel efforts to identify auditing and quality control issues that could affect the effectiveness of financial statements prepared in accordance with IASC standards. Potential issues include:

- whether the accounting profession and firms have adequate auditing standards, training, and technical resources to result in

high quality audits of financial statements prepared using international accounting standards; and

- what type of quality controls to monitor the application of auditing standards are needed for audits on non-U.S. GAAP financial statements (for example, a peer review function like that administered by the POB).

The SEC staff also has participated in discussions with the International Auditing Practices Committee (IAPC) of the International Federation of Accountants and has, through IOSCO, commented on some of IAPC's recent proposed international standards on auditing.

Other Litigation and Legal Activities

The Office of General Counsel provides legal services to the Commission concerning its law enforcement, regulatory, legislative, and adjudicatory activities. The office represents the Commission in appeals in enforcement cases and provides technical assistance on legislative initiatives.

Key 1998 Results

With assistance from the General Counsel, the Commission adopted a rule clarifying the "improper professional conduct" for which accountants can be sanctioned under SEC Rule of Practice 102(e). The Commission also testified regarding, and the staff played a significant role in the enactment of, the Securities Litigation Uniform Standards Act of 1998, which was signed by President Clinton in November 1998.

Significant Litigation Developments

Primary Violator Liability

In *SEC v. U.S. Environmental,*[131] the United States Court of Appeals for the Second Circuit ruled that a stockbroker could be liable as a primary violator, and not just as an aider and abettor, for stock price manipulation if he had, at the direction of the promoter of a manipulation, executed matched orders and wash sales transactions that he knew were part of the promoter's manipulative scheme. The court of appeals ruled that a stockbroker could be so liable even if he did not stand to benefit personally from the manipulative scheme

(aside from receiving commissions for executing the trades) and did not share the promoter's purpose to manipulate the market.

In *Klein* v. *Boyd,*[138] the Commission filed a friend of the court brief arguing that a person—in this case a lawyer--who drafts a document knowing that it contains material misrepresentations and omissions, and who knows that the document will be given to investors, is liable as a primary violator, even if his identity is not known to the investors. The parties subsequently settled the case, and the appeal was dismissed.

Insider Trading

In *SEC v. Adler,*[139] the Court of Appeals for the Eleventh Circuit ruled that the possession of material nonpublic information by an insider who trades in his company's stock gives rise to a strong, but rebuttable, inference that the insider used the information. In so ruling, the court did not accept the position, urged by the Commission, that an insider who trades in his company's stock while in possession of material nonpublic information is liable for insider trading regardless of whether his trading was based on that information.

In *United States v. Smith,*[140] a criminal case in which the Commission had filed a friend of the court brief, the United States Court of Appeals for the Ninth Circuit stated in dictum that, in order for an insider to violate the prohibition against insider trading in his company's stock, he must not only have traded while in possession of nonpublic information but must also have used the information in his trading. Because it was a criminal case, the court declined to adopt an inference of use from the fact of possession, but expressly left open whether it would do so in a civil case brought by the Commission.

The Shingle Theory and Excessive Markups

In *Banca Cremi* v. *Alex. Brown & Sons, Inc.,*[141] the court of appeals, as urged by the Commission in friend of the court briefs, held that a broker-dealer has a duty to disclose excessive markups by virtue of the "shingle theory," under which a broker-dealer makes an implied representation of fair dealing with customers. The court also agreed with the Commission that whether a markup is excessive must be determined on a case-by-case basis, taking into account all relevant factors. The court, however, viewed debt securities as subject to the same 5% markup guideline applicable to equity securities, in contrast with the Commission's position that markups on debt securities should be significantly lower than those on equity securities.

In *Grandon v. Merrill Lynch & Co.,*[142] the court of appeals took judicial notice of the Commission's briefs in the *Banca Cremi* case. The Second Circuit endorsed the shingle theory, agreed with the Commission that excessiveness of markups must be determined based on all relevant factors in each case, and held that the absence of clear guidelines did not preclude finding any percentage excessive in appropriate circumstances. The court also recognized the Commission's longstanding view that markups on debt securities should be significantly lower than those on equity securities.

In the pending appeal in *Press v. Chemical Investment Services Corp.,*[143] the lower court had dismissed the plaintiffs claim of a fraudulent undisclosed excessive markup on the ground that the markup was below 3% and, in the district court's view, the Commission's decisions and releases had established a safe harbor of 3% to 3-1/2% for markups on debt securities, below which markups as a matter of law could not be excessive. The Commission filed a friend of the court brief in the court of appeals, urging that there is no safe harbor percentage for excessiveness of markups.

“In Connection With” Requirement

In Jakubowskj v. SEC,[144] the court of appeals ruled in favor of the Commission in a Commission action in which the defendant purchased savings and loan conversion stock from the savings institutions by misrepresenting on stock order forms that the purchasers were deposit account holders, who had nontransferable stock subscription rights as required by applicable banking regulations. The court rejected the defendant's argument that the antifraud provisions of section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) prohibit only misrepresentations about the stock itself or the consideration paid, holding that in the circumstances of this case the misrepresentations of the purchasers' identities were “in connection with the purchase or sale” of the stock within the meaning of section 10(b) because they induced the institutions to sell.

The Commission addressed the pleading standard under the Private Securities Litigation Reform Act 1995 (Reform Act) in friend of the court briefs filed in the pending appeals in *Hoffman v. Comshare, Inc..,*[145] and *In re Silicon Graphics, Inc. Sec. Litig.*[146] These briefs took the position that the pleading standard did not eliminate recklessness as a basis for liability and that courts should rely upon the Second Circuit tests in interpreting the pleading standard of the Reform Act.

Disciplinary Standards for Accountants

In *Potts v. SEC,*[147] the United States Court of Appeals for the Eighth Circuit affirmed a Commission decision disciplining an accountant for improper professional conduct as concurring partner in an audit. The court found that substantial evidence supported the Commission's finding that the accountant had recklessly failed to comply with the applicable professional standards, and it rejected the accountant's

assertion that those standards were unconstitutionally vague as applied to a concurring partner.

The Double Jeopardy Clause

In *SEC v. Palmisano*[148] the United States Court of Appeals for the Second Circuit rejected a defendant's claim under the multiple punishment prong of the Fifth Amendment's Double Jeopardy Clause that the Commission action for disgorgement and a civil penalty was barred by his prior criminal conviction for the same misconduct. The court found that neither disgorgement nor the civil penalty was punishment for purposes of the Double Jeopardy Clause.

Significant Adjudication Developments

The staff submitted to the Commission 80 draft opinions and orders resolving substantive motions. The Commission issued 47 opinions and 35 orders, and the staff resolved by delegated authority an additional 71 motions. Appeals from decisions of administrative law judges continue to make up a high percentage of the Commission's docket.

Jurisdiction

The Commission *in Morgan Stanley & Co., Inc.*[149] considered whether it has jurisdiction under the Exchange Act to consider an appeal of a decision of the National Association of Securities Dealers, Inc (NASD) to deny Morgan Stanley an exemption from a two-year prohibition against engaging in municipal securities business in Massachusetts due to a violation of Municipal Securities Rulemaking Board (MSRB) rule G-37 Section 19(d) of the Exchange Act authorizes Commission review of NASD action generally if it:

- imposes any final disciplinary sanction,
- denies membership to any applicant,
- prohibits or limits access to services offered by such organization, or
- bars any person from becoming associated with a member.

The Commission concluded that, because the NASD's decision to deny Morgan Stanley an exemption did not fall into any of these jurisdictional categories, it was not reviewable by the Commission.

Sanctions

In *Victor Teicher, Victor Teicher & Co., L.P., & Ross S. Frankel,*[150] the Commission reaffirmed its authority under *Meyer Blinder*[151] to impose collateral bars. It found that Ross S. Frankel's misconduct satisfied the two-pronged test for imposing such a bar because it was both egregious and, by its nature, flowed across the various securities professions and posed a risk of harm to the investing public. Commissioner Isaac Hunt, dissenting in part, stated his view that the Commission and its staff may not seek collateral sanctions in litigated matters, and should not seek them in settled matters.

Fraud/Sales Practices Violations/Failure to Supervise

The Commission in *L.C. Wegard & Co., Inc. & Leonard B. Greer*[152] concluded that the respondents deliberately assisted two brokerage firms in manipulating securities. The respondents' purchases of certain securities played a significant role in causing the price to nearly double in 10 trading days. The Commission concluded that

scienter was established by the firm's trading pattern, which was inconsistent with the legitimate business objective of seeking a profit.

In *Steven P. Sanders and Daniel M. Porush,*[153] the Commission upheld NASD findings that Sanders was responsible for customers being charged excessive and fraudulent prices, and that Porush was responsible for deficient written supervisory procedures and a supervisory system that failed to prevent or detect the pricing violations at issue. The Commission found that, because Stratton Oakmont dominated and controlled the market for the underlying security, it was appropriate to calculate Stratton's markups in the warrants based on its contemporaneous wholesale cost. In finding Porush liable for supervisory failure, the Commission rejected his defense that, although Porush held the title of president during the period at issue, another individual at the firm was the actual chief executive officer. The Commission noted that Porush executed a registration form for the firm, in which he described himself as president, and that the record established that Porush did have some supervisory responsibility.

The Commission remanded an administrative proceeding against *D.E. Wine Investments, Inc., W. Randal Miller, Kenneth Karpf, and Duncan Wine*[154] because it determined that the law judge's calculation of D.E. Wine's markups and markdowns conflicted with Commission precedent in several respects. Specifically, the Commission found that the law judge:

- improperly gave a preference to trades involving D.E. Wine over other market makers in determining the prevailing market price for the securities at issue,

- failed to use interdealer trades occurring after the particular retail trade in question to determine the prevailing market price, and

- erroneously based some of the markups on D.E. Wine's contemporaneous costs.

The Commission also considered and rejected respondents' argument that they were entitled to base their retail prices on quotations, in view of the abundance of information in the record concerning interdealer trades. The Commission remanded the case for further factual findings and a revised analysis consistent with its opinion.

Denial of Access Claims/Market Listing Issues

In *Interactive Brokers LLC,*[155] the Commission set aside action of the Pacific Exchange, Inc. (PCX) restricting the use of hand-held brokerage order routing terminals in its options trading crowds. Hand-helds are computer devices that can receive customer orders directly. Floor brokers carry them onto the trading floor, speeding execution of orders. A pilot program to use hand-helds was established by the PCX in 1995. Subsequently, the PCX adopted a formal policy on hand-helds that created certain restrictions. The Commission held that the PCX restriction on Interactive's use of hand-helds was an unlawful prohibition or limitation of access to services. The Commission found that the pilot program, which was never submitted to the Commission for its approval as required by the Exchange Act, was an invalid rule. Because PCX's restriction on the use of hand-helds was imposed under an invalid rule, the Commission set it aside and ordered the PCX to allow the use of hand-helds in trading crowds.

Net Capital Violations

In *First Colorado Financial Services Company, Inc. and Mark P. Augustine,*[156] the Commission modified and remanded NASD disciplinary action against First Colorado Financial Services and its registered financial and operations principal Mark P. Augustine. The Commission, unlike the NASD, determined that First Colorado, an introducing firm operating as a $5,000 broker, did not violate the net capital rule by participating in the firm commitment underwriting when the firm placed for its customer a single order for 500 shares of a company (without soliciting the order from its customer or marketing the offering). The Commission, however, agreed with the NASD that First Colorado, through Augustine, had filed an inaccurate Financial and Operational Combined Uniform Single Report. Therefore, the proceedings were remanded for a redetermination of sanctions because it was unclear what sanctions the NASD would have imposed for the reporting violation alone.

Denial of Proposed Futures and Futures Options Trading on Stock Indices Under the Commodity Exchange Act

Following a hearing conducted pursuant to the Commodity Exchange Act (CEA), the Commission in *The Chicago Board of Trade*[157] denied the applications of the Chicago Board of Trade (CBOT) to trade futures and futures options contracts on the Dow Jones Utilities Average Index and the Dow Jones Transportation Average Index. These applications were the first for non-diversified stock indices received by the Commission since 1984. Non-diversified stock indices reflect securities of issuers in the same or similar industry. The CEA requires that the Commission find that a non-diversified

stock index reflects a substantial segment of the market as a whole, or be comparable to such a measure, in order to allow the CBOT to trade in these stock indices. The Commission found, based on the totality of the circumstances and in light of its experience in regulating the equity markets, that the Dow Jones Utilities Average Index and Dow Jones Transportation Average Index did not satisfy the CEA's substantial segment requirement. In addition, the Commission interpreted the “comparable to” standard to require that the proposed index must be

comparable to the widely-published index both in measuring and reflecting the segment. Accordingly, the Commission rejected the CBOTs view that an index was comparable to a second widely-published index if the first index's movement tracked the widely-published index's movement. Because the proposed contracts' inability to satisfy the substantial segment requirement was alone sufficient to deny the CBOT's applications, the Commission did not resolve the question whether the proposed contracts met the alternative requirement that they not be readily susceptible to manipulation.

Legal Policy

The General Counsel's responsibilities include providing legal and policy advice on SEC enforcement and regulatory initiatives before they are presented to the Commission for a vote. The General Counsel also advises the Commission on administrative law matters, and has substantial responsibility for carrying out the Commission's legislative program, including drafting testimony, developing the Commission's position on pending bills in Congress, and providing technical assistance to Congress on legislative matters.

On the regulatory front, the General Counsel played a significant role in drafting an SEC rule clarifying the improper professional conduct for which accountants can be sanctioned under SEC Rule of Practice 102(e) In the administrative area, the General Counsel took a lead role in coordinating the preparation of reports to Congress on the year 2000 readiness of the securities industry, and on several matters related to the Small Business Regulatory Enforcement Fairness Act of 1996. In the legislative area, the General Counsel played a significant role in the enactment of the Securities Litigation Uniform Standards Act of 1998.

Significant Legislative Developments

Litigation Reform

On November 3, 1998, President Clinton signed into law S. 1260, the Securities Litigation Uniform Standards Act of 1998. The Act preempts class actions involving certain securities (generally, nationally traded securities and shares of open-end mutual funds) that are brought by private plaintiffs in state court or under state law. The Act does not preempt actions, such as shareholder derivative suits, that relate to certain provisions of state corporate governance law. Notably, the Uniform Standards Act does not affect the standard of liability in federal securities fraud actions, and its legislative history stresses the importance of liability for reckless conduct in such actions.

In addition to its testimony regarding the impact of prior securities litigation reform given on October 21, 1997 before the Subcommittee on Finance and Hazardous Materials of the House Commerce Committee, the Commission testified twice in 1998 with regard to the

House and Senate versions of the Uniform Standards Act, H.R. 1689 and S. 1260. The Commission testified regarding the Senate bill on October 29, 1997 before the Subcommittee on Securities of the Senate Banking Committee, and regarding the House bill on May 19, 1998 before the Subcommittee on Finance and Hazardous Materials of the House Commerce Committee. The Commission's testimony initially expressed concern that the bill was too broad and that the need for further legislation to reform securities litigation was not clearly established. Eventually, however, the Commission was able to support the bill, based on the addition of the corporate law carve-out and other amendments, and based on reassurances in the legislative history that the bill was not meant to alter the intent standard for private securities litigation that had been established by the Private Securities Litigation Reform Act of 1995, and specifically, that liability for reckless conduct would be preserved.

Foreign Corrupt Practices Act

On November 10, 1998, President Clinton signed into law S. 2375, the International Anti-Bribery Act of 1998, which amended the Foreign Corrupt Practices Act of 1977 (FCPA). This statute implements the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, a treaty negotiated by the Organization for Economic Cooperation and Development. The Convention establishes standards for prohibiting bribery of foreign officials to obtain or retain business. The International Anti-Bribery Act adds the concept of nationality jurisdiction to the FCPA, so that the FCPA now covers acts of United States businesses and nationals in furtherance of unlawful payments that take place wholly outside the United States, whether or not the transactions involve interstate commerce. The Act also changes certain provisions of the FCPA to conform them to the Convention by banning payments made to secure any improper advantage, expanding the definition of

covered foreign official to include officials of public international organizations, and subjecting both foreign and United States citizens to civil and criminal penalties. The Commission testified in support of these changes at a hearing on the House version of the bill (H.R. 4353) on September 10, 1998 before the Subcommittee on Finance and Hazardous Materials of the House Commerce Committee.

Securities Activities of Banks

In 1998, Congress again devoted considerable attention to Glass-Steagall reform. The leading vehicle for banking reform, H.R. 10, the Financial Services Competitiveness Act of 1998, was the subject of extensive negotiations between the Banking and Commerce Committees before it passed the House by a one-vote margin in May 1998. The bill was referred to the Senate and, after several days of hearings, reported out of the Senate Banking Committee in September 1998. Although H.R. 10 was never scheduled for a floor vote in the Senate, Representative Leach re-introduced the Senate Banking Committee version of H.R. 10 (as H.R. 4870) in the House shortly before adjournment, and he expressed his intention to do so again when the 106th Congress convened in January 1999.

On June 25, 1998, the Commission testified before the Senate Banking Committee regarding H.R. 10 and its views regarding Glass-Steagall reform. In general, the Commission has supported Glass-Steagall reform, provided that the resulting regulatory structure is established along functional lines. The concept of functional regulation would require that a bank engage in most securities activities through a registered broker-dealer, fully subject to the federal securities regulatory scheme. The Commission has testified that this is important because banking law does not contain specific provisions that provide for investor protection; the Commission believes that investors who purchase securities through banks should

receive the same investor protections as those who purchase securities from broker-dealers. Functional regulation would achieve this result. The Commission's testimony on H.R. 10:

- supported the elimination of the bank exclusions from the federal securities laws;

- advocated the concept of a “two-way street” to allow equal competitive opportunities to all financial services providers; and

- criticized the application of bank-oriented safety and soundness regulation to securities firms' activities, which would inhibit risk-taking by securities firms affiliated with banks.

SEC-Commodity Futures Trading Commission Issues

In 1998, Congress imposed a moratorium on the Commodity Futures Trading Commission's (CFTC's) regulation of the over-the-counter (OTC) derivatives market, in response to a May 7, 1998 CFTC concept release on the OTC derivatives market suggesting that the CFTC might revisit the existence and scope of exemptions under CFTC rules for swaps and hybrid instruments. The concept release raised concerns in the OTC derivatives market about legal uncertainty and the validity and enforceability of existing and future OTC derivatives contracts. Because of the size and importance of the OTC derivatives market to the United States economy, the Treasury Department, along with the Commission and the Federal Reserve Board, sought legislative action to prevent the CFTC from dismantling the swaps and hybrid instruments exemptions or from imposing additional requirements on such products.

Two bills were introduced in the House to prevent the CFTC from acting further with respect to OTC derivatives--H.R. 4062, on June

16, 1998, and H.R. 4507, on August 6, 1998. The Commission testified in support of the principles behind these bills at hearings on June 10, 1998 before the House Agriculture Committee; on July 24, 1998 before the House Banking Committee; and on July 30, 1998 before the Senate Agriculture Committee. Ultimately, language inserted into H.R. 4328, the omnibus spending bill passed at the end of the 105th Congress, placed a moratorium on CFTC regulation of the OTC derivatives market until March 30, 1999, or until the enactment of CFTC authorizing legislation. As a result of the CFTC's concept release and the collapse of Long-Term Capital Management, the President's Working Group on Financial Markets is now preparing separate studies on hedge funds and the OTC derivatives market, both of which are expected to be the subject of congressional hearings in fiscal 1999.

Year 2000 Computer Issue

In response to an inquiry from Congressman Dingell of the House Commerce Committee, the SEC staff submitted a report in June 1998 on the readiness of the United States securities industry and public companies to respond to the year 2000 computer issue, and on their disclosure obligations regarding year 2000 issues. The Commission testified four times in 1998 regarding year 2000 readiness and disclosure issues on October 22, 1997 and June 10, 1998 before the Subcommittee on Financial Services of the Senate Banking Committee, and on July 6, 1998 and September 17, 1998 before the Senate Special Committee on the Year 2000 Technology Problem. Congress passed S. 2392, the Year 2000 Information Disclosure Act of 1998, a bill promoted by the Administration's Year 2000 Task Force and by industry groups, and that was signed into law on October 19, 1998. The Act attempts to encourage businesses and other entities to share information about their year 2000 solutions by creating a safe harbor from private liability for most statements about

this information. The Act's safe harbor does not apply to actions under the securities laws based on information contained in SEC filings or on disclosures accompanying a solicitation of the offer or sale of securities.

SEC Appropriations and Fees

On March 18, 1998, the Commission testified before the Subcommittee on Commerce, Justice, and State, the Judiciary, and Related Agencies of the House Appropriations Committee. The testimony supported the President's 1999 budget request of $341.1 million for the Commission. The Commission testified again in support of the Commission's budget request on March 19, 1998 before the Subcommittee on Commerce, Justice, and State, the Judiciary, and Related Agencies of the Senate Appropriations Committee.

From October 1, 1998 until final signing of an omnibus appropriations bill on October 21, 1998, the Commission operated pursuant to six continuing resolutions, which provided the Commission with authority to operate at its fiscal 1998 budget level. On October 21, 1998, H.R. 4328, the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1998, was enacted. The Act provides the SEC with $324 million for 1998, and its legislative history states that the SEC is expected to use an additional $6 million from its carryover funds. Separately, the SEC also received $7.4 million in funding for year 2000 preparations. Because of controversy over the census, which is included in the Commerce-Justice-State appropriations package with the SEC, all agencies in that package, including the SEC, are funded only though June 15, 1999. In addition, three ultimately unsuccessful bills were introduced in 1998 to cap SEC fee collections under section 31 of the Exchange Act—H.R. 4120,

introduced June 23, 1998; H.R. 4213, introduced July 14, 1998; and H.R. 4269, introduced July 17, 1998.

SEC Reauthorization

H.R. 1262, a bill reauthorizing the SEC at funding levels of $320 million for 1998 and $342.7 million for 1999, passed the House on November 13, 1997. When the bill failed to move in the Senate, the House Commerce Committee attached to H.R. 1689, the House version of the Securities Litigation Uniform Standards Act, language reauthorizing the SEC for appropriations of up to $351.3 million for 1999. This language was preserved in conference and ultimately signed into law as part of S 1260 on November 3, 1998.

Bankruptcy

The omnibus spending bill signed into law on October 21, 1998 contained provisions amending the Bankruptcy Code to protect the SEC's ability to obtain asset freezes and receivers despite a bankruptcy filing by a defendant. On March 18, 1998, our staff in the Division of Enforcement testified in support of these provisions before the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee. The new provisions remove any doubt that, in the context of a regulatory proceeding, asset freezes, receiverships, and actions taken to recover assets are unaffected by the automatic stay that follows the filing of a debtor's bankruptcy provision. They may discourage defendants from filing for bankruptcy as a litigation tactic.

The Public Utility Holding Company Act of 1935

In 1998, Congress continued to consider several bills to repeal the Public Utility Holding Company Act of 1935 (PUHCA). Repeal of

PUHCA has been stalled as Congress debates whether to simply repeal PUHCA or to repeal it as part of more sweeping electric utility deregulation. Two bills were introduced in 1998 to repeal PUHCA, both similar to a bill (S. 621) that had been introduced in 1997. These were H.R. 3976, the Public Utility Holding Company Act of 1998, introduced on May 22, 1998, which was virtually identical to S. 621, and S. 2287, the Comprehensive Electricity Competition Act, introduced on July 10, 1998, which linked PUHCA repeal to reform of other aspects of the federal regulatory scheme for electricity. Although the Commission was not asked to testify regarding either of these bills, its testimony in prior years has supported S. 621, the model for H.R. 3976, but has taken no position on the broader issues of electric utility deregulation.

Corporate Reorganizations

The Commission, as a statutory adviser in cases under Chapter 11 of the Bankruptcy Code, seeks to assure that the interests of public investors in companies undergoing bankruptcy reorganization are protected. During the past year, the Commission entered a formal appearance in 36 Chapter 11 cases with significant public investor interest.

Committees

Official committees negotiate with debtors on the formulation of reorganization plans and participate in all aspects of a Chapter 11 case. The Bankruptcy Code provides for the appointment of official committees for stockholders where necessary to assure adequate representation of their interests. During 1998, committees were appointed in two cases as a result of informal discussions by our staff with U S. Trustees, who have broad administrative responsibilities in bankruptcy cases.

Disclosure Statements/Reorganization Plans

A disclosure statement is a combination proxy and offering statement used to solicit acceptances for a reorganization plan. During 1998, the Commission's bankruptcy staff commented on 92 of the 130 disclosure statements it reviewed. Recurring problems with disclosure statements included inadequate financial information, lack of disclosure on the issuance of unregistered securities and insider transactions, and plan provisions that contravene the Bankruptcy Code. Most of the staffs comments to debtors or plan proponents were adopted, formal Commission objections were filed in seven cases.

The Commission made successful formal objections to five plans of reorganization that improperly attempted to release officers, directors, and other related persons from liability. The staff was able to obtain the deletion of improper third party release provisions in six cases during the disclosure statement review and comment process. This is a significant issue for investors because in many cases debtors improperly seek to use the bankruptcy discharge to protect officers and directors from personal liability for various kinds of claims, including liability under the federal securities laws.

In three cases, the Commission successfully objected to attempts to discharge claims of creditors and sell the remaining assetless public corporate shell. The staff was able to prevent improper attempts to use the debtor's public shell in four cases during the disclosure statement review and comment process. The trafficking in public company corporate shells—which can lead to stock market manipulation—is specifically prohibited by the Bankruptcy Code.

Law Enforcement Matters

Bankruptcy issues frequently arise in Commission enforcement actions. In *In re Bilzerian*[158] the Eleventh Circuit concluded that the district court was correct to apply the legal doctrine of collateral estoppel (that is, to accept the factual findings of another court and preclude relitigation of the issue) to the Commission's $33 million securities fraud disgorgement judgment. The court found that all of the legal requirements for excluding a debt from discharge in bankruptcy were established by the prior criminal and civil proceedings against Bilzerian, and directed the bankruptcy court to enter an order holding that the Commission's fraud claim was not discharged by Bilzerian's bankruptcy [159]

In *In re Cross,* [160] the Commission appealed a bankruptcy court order dismissing its $6.5 million debt against Cross, which was based upon an illegal offering of unregistered debt securities, to the Bankruptcy Appellate Panel for the Ninth Circuit. The Commission argued that this debt could not be discharged in Cross' bankruptcy because it was based on his fraudulent conduct. The bankruptcy court had held that the Commission lacked standing as a creditor because payment of the Commission's claim was to be made to a court-appointed receiver.[161] The Appellate Panel agreed with the Commission's position and reversed the bankruptcy court's decision, holding, that "as the chief enforcer of the securities laws, the Commission should not have to depend upon the receiver to enforce its judgments," and that "designating the receiver as the depository was merely a procedural step done for administrative convenience."[162] The panel concluded that the Commission held a valid claim against the debtor and was entitled to argue that this claim could not be discharged in Cross' bankruptcy.

In *In re Hibbard Brown*[163] a Chapter 11 case involving a penny stock broker-dealer, the Commission objected to confirmation of a plan that

sought to implement an unfair settlement with former registered representatives and employees who defrauded investors of more than $115 million. The Commission argued that the proposed contributions by these third parties were not enough to justify a release of all claims arising from their fraudulent activity. The bankruptcy court confirmed the plan notwithstanding the Commission's objection.

Ethical Conduct Program

In 1998, our ethics staff responded to 1,475 counseling inquiries and reviewed and cleared 162 speeches and articles submitted by SEC employees. The staff assisted in the renomination process of the Chairman.

Municipal Securities Initiatives

The Office of Municipal Securities provides expertise on municipal securities matters to the Commission and its divisions, and to municipal market participants.

Key 1998 Results

The Office of Municipal Securities devoted significant attention to alerting the municipal market of the need to disclose material issues arising from the year 2000. The staff also continued to coordinate the agency's efforts to end pay-to-play practices in the municipal securities markets.

Municipal Securities Disclosure

The Office of Municipal Securities worked closely with various SEC divisions and offices and municipal market participants on a number of important disclosure issues. Some of those issues included-

- the need to disclose material issues arising from the year 2000;
- implementation of, and compliance with, amendments to rule 15c2-12, which requires secondary market disclosure; and
- recent SEC enforcement decisions that apply the antifraud provisions of the federal securities laws to municipal securities.

Outreach

Our municipal securities staff met with numerous organizations representing participants involved in the municipal finance industry. Among the organizations were the Government Finance Officers Association, National League of Cities, National Association of Counties, The Bond Market Association, National Association of Bond Lawyers, and a variety of regional and local municipal government educational groups. The meetings focused on methods of improving compliance with existing regulations. The Office of Municipal Securities acted as a point of contact for municipal bond issuers and provided them access to the Commission.

Technical Assistance

The Office of Municipal Securities provided technical assistance to various SEC divisions and offices on various municipal securities matters. Some of the more significant matters included:

- enforcement cases involving municipal securities and the municipal securities markets *(e.g., Securities and Exchange Commission* v. *Rauscher Pierce Refsnes, Inc. and James R. Feltham*[164] *and In the Matter of Meridian Securities Inc. et al*[165]);

- the tax exempt aspects of municipal securities, including the tax regulations relating to situations involving potential yield burning;

- Municipal Securities Rulemaking Board rule G-37, which prohibits pay-to-play practices in the municipal securities markets;

- Municipal Securities Rulemaking Board rule G-38, which requires disclosure regarding consulting arrangements;

- various issues surrounding the implementation of amendments to rule 15c2-12;

- issues pertaining to individual investors and municipal securities price transparency; and

- municipal bankruptcy and other municipal securities matters.

Economic Research and Analysis

The SEC's economic analysis program provides the technical and analytical support necessary to understand and evaluate the economic effects of Commission regulatory policy, including the costs and benefits of nilemaking initiatives. The staff reviews all rule proposals to assess their potential effects on:

- *small businesses as required by the Regulatory Flexibility Act and Section 502 of the Small Business Investment Incentives Act, both enacted in 1980;*

- *competition within the securities industry and competing securities markets as required by the 1975 amendments to the Securities Exchange Act of 1934;*

- *efficiency, competition, and capital formation pursuant to Section 106 of the National Securities Markets Improvement Act; and*

- *costs, prices, investment, innovation, and the economy as required by the Small Business Regulatory Enforcement Fairness Act.*

Key 1998 Results

Our economic analysis staff analyzed the performance of the two circuit breakers triggered by the sharp decline in stock prices on October 27, 1997. The staff also provided economic advice, empirical data, and analytical support in connection with important policy initiatives, such as the Securities Act Reform Release, the Exchange

Concept Release, and Regulation ATS. These initiatives are designed to modernize and streamline securities regulations.

Economic Analysis and Technical Assistance

Securities Offerings and Capital Formation

Our economic analysis staff provided substantial quantitative economic evidence on a number of mlemaking projects.

Securities Act Reform Release. Provided economic advice and analysis focusing on how various aspects of the proposal designed to streamline the securities offering process could lower capital-raising costs and enhance the availability of information to investors.

Shareholder Proposals. Provided extensive empirical data and analyses in connection with proposed changes to the proxy rules, concentrating on how the rule change could affect the number of shareholder proposals submitted and shareholder wealth.

Regulation S. Analyzed the impact of new disclosure requirements governing offshore distributions of securities, focusing on the timing and amount of sales and the cost of raising capital under the amended regulation.

Securities Act Rule 701. Analyzed 1,300 filings of Form 701 for a five-year period and provided data on the number of companies using the rule to issue securities to employees, consultants, and advisers under compensatory plans or contracts, such as profit sharing and savings plans.

Mutual Funds

Our staff provided advice and analytical support to the Division of Investment Management in connection with the development of the profile prospectus and methods of displaying the riskiness of funds. The advice and technical assistance focused on ways to improve mutual fund disclosures to help investors evaluate and compare funds.

Market Structure and Trading Practices

Our economic analysis staff provided data, analyses, and economic advice to help craft policy initiatives.

The Exchange Concept Release and Regulation ATS. The staff provided data, analyses, and economic advice to help the Division of Market Regulation craft the Exchange Concept Release and Regulation ATS. These address the need to update the regulatory framework for exchanges and alternative trading systems (ATSs) in response to rapid technological developments affecting the securities markets. The advice and analysis focused on how the new display and access requirements of Regulation ATS could enhance market transparency, narrow bid-ask spreads, and provide investors with opportunities for better transaction prices.

Report to the President's Working Group on Financial Markets. The staff provided extensive empirical data and analytical support, including an analysis of the performance of the two circuit breakers triggered by the sharp decline in stock prices on October 27, 1997. The analyses was incorporated into a report issued by the Division of Market Regulation in September of 1998.

Nasdaq's Fixed Income Pricing System. The staff conducted the first-ever empirical analysis of this system's bond trading data. The

analysis assessed the transparency and trading patterns of approximately 1,350 below-investment-grade corporate bonds.

Regulation M. This rule, which went into effect in April 1997,

replaces the Commission's trading practice rules governing potentially manipulative trading during a securities distribution. The staff conducted a study of the aftermarket activities of underwriting syndicates and provided a comprehensive review and analysis of empirical data on underwriters' use of penalty bids and short-covering following the completion of securities distributions.

Order Handling and Tick Size Rules. The staff analyzed the effect of the Commission's new order handling rules and reductions in the minimum tick size from eighths to sixteenths. The analyses examined the impact of these events on bid-ask spreads, quotation depth, and transaction prices relative to contemporaneous price quotations. The analyses indicated these changes narrowed bid-ask spreads and that investors have benefited from their ability to trade at the improved price quotations.

Enforcement Issues

Our economic analysis staff provided assistance in investigations and enforcement actions involving the Nasdaq market, yield burning, insider trading, mutual fund trade allocation, market manipulation, fraudulent financial reporting, and other violations of securities laws. The staff applied financial economics and statistical techniques to determine whether the elements of fraud were present and to estimate the amount of disgorgement to be sought. They also assisted in evaluating the testimony of experts hired by opposing parties.

Inspections and Examinations

Our economic analysis staff worked closely with the SEC's Office of Inspections and Examinations (OCDE) to:

- apply large sample and statistical techniques to improve the efficiency and effectiveness of OCIE's examinations and inspections;

- assist in developing a system to prioritize broker-dealer examinations based on empirical data from regulatory reports; and

- assist OCIE in a number of its inspections involving securities exchanges, Nasdaq market makers, electronic communications networks, and mutual fund complexes.

Special Projects

In addition to working with the SEC divisions and offices, the economic analysis staff:

- analyzed the extent of trading in ATSs and the accuracy of transaction fees collected by the Commission;

- provided assistance in connection with applications by exchanges to trade options and swaps contracts and in conjunction with applications for exemptions filed by public utilities; and

- provided several offices and divisions with assistance in understanding the economic value of complex financial

instruments and transactions, such as collateralized mortgage obligations and wrapper agreements.

Policy Management and Administrative Support

Our policy management and administrative support staff provide the Commission and operating divisions with the necessary services to accomplish the agency's mission. The responsibilities and activities include developing and executing management policies, formulating and communicating program policy, overseeing the allocation and expenditure of agency funds, maintaining liaison with the Congress, disseminating information to the press, and facilitating Commission meetings. Administrative support services include information technology, financial, space and facilities, and human resources management.

Key 1998 Results

The Commission held 50 meetings in 1998, during which it considered 186 matters. The Commission acted on 1,051 staff recommendations by seriatim vote. The agency collected $1.78 billion in fees, of which $250 million was used to directly fund the agency in 1998.

Policy Management

Commission Activities

During the 50 Commission meetings held in 1998, the Commission considered 186 matters, including the proposal and adoption of Commission rules, enforcement actions, and other items that affect the nation's capital markets and the economy. The Commission also acted on 1,051 staff recommendations by seriatim vote.

Significant Regulatory Actions

- Adoption of requirements for plain English disclosure.
- Adoption of measures intended to deter microcap fraud
- Adoption of a new mutual fund disclosure document, the profile prospectus.
- Interpretations and rules for issuers, broker-dealers, investment advisers, and transfer agents concerning year 2000 computer problems.
- Proposal on regulation of exchanges and alternative trading systems.
- Adoption of reforms to address concerns about the shareholder proposal process.

Management Activities

Our staff continued to promote management controls and financial integrity and to manage the agency's audit follow-up system. In addition, we analyzed the efficiency and effectiveness of operating divisions and support offices and coordinated and implemented the agency's compliance with and response to actions under the Government Performance and Results Act of 1993, including development of the agency's strategic plan. Working closely with other senior officials, the office formulated the agency's budget submissions to the Office of Management and Budget and the Congress.

Public Affairs

Our Public Affairs, Policy Evaluation and Research staff:

- informed those interested in or affected by Commission actions of SEC activities;

- published the *SEC News Digest,* which provides information on rule changes, enforcement actions against individuals or corporate entities, administrative actions, decisions on requests for exemptions, upcoming Commission meetings, and other events of interest;

- provided support for the Chairman's investor education initiatives, the SEC's Internet Web site, the agency's foreign visitors program, and the SEC International Institute for Securities Market Development; and

- responded to over 50,000 requests for specific information on the SEC or its activities and coordinated programs for 878 foreign visitors.

Equal Employment Opportunity

Our Equal Employment Opportunity (EEO) staff monitored the SEC's compliance with EEO laws and regulations. In an effort to establish and maintain a discrimination-free workplace, our staff counseled employees, mediated complaints of discrimination, and investigated complaints not resolved through mediation. We trained managers and supervisors on prevention of sexual harassment and upholding the EEO responsibilities of the Commission. The SEC sponsored minority

recruitment events and programs to promote diversity and cultural awareness within the SEC and the industry.

Freedom of Information Act and Privacy Act

Our Freedom of Information Act (FOIA) and Privacy Act staff responded to requests for access to information under FOIA, the Privacy Act, and the Government in the Sunshine Act, and processed requests under the agency's confidential treatment rules. In 1998, we received 3,155 FOIA requests and appeals, 12 Privacy Act requests and appeals, 21 Government in the Sunshine Act requests, 12 government referrals, and 8,733 requests and appeals for confidential treatment.

Administrative Support

Financial Operations

The SEC deposited $1.78 billion in fees in the U.S. Treasury in fiscal 1998, of which $250 million was used to directly fund the agency in 1998. Of the $1.78 billion in total fees collected, 58% were from securities registrations; 36% were from securities transactions, and 6% were from tender offer, merger, and other filings.

Offsetting fee collections were affected by the enactment of Title IV of the National Securities Markets Improvement Act of 1996 (NSMIA). Specifically, NSMIA extended the collection of existing transaction fees to the over-the-counter market at the rate of 1/300 of 1% starting in 1997. It also increased the frequency of transaction fee collections on the exchanges, which resulted in the collection of 20 months of transaction fees from the exchanges in 1998 as the shift to the new schedule occurred. Starting in 1999, all transaction fee collections will be based on a 12-month cycle

In addition, NSMIA reduced the registration fee rate from roughly $303 per million (1/33 of 1%) in 1997 to $295 per million (1/34 of 1%) in 1998. NSMIA further reduces the registration fee rate to $278 per million (1/3 6 of 1%) in 1999

Year 2000

In 1998, preparations for year 2000 compliance of our internal systems remained our highest management priority. We completed an assessment of all mainframe, client/server, and PC-based applications, and developed our strategy for repairing, replacing or retiring these applications. We continued assessing and upgrading the agency's infrastructure (including hardware, software, and PC's) to achieve year 2000 compliance. Test plans, including independent verification and validation, were prepared

On July 1, 1998, the SEC awarded a contract to TRW for the modernization and ongoing maintenance of the EDGAR system. The first release of the three-year modernization effort was implemented in November with major components affecting text management and the dissemination of EDGAR filing data. The text management subsystem allows SEC and public reference room users to retrieve and print EDGAR filings using a new browse-based interface and Internet technology. The new privatized dissemination system significantly reduced the cost for subscribers who purchase and reformat the EDGAR data.

The agency's Internet Web site provides the public with electronic access to the EDGAR database and a wide range of other information of interest to the investing public. The site averaged 650,000 connections and over 25 gigabytes of data downloaded each day.

Administrative and Personnel Management

This year, our staff:

- continued efforts to migrate our in-house personnel/payroll system and operations to the Department of the Interior;

- met our goal of hiring 10 employees under the Welfare to Work Program;

- consolidated our desktop publishing, printing, publications, and mail room operations to improve efficiency, increase automation, and dispose of outdated equipment; and

- conducted special recruitment efforts through organizations and

- educational institutions involving minorities and persons with disabilities, resulting in 27% of new hires in 1998 being minorities or persons with disabilities.

ENDNOTES

[1] *SEC v. Steven Samblis, et al..,* Litigation Rel. No. 15609 (Jan. 6, 1998), M.D. Fla.

[2] *SEC v. Jerome M. Wenger,* Litigation Release No. 15707 (Apr. 15, 1998), S.D.N.Y.

[3] *SEC v. Michael R. Milken and MC Group,* Litigation Rel. No. 15654 (Feb. 26, 1998), S.D.N.Y.

[4] *In the Matter of Olde Discount Corp,, et al.,* Securities Act Rel. No. 7577 (Sept. 10, 1998).

[5] *SEC v. Szur, et al.,* Litigation Rel. No. 15595 (Dec. 18, 1997), S.D.N.Y

[6] *SEC v. Thomas Edward Cavanagh, et al.,* Litigation Rel. No. 15669 (March 13, 1998), S.D.N.Y

[7] *In the Matter of Monetta Financial Services, Inc., et al.*, Securities Act Rel. No. 7510 (Feb. 26, 1998).

[8] *SEC v. Sweeney Capital Management Inc., et al..,* Litigation Rel. No. 15664 (March 10, 1998), N.D. Cal.

[9] *SEC v. International Heritage, Inc., et al.,* Litigation Rel. No. 15672 (March 17, 1998), N.D. Ga.

[10] *SEC v. American Automation, Inc., et al.,* Litigation Rel. No. 15872 (Sept. 4, 1998), N.D. Tex.

[11] *In The Matter of KPMG Peat Marwick LLP,* Exchange Act Rel. No 39400 (Dec. 4, 1997).

[12] *In the Matter of Sony Corp. and Sumio Sano,* Exchange Act Rel. No. 40305 (Aug. 5, 1998).

[13] *SEC* v. *Sony Corp.,* Litigation Rel. No. 15832 (Aug 5, 1998), D D.C.

[14] *SEC v. One or More Unknown Purchasers of Call Options and Common Stock of USCS International, Inc.),* Litigation Rel. No 15875 (Sept. 9, 1998), S.D.N.Y.

[15]*SEC v. Rauscher Pierce Refsnes, Inc. and James R. Feltham,* Litigation Release No. 15613 (Jan. 8, 1998), D. Ariz.

[16] *In the Matter of Meridian Securities, Inc., et al.,* Securities Act Rel No. 7525 (Apr. 23, 1998).

[17] The SEC, Department of the Treasury, and the Federal Reserve Board issued a “Joint Study of the Regulatory System for Government Securities” in March 1998

[18] *The Importance of Transparency in America's Debt Market,* Remarks by SEC Chairman Arthur Levitt at the Media Studies Center, New York, New York (Sept. 9, 1998)

[19] Letters regarding Instinct Real-Time Trading Service (Jan. 17, 1997), the Island System (Jan. 17, 1997), the Bloomberg Tradebook System (Jan. 17, 1997), the TONTO System (Jan. 17, 1997), the Routing and Execution DOT Interface Electronic Communications Network (Oct. 6, 1997), the ATTAIN System (Feb. 4, 1998), the Brass Utility System (Apr. 21, 1998), the Strike System (Nov 13, 1998), and the PDVI Global Equities Trading System (Nov. 13, 1998).

[20] Release No. 39829 (Apr. 6, 1998), 63 FR 17943 (Apr. 13, 1998).

[21] Release No. 34-40357 (Aug. 24, 1998), 63 FR 46261 (Aug. 31, 1998).

[22] Release No. 34-40361 (Aug. 25, 1998), 63 FR 46262 (Aug. 31, 1998).

[23] Release No. 34-39445 (Dec. 11, 1997), 62 FR 66709 (Dec. 19, 1997).

[24] Release No. 34-39846 (Apr. 9, 1998), 63 FR 18477 (Apr. 15, 1998) (regarding AMEX-98-09, BSE-98-06, CHX-98-08, NASD-98-27, NYSE-98-06, and PHLX-98-15)

[25] Staff Legal Bulletin No. 8 (MR) (Sept. 9, 1998).

[26] Release No. 34-40377 (Aug. 27, 1998), 63 FR 47051 (Sept. 3, 1998).

[27] Release Nos. 34-40162 (July 2, 1998), 63 FR 37668 (July 13, 1998) (regarding broker-dealers); 34-40163 (July 2, 1998), 63 FR 37688 (July 13, 1998) (regarding transfer agents).

[28] Release Nos. 34-40608 (Oct. 28, 1998), 63 FR 59208 (Nov. 3, 1998) (regarding broker-dealers); 34-40587 (Oct. 22, 1998), 63 FR 58630 (Nov. 2, 1998) (regarding transfer agents).

[29] Release No. 34-40622 (Oct. 30, 1998), 63 FR 59819 (Nov. 5, 1998) (regarding AMEX-98-32, NASD-98-56, and NASD-98-67).

[30] Press Conference by David Krell, President & CEO, ISE, Nov. 10,

1998, New York City.

[31] Release No. 34-40204 (July 15, 1998), 63 FR 39306 (July 22, 1998).

[32] Release No. 34-40260 (July 21, 1998), 63 FR 40748 (July 30, 1998).

[33] Release No. 34-40077 (June 8, 1998), 63 FR 32628 (June 15, 1998).

[34] See Testimony of Richard R. Lindsey, Director, Division of Market Regulation, SEC, before the House Committee on Banking and Financial Services, dated Oct. 1, 1998.

[35] Release No. 34-39670 (Feb. 25, 1998), 63 FR 9661 (Feb. 25, 1998)

[36] Letter regarding Rule 15c2-11: OTC Bulletin Board: Removal of Foreign Equities and ADRs, dated Mar. 13, 1998.

[37] Release No 34-38456 (Mar. 31, 1997) 63 FR 16635 (Apr. 7, 1998).

[38] Letter regarding Principal Trading and Market Making Activities in Certain Securities on the London Stock Exchange, dated June 29, 1998 and Letter regarding Application of Rule 10b-13 During Return of Capital Share Redemptions, dated July 22, 1998.

[39] Letter regarding Exchange Distributions/Block Crossing Transactions, dated Aug. 7, 1998.

[40] Release No. 34-40594 (Oct 23, 1998), 63 FR 59362 (Nov. 3, 1998).

[41] Letter regarding StockPower Inc., dated Mar. 26, 1998.

[42] Letter regarding StockPower Inc., dated July 13, 1998

[43] Letter regarding HIH Winterthur International Holdings Limited, dated July 8, 1998.

[44] Letter regarding Telecom Corporation of New Zealand Limited, dated Feb. 20, 1998.

[45] Letter regarding Technology Funding Securities Corporation, dated May 20, 1998.

[46] Letter regarding Wrap Fee Programs of Prudential Securities, Inc. and Wexford Clearing Services Corp., dated Aug. 3, 1998.

[47] Letter regarding Rule 10b-10/Calculation of Yield to Maturity, dated Aug. 24, 1998.

[48] Letter regarding Intermarket Surveillance Group, dated Aug. 21, 1998.

[49] Letter regarding Net Capital Treatment of Proprietary Accounts of Introducing Brokers, dated Nov. 3, 1998.

[50] Letter regarding Deficit Charges for Repurchase Transactions, dated Apr. 1, 1998.

[51] Release No. 34-40518 (Oct. 2, 1998), 63 FR 54404 (Oct. 9, 1998).

[52] Release No 34-40109 (June 22, 1998), 63 FR 35299 (June 29, 1998).

[53] Release No. 34-40479 (Sept. 24, 1998), 63 FR 52782 (Oct. 1, 1998).

[54] Release Nos. 34-40555 (Oct. 14, 1998), 63 FR 56670 (Oct. 22, 1998), and 34-40556 (Oct. 14, 1998), 63 FR 56957 (Oct. 23, 1998).

[55] Release No. 34-39846 (Apr. 9, 1998), 63 FR 18477 (Apr. 15, 1998) (regarding AMEX-98-09, BSE-98-06, CHX-98-08, NASD-98-27, NYSE-98-06, and PHLX-98-15).

[56] Release No. 34-40529 (Oct. 7, 1998) 63 FR 55667 (Oct. 16, 1998) (regarding NYSE-98-16).

[57] Release No. 34-39729 (Mar 6, 1998), 63 FR 12559 (Mar. 13, 1998) (regarding NASD-97-56).

[58] Release No. 34-39516 (Jan. 2, 1998), 63 FR 1520 (Jan. 9, 1998) regarding NASD-97-21).

[59] Release No. 34-39883 (Apr. 17, 1998), 63 FR 20232 (Apr. 23, 1998) (regarding NASD-97-69).

[60] Release No. 34-39712 (Mar. 3, 1998), 63 FR 1193 (Mar. 11, 1998) (regarding NASD-98-03, CBOE-97-68, MSRB-98-02, and NYSE-97-33). Note that the Commission approved at the same time similar amendments to the rules of the CBOE, the Municipal Securities Rulemaking Board, and the NYSE.

[61] Letter from Jonathan G. Katz, Secretary, SEC, to Jean A. Webb, Secretary, CFTC, dated Dec. 4, 1997.

[62] Release No. 34-40216 (July 16, 1998).

[63]7U.S.C. §2a(ii)(III).

[64] Release Nos. 34-39326 (Nov. 14, 1997), 62 FR 62385 (Nov. 21, 1997) (regarding NASD -97-71, NASD-96-20, and NASD-96-29); 34-39759 (Mar. 6, 1998), 63 FR 14153 (Mar. 24, 1998) (regarding CHX-97-36); 34-38960 (Aug. 22, 1997), 62 FR 45904 (Aug. 29, 1997) (regarding PHLX-97-31).

[65] *Id.* (Discussing committee changes in context of general corporate governance reorganization.)

[66] Release Nos. 34-40499 (Sept. 29, 1998), 63 FR 53739 (Oct. 6, 1998) (regarding MSRB 97-9); 34-39495 (Dec. 29, 1997), 63 FR 585 (Jan. 6, 1998) (regarding MSRB 97-18); 34-40167 (July 2, 1998), 63 FR 37434 (July 10, 1998) (regarding MSRB 98-10); 34-39712 (Mar. 3, 1998); 63 FR 11939 (Mar. 11, 1998) (regarding CBOE-97-68, MSRB-98-02, NASD-98-03, and NYSE-97-33).

[67] Release No. 34-40230 (July 17, 1998), 63 FR 40148 (July 27, 1998) (regarding MSRB 97-14).

[68] Release No. 34-40014 (May 20, 1998), 63 FR 29282 (May 28, 1998) (regarding MSRB 98-1).

[69] Release Nos. 34-40337 (Aug. 19, 1998), 63 FR 45544 (Aug. 26, 1998) (regarding MSRB-98-9); 34-40349 (Aug. 20, 1998), 63 FR 45545 (Aug. 26, 1998) (regarding MSRB-98-11) (establishing an effective date of Aug. 24, 1998, for the MSRB to begin operation of the Service).

[70] Release No. 34-40161 (July 2, 1998), 63 FR 37146 (July 9, 1998).

[71] Brady bonds are named after former U.S. Treasury Secretary Nicolas Brady who developed a plan that allowed certain countries to issue collaterized debt securities in exchange for outstanding bank loans as part of an internationally supported debt restructuring. Typically, the collateral would be U.S. Treasury securities; more recently, however, some bonds have been issued without collateral.

[72] Release No. IC-23064 (Mar. 13, 1998), 63 FR 13916 (Mar. 23, 1998).

[73] Release No. IC-23065 (Mar. 13, 1998), 63 FR 13968 (Mar. 23, 1998).

[74] Release No IC-22921 (Dec. 2, 1997), 62 FR 64968 (Dec. 9, 1997).

[75] Release No. IC-22884 (Nov. 13, 1997), 62 FR 61933 (Nov. 20, 1997)

[76] Release No. IC-23325 (July 22, 1998), 63 FR 40231 (July 28, 1998).

[77] *Emerging Markets Growth Fund, Inc.,* Release Nos. IC-23433 (Sept. 11, 1998), 63 FR 49717 (Sep. 17, 1998) (notice); and 23481 (Oct. 7, 1998) (order).

[78] *Daily Money Fund, et al.,* Release Nos. IC-23004 (Jan. 20, 1998), 63 FR3933 (Jan. 27, 1998) (notice); and 23030 (Feb. 18, 1998) (order).

[79] *In the Matter of the Chase Manhattan Bank, N.A. and Chemical Bank,* Release No. IC-23186 (May 14, 1998).

[80] *Europacific Growth Fund, et al.,* Release Nos. IC-23307 (July 9, 1998), 63 FR 38219 (July 15, 1998) (notice); and 23374 (Aug. 4, 1998) (order).

[81] The New Germany Fund, Inc. (pub. avail May 8, 1998).

[82] Investment Company Institute (pub. avail. Oct. 30, 1998).

[83] Zurich Insurance Company (pub. avail. Aug. 31, 1998).

[84] American Century Companies, Inc./J.P. Morgan & Co. Incorporated (pub. avail. Dec. 23, 1997).

[85] Pilgrim America Prime Rate Trust (pub. avail. May 1, 1998).

[86] Letter to Confidential Treatment Filers (pub. avail. June 17, 1998).

[87] Investment Company Institute (pub. avail. May 14, 1998).

[88] DALBAR, Inc. (pub. avail. Mar. 24, 1998).

[89] Paragon Advisers, Inc. (pub. avail. Oct. 1, 1998).

[90] Goodwin Procter & Hoar (pub. avail. Oct. *5,* 1998).

[91] Wilmer, Cutler & Picketing and Davis Polk and Wardwell (pub. avail. Oct. 5, 1998).

[92] *Statement of the Commission Regarding the Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore,* Release Nos. IC-23071 and IA-1710 (Mar. 23, 1998), 63 FR 14806 (Mar. 27, 1998).

[93] Release No. I A-1732 (July 17, 1998), 63 FR 39505 (July 23, 1998).

[94] Release Nos 33-7514 and IC-23066 (Mar. 13, 1998), 63 FR 13988 (Mar. 23, 1998).

[95] Rydex Advisor Variable Annuity Account (pub. avail. Sept. 29, 1998).

[96] State Street Bank and Trust Company (pub. avail. Aug. 1, 1996).

[97] Massachusetts Mutual Life Insurance Company (pub. avail. Aug. 10, 1998).

[98] Release No. IA-1733 (July 17, 1998), 63 FR 39708 (July 24, 1998).

[99]Id.

[100] Release No. IA-1731 (July 15, 1998), 63 FR 39022 (July 21, 1998).

[101] StaffLegal Bulletin No. 5 (CF/IM) (Jan. 12, 1998).

[102] Release No. IA-1769 (Oct. 1, 1998), 63 FR 54307 (Oct. 8, 1998).

[103] *Sempra Energy,* Release Nos. 35-26711 (Apr. 25, 1997), 62 FR 24141 (May 2, 1997) (notice); and 35-26890 (June 26, 1998) (order).
[104] *WPL Holdings, Inc.,* Release Nos. 35-26593 (Oct. 11, 1996), 61 FR 54687 (Oct. 21, 1996) (notice); and 35-6856 (Apr. 14, 1998) (order). [105] *American Electric Power Company,* Release Nos. 35-26708 (Apr. 18, 1997), 62 FR 20024 (Apr. 24, 1997) (notice); and 35-26864 (Apr. 27, 1998) (order). *Cinergy Corporation,* Release Nos. 35-

26698 (Mar. 28, 1997), 62 FR 16206 (Apr. 4, 1997) (notice); and 35-26848 (Mar. 23, 1998) (order).

[106] Release No. 33-7606A (Nov. 13, 1998), 63 FR233 (Dec. 4, 1998).

[107] Release No, 33-7607 (Nov. 3, 1998), 63 FR 233 (Dec. 4, 1998).

[108] Release No. 33-7497 (Jan. 22, 1998), 66 SEC Docket 8.

[109] Release No. 33-7380 (Jan. 14, 1997), 63 SEC Docket 14.

[110] Release No. 34-40678 (Nov. 13, 1998), 68 SEC Docket 10.

[111] Release No. 34-39538 (Jan. 12, 1998), 66 SEC Docket 6.

[112] Release No. 33-7516 (Mar. 23, 1998), 66 SEC Docket 16.

[113] Release No. 33-7505 (Feb. 17, 1998), 66 SEC Docket 11.

[114] Release No. 33-7511 (Feb. 27, 1998), 66 SEC Docket 11.

[115] Release No. 33-7541 (May 1, 1998), 67 SEC Docket 4.

[116] Release No. 34-40018 (May 21, 1998), 67 SEC Docket 4.

[117] Release No. 33-7558 (July 29, 1998), 67 SEC Docket 14.

[118] Release No. 33-7609 (Nov. 9, 1998), 68 SEC Docket 9.

[119] Release No. 33-7506 (Feb. 17, 1998), 66 SEC Docket 11.

[120] Release No. 33-7472 (Oct. 24, 1997), 65 SEC Docket 15.

[121] Release No. 33-7550 (June 25, 1998), 67 SEC Docket 9.

[122] Release No. 33-7549 (June 24, 1998), 67 SEC Docket 9.

[123] Release No. 33-7386 (Jan. 31, 1997), 63 SEC Docket 2182.

[124] Financial Reporting Release No. 54 (Jan. 5, 1999), 68 SEC Docket 17.

[125] Statement of Financial Accounting Standards No. 131, *Disclosure about Segments of an Enterprise and Related Information* (June 1997).

[126] Staff Accounting Bulletin No. 98 (Feb. 3, 1998), 66 SEC Docket 1422.

[127] Statement of Financial Accounting Standards No. 128, *Earnings Per Share, (Feb.* 1997).

[128] Statement of Financial Accounting Standards No. 133, *Accounting for Derivative and Similar Financial Instruments and for Hedging Activities,* (June 1998).

[129] Special Report, *A Guide to Implementation of Statement 125 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* Questions and Answers (Sept. 1998).

[130] Invitation to Comment, Methods of Accounting for Business Combinations: Recommendations of the G4+1 for Achieving Convergence (Dec. 15, 1998). The G4+1 includes representatives from the accounting standards boards of Australia, Canada, New Zealand, the United Kingdom, and the U.S. Representatives of the

International Accounting Standards Committee participate as observers.

[131] Statement on Standards for Attestation Engagements No. 8, *Management's Discussion and Analysis* (June 1998).

[132] Statement of Position 98-8, *Engagements to Perform Year 2000 Agreed-Upon Procedures Attestation Requirements Pursuant to [Various Securities Exchange Act Rules]* (Sept. 30, 1998).

[133] Statement of Position 98-8, *Engagements to Perform Year 2000 Agreed-Upon Procedures Attestation Requirements Pursuant to [Various Securities Exchange Act Rules]*(Sept. 30, 1998).

[134] Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (May 4, 1998).

[135] Statement of Position 98-5, *Reporting on the Costs of Start-up Activities (Apr.* 3, 1998).

[136] Financial Reporting Release No. 50 (Feb. 18, 1998), 66 SEC Docket 1657.

[137]155F.3d 107(2d Cir. 1998).

[138] Nos. 97-1143, 97-1261 (3d Cir.) (en banc).

[139] 137F.3d 1325 (11th Cir. 1998).

[140]155 F.3d 1051 (9th Cir. 1998).

[141]132 F.3d 1017 (4th Cir. 1997).

[142]147 F.3d 184 (2d Cir. 1998).

[143] No. 98-7123 (2d Cir.).

[144] 150 F.3d 675 (7th Cir. 1998).

[145] No. 97-2098 (6th Cir.).

[146] No. 97-16240 (9th Cir).

[147]151 F.3d 810 (8th Cir. 1998).

[148] 135 F.3d 860 (2d Cir. 1998).

[149] *Morgan Stanley & Co., Inc.,* Exchange Act Rel. No. 34-39459 (Dec. 17, 1997), 66 SEC Docket 351.

[150] *Victor Teicher, Victor Teicher & Co., L.P., & Ross S. Frankel,* Exchange Act Rel. No. 34-40010 (May 20, 1998), 67 SEC Docket 542, *appeal filed,* No. 98-1287 (D.C. Cir. June 24, 1998).

[151] *Meyer Blinder,* Exchange Act Rel. No. 34-39180 (Oct. 1, 1997), 65 SEC Docket 1970.

[152] *L.C. Wegard & Co., Inc. & Leonard B. Greer,* Exchange Act Rel. No. 34-40046 (May 29, 1998), 67 SEC Docket 814.

[153] *Steven P. Sanders and Daniel M. Porush,* Exchange Act Rel. No. 34-40600 (Oct. 26, 1998), 68 SEC Docket 982.

[154]D.L. *Wine Investments, Inc., W. Randal Miller, Kenneth Karpf, and Duncan Wine,* Exchange Act Rel. No. 34-39517 (Jan. 6, 1998), 66 SEC Docket 763.

[155] *Interactive Brokers LLC,* Exchange Act Rel. No. 34-39765 (Mar. 17, 1998), 66 SEC Docket 2346.

[156] *First Colorado Financial Services and Mark P. Augustine,* Exchange Act Rel. No. 34-40436 (Sept. 14, 1998), 68 SEC Docket 24.

[157] The Chicago Board of Trade, Exchange Act Rel. No. 34-40216 (July 16, 1998), 67 SEC Docket 1640, appeal filed, No. 98-2923 (7th Cir. July 31, 1998).

[158] *In re Bilzerian,* Case No. 91-10466-8P7 (Bankr. M.D. Fla.).

[159] *SEC v. Bilzerian,* 153 F. 3d 1278 (11th Cir. 1998).

[160] *In re Cross,* Case No. SA-95-15228-JB (Bankr. C.D. Cal.).

[161] *SEC v. Cross,* 203 B.R. 456 (Bankr. C.D. Cal. 1996).

[162] *SEC v. Cross,* 218 B. R. 76 (Bankr. 9th Cir. 1998).

[163] *In re Hibbard Brown & Co., Inc.,* Case No. 94 B 44809 (CB) (Bankr. S.D. N.Y.).

[164] Case No. CV-98-0027 PHX ROS (Ariz., Jan. 8, 1998) (amended complaint, filed March 6, 1998); Amended Order Denying Motion to Dismiss, 1998 U.S. Dist. LEXIS 13164 (Aug. 24, 1998).

[165] Release No. 33-7525, Admin Proc. File No. 3-9582 (Apr. 23, 1998).