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Significant 1985 Regulatory and Legislative Developments

*By the Subcommittee on Annual Review**

SEC PROXY REVIEW PROGRAM

With adoption of new Form S-4, which simplifies the process of registration and proxy solicitation in connection with business combinations, and with the proposed revisions to update and simplify the proxy rules, the SEC has nearly completed the proxy review program begun in 1982. The SEC program has already resulted in the adoption of a uniform regulation for the disclosure of management relationships and transactions, amendments to facilitate shareholder communications, revisions of SEC regulations on shareholder proposals, and uniform regulations for disclosure of executive compensation. The principal task remaining is review of the proxy contests regulations. Proposals for revised regulations should be issued early in 1986.

Practitioners should note that several new terms have been added to securities law jargon as the result of the integrated disclosure system, which reduces duplication of disclosures by permitting incorporation by reference. There is the "S-1-2-3 approach," which permits "tiering." This means that, depending on the time that a company has been subject to periodic reporting requirements under the Exchange Act, and the performance of the obligations imposed upon it by the Exchange Act and by the terms of its outstanding preferred stock and debt, the company may be permitted to refer to information filed with the SEC in other documents instead of repeating it in the registration statement. "Tiering" refers to the fact that a blue-chip company that can incorporate most information by reference (Form S-3) is in the top tier, and the company that has to furnish all of the required information in the registration form (Form S-1) is in the bottom tier.

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REGISTRATION OF SECURITIES IN BUSINESS COMBINATIONS: NEW FORM S-4

On April 23, 1985, the Commission announced the adoption of Form S-4,¹ a new form used to register securities under the Securities Act in connection with business combinations. This new form applies the principles of integrated disclosure to disclosures in merger and exchange-offer transactions. The purpose is to simplify the disclosure of information to securityholders in mergers and exchange offers so that the former bulky prospectuses and proxy statements will no longer be necessary. This action implements the recommendation of the SEC Advisory Committee on Tender Offers, which was intended to make exchange offers as easy as cash offers in taking over another company by reducing the complexity of documenting an exchange offer.² Adoption of new Form S-4, however, does not permit an exchange offer to be commenced before the registration becomes effective, an additional recommendation of the SEC Advisory Committee not yet implemented.³

The new Form S-4 can be used to register securities in transactions of the kind specified in rule 145(a);⁴ mergers in which state law does not require approval or consent of all the securityholders; exchange offers made to securityholders of another issuer; and reoffers or resales of securities registered on this form. It replaces Form S-14 and Form S-15, which were originally adopted on an experimental basis as part of the first phase of the Commission's integrated disclosure system. Form S-4 permits use of the principles underlying the integrated disclosure system in all business combinations, not just those involving small transactions. In addition, the same streamlined disclosure requirements are applicable to business combinations whether effected by a merger or an exchange offer.

By using the S-1-2-3 approach in Form S-4, the Commission confirmed its basic premise that decisions made in business combinations are substantially the same as those made in the purchase of a security in the primary or trading market. Based on this premise, the integrated disclosure system specifies the manner in which information must be made available to investors. Under Forms S-2 and S-3, transaction information must be presented in the prospectus, but company-oriented information may be incorporated by reference depending on the extent to which the Exchange Act reports containing that information have been disseminated in the market. Registrants who use Form S-3, the most widely followed companies, do not have to include company-specific information included in Exchange Act reports but may incorporate this information by reference. Registrants who use Form S-2, less widely followed

1. SEC Securities Act Release No. 6578, SEC Exchange Act Release No. 21,982, 6 Fed. Sec. L. Rep. (CCH) ¶ 72,418 (Apr. 23, 1985).

2. SEC Advisory Committee on Tender Offers, Report of Recommendations (Recommendation 11), Fed. Sec. L. Rep. No. 1028 (CCH) 21 (July 15, 1983).

3. *Id.*, Recommendation 12.

4. 17 C.F.R. § 230.145 (1985). Rule 145 transactions include certain reclassifications, mergers, consolidations, and transfers of assets.

reporting companies, must present certain company information either by delivering the annual report to securityholders or by reiterating that level of company information in the prospectus. Finally, registrants who use Form S-1 must present all company information in the prospectus.

Form S-4, like other Securities Act forms, is divided into two parts. Part I is the information that must be included in the prospectus, and part II is the information that does not have to be included. Part I of the form is divided into four sections addressing the transaction, the registrant, the company being acquired, and voting and management information.

Section A pertains to the transaction. This information must be presented in the prospectus, not incorporated by reference.⁵ Included in section A are items 1 and 2, information called for by items 501 and 502 of regulation S-K; item 3, risk factors and ratio of earnings to fixed charges as required by item 503 of regulation S-K, and other information; item 4, terms of the transaction, such as the terms of the acquisition agreement, and reason for and consequences of the transaction; item 5, pro forma financial information; item 6, material contracts with the company being acquired; item 7, additional information concerning resales; item 8, the interests of named experts and counsel as required by item 509 of regulation S-K; and item 9, indemnification for Securities Act liabilities as specified by item 510 of regulation S-K.

Section B requires information about the registrant depending upon whether the registrant is eligible to use Form S-1, Form S-2, or Form S-3. If the registrant is subject to either section 13(a) or section 15(d) of the Exchange Act, it is required to present the same information about itself as that required by Form S-1, Form S-2, or Form S-3 in making a primary securities offering. If the registrant is not subject to the reporting requirements of the Exchange Act, the registrant is required to disclose information about itself at the Form S-1 level.

Section C specifies what information to present about the company being acquired. If the company being acquired is a reporting company, Form S-4 requires the same information about the company being acquired as if that company were the registrant. Thus, for a Form S-2 or Form S-3 company being acquired, the registration may incorporate by reference to the documents filed by the acquired company with the SEC. If the company being acquired is not a reporting company, Form S-4 allows the registrant to elect to disclose information about the company being acquired at either the Form S-1 level or at the

5. Included in § A are: items 1 and 2, information called for by items 501 and 502 of regulation S-K; item 3, risk factors and ratio of earnings to fixed charges as required by item 503 of regulation S-K, and other information; item 4, terms of the transaction, such as acquisition agreement, and reason for and consequences to the transactions; item 5, pro forma financial information; item 6, material contracts with the company being acquired; item 7, additional information concerning resales; item 8, the interests of named experts and counsel as required by item 509 of regulation S-K; and item 9, indemnification for Securities Act liabilities as specified by item 510 of regulation S-K.

same level as that required under Form S-15 for nonreporting companies being acquired.

Section D requires voting and management information. If a proxy, consent, or authorization is to be solicited, the registrant is required to present information in the prospectus concerning the vote needed for approval, dissenters' rights of appraisal, revocability of proxies, persons making the solicitation, and the registrant's relationship with the independent public accountants. If a solicitation is not made, Form S-4 requires that the registrant provide information in the prospectus about the date of the shareholder meeting, the vote required for approval, dissenters' appraisal rights, and the registrant's relationship with independent accountants, and a statement that proxies, consents, or authorizations are not being solicited. Whether or not proxies are solicited, Form S-4 also requires information on voting securities and the principal holders⁶ and information about both entities' directors and officers, executive compensation, and certain relationships and related transactions.⁷

Part II of Form S-4 requires information called for by item 702 of regulation S-K, regarding indemnification of directors and officers; by item 602 of regulation S-K, on exhibits; and by item 512 of regulation S-K, on undertakings. This information does not have to be in the prospectus but must be in the registration statement.

If incorporation by reference is used instead of presenting the information in the prospectus, the prospectus must be sent at least twenty business days in advance of the date of the shareholder meeting or the date of the final investment decision. If the registrant wants to proceed at a faster pace, it can do so, but it must present the same information in the prospectus as is required by Form S-1.

Although Form S-1 continues to be available for mergers and exchange offers, Forms S-2 and S-3 have not been and will not be available for such transactions. Form S-4 now provides the opportunity for incorporation by reference to registrants qualified to use Forms S-2 and S-3. Form S-4 also is available to an issuer for exchange offers with its own securityholders.

Not everyone is happy with this step in the SEC's proxy review program. In a letter addressed to the Commission before adoption of the new form, the National Association of Manufacturers (NAM) observed:

The NAM believes the effect of integration of exchange offers will be to offset the balance which has evolved over many years between raiders employing the tender offer method of acquisitions for control of targets. The SEC readily acknowledges that integration of exchange offers will result in the acceleration of the tender offer process. Acceleration clearly

6. See item 5 of schedule 14A, 17 C.F.R. § 240.14a-101 (1985).

7. See items 401, 402, and 404 of regulation S-K, 17 C.F.R. §§ 229.401, 229.402, 229.404 (1985).

tilts the process to favor the raider side. Such changes could have dramatic consequences⁸

COMPREHENSIVE "SUNSET" REVIEW OF THE PROXY RULES

On July 1, 1985, the Commission published proposed revisions to update and simplify the Exchange Act proxy rules.⁹ The principal substantive revisions streamline the proxy disclosure system by applying the principles of integrated disclosure to proxy and information statements and enhance investor protection by requiring additional disclosure relating to independent public accountants. The proposed revisions affect regulation 14a, including schedules 14A and 14B; regulation 14C; regulation S-K; and Form S-18.

Under rule 14a-1, the Commission proposes to add a definition of "record date" and to revise the definition of "solicitation." Under the proposal, the record date would be defined in accordance with state law. The definition of "solicitation" would be revised to conform with case law.¹⁰ Thus, a solicitation would be expanded from a communication "reasonably calculated to result in" to a communication "which reasonably could be expected to affect" the procurement, withholding, or revocation of a proxy. For a long time, the SEC has posited that almost any communication with securityholders prior to a contemplated meeting is a proxy solicitation. But the revision would provide additional authority for the Staff's extremely broad interpretation. The Staff does not enumerate in either existing regulations or the proposed revision what factors will be considered. The SEC noted that, in the case law defining "solicitation," an important factor in determining whether the communication has such effect is the length of time between the making of the communication and the taking of such vote. The shorter the time, the greater the effect on the proxy process. However, the Staff did not follow through by suggesting guidelines for communications that would not be treated as solicitations if made substantially in advance of meetings.

Regulation 14a-2, entitled "Solicitations to Which Rules 14a-3 to 14a-12 Apply," actually lists solicitations to which those rules do not apply. The only proposed revision to rule 14a-2 involves a plan for reorganization under the bankruptcy law. Under a proposed revision to paragraph (a)(4), rule 14a-2 would not apply to a solicitation made after court approval of a written disclosure statement concerning a plan of reorganization filed under chapter 11 of the bankruptcy laws.

Under rule 14a-3, before a solicitation can be made, securityholders must be furnished with a proxy statement; if the solicitation relates to the annual

8. Letter from H.A. Vine, on behalf of NAM, to SEC (Aug. 24, 1984).

9. SEC Securities Act Release No. 6592, SEC Exchange Act Release No. 22,195, [Current] Fed. Sec. L. Rep. (CCH) ¶ 83,901 (July 1, 1985).

10. *Dyer v. SEC*, 291 F.2d 774 (8th Cir. 1961); *SEC v. Okin*, 132 F.2d 784 (2d Cir. 1943), as cited in SEC Securities Act Release No. 6592, SEC Exchange Act Release No. 22,195, [Current] Fed. Sec. L. Rep. (CCH) ¶ 83,901 n.30 (July 1, 1985).

election of directors, an annual report must also be provided.¹¹ The Commission proposes to revise paragraph (b) of the rule to provide that if a special meeting is convened to elect directors in lieu of an annual meeting, the securityholders will be furnished with an annual report in connection with such meeting.¹² The Staff has also stated throughout the release that proposals applicable to proxy solicitations would be equally applicable to situations involving consents and authorizations. For example, paragraph (b) would be revised to clarify that the annual report must be furnished to securityholders whether the solicitation involves proxies or consents in connection with the annual election of directors. In addition, the Commission proposes to revise paragraph (b)(10) to require a proxy statement to contain an undertaking not only that the registrant will provide, upon written request, a copy of its annual report on Form 10-K but also any additional information contained in other documents required by section 13(a), such as the quarterly reports on Form 10-Q and current reports on Form 8-K.

The most significant proposed revisions concern integration and the additional disclosure requirements regarding independent public accountants. Currently, schedule 14A permits incorporation by reference only of financial statements included in the annual report.¹³ Proposed items 11, 12, 13, and 14, however, would permit incorporation by reference of part or all of the information, either pursuant to the tiered S-1-2-3 approach or from an annual report to securityholders furnished in connection with the same meeting. The additional information permitted to be incorporated by reference would include the business description and the other uniform disclosure items that comprise the basic information package. In addition, the proxy statement must contain an undertaking to furnish the incorporated documents upon request when the incorporated information is not delivered with the proxy statement.

The Commission also is proposing additions to the disclosure requirements of proposed item 9 concerning independent public accountants. These proposals would require disclosures concerning peer review and changes of accountants.¹⁴

SHAREHOLDER PROPOSALS: RULE 14a-8(c)(12)

Six church groups challenged the validity of 1983 revisions of SEC rule 14a-8(c)(12), which permits a company to omit a shareholder proposal from its proxy statement if substantially the same proposal has already been submitted to shareholders and received less than specified percentages of votes in its favor. The 1983 revisions had increased the percentage of votes required, thereby disqualifying the plaintiffs from resubmitting their proposals. The church

11. 17 C.F.R. § 240.14a-3 (1985).

12. SEC Securities Act Release No. 6592, SEC Exchange Act Release No. 22,195, [Current] Fed. Sec. L. Rep. (CCH) ¶ 83,901 (July 1, 1985).

13. 17 C.F.R. § 204.14A-101 (1985).

14. SEC Securities Act Release No. 6592, SEC Exchange Act Release No. 22,195, [Current] Fed. Sec. L. Rep. (CCH) ¶ 83,901 (July 1, 1985). For further discussion, see *infra*, "Proposed Proxy Rules Requiring Disclosure Affecting Accountants."

groups would have been able to submit their proposals under the prior rule, however.

The federal court granted the church groups' motion for summary judgment, holding that the revised rule was invalid because the SEC failed to give adequate notice and adequate explanation of its proposed action under the Administrative Procedure Act. The SEC agreed to reinstate the prior rule and to monitor its effects during the 1986 proxy season. Thus, rule 14a-8(c)(12) provides once again that a registrant may omit from its proxy material any shareholder proposal substantially the same as a proposal previously included in proxy material within the preceding five years, if the proposal had been submitted only once during that period and received less than three percent of the total votes cast; or if submitted twice, had received less than six percent of the total votes cast; or if submitted three or more times, had received less than ten percent of the total votes cast.¹⁵

PROXY RULES EXTENDED TO BANKS

In December 1985, section 14(b) of the Exchange Act was amended to authorize the SEC to extend to banks and other financial institutions its rules governing distribution of proxy materials, whether or not they solicit brokerage business.¹⁶ The legislation becomes effective December 28, 1986.

The SEC has been concerned that banks, although they hold considerably more stock than brokerage firms, have not been subject to the same regulations as registered brokers and dealers. As a partial remedy for this regulatory gap, the SEC recently adopted regulations requiring registration of banks as broker-dealers if they solicit brokerage business. (New rule 3b-9 is discussed below.) The legislation also authorizes the SEC to require banks, like brokerage firms, to disclose the names of beneficial owners to corporations requesting a list of their own shareholders, provided that the beneficial owner consents to such disclosure.

TENDER OFFER DEVELOPMENTS—PROPOSED ALL-HOLDERS RULE

As the result of litigation growing out of the efforts of Mesa Petroleum Company to take over Unocal Corporation, the SEC announced that the Williams Act by implication prohibits an issuer from excluding some of its shareholders from a tender offer for its own shares. The SEC also proposed a rule to codify its interpretation: the all-holders rule, which would apply both to tender offers by third parties and to tender offers by an issuer for its own shares. In doing so, the Commission sought, in effect, to overrule a federal district court and the Delaware Supreme Court.

15. SEC Exchange Act Release No. 22,625, [Current] Fed. Sec. L. Rep. (CCH) ¶ 83,937 (Nov. 14, 1985). For discussion of the issues, see *United Church Bd. v. SEC*, 617 F. Supp. 837 (D.D.C. 1985).

16. Shareholder Communication Act of 1985, Pub. L. No. 99-222 (Dec. 28, 1985).

In defending itself against the hostile takeover, Unocal Corporation offered to exchange new debt securities valued at \$72 for a portion of its outstanding common stock, a substantial premium over the offer by Mesa of cash and securities valued at \$54 per share. Unocal, however, excluded Mesa from the offer, even though Mesa then held thirteen percent of Unocal's common stock.

Mesa sought to enjoin the exchange offer in both federal and Delaware courts. In the federal court action in California, Mesa claimed that the selective exchange offer violated section 13(e) and section 14(e) of the Securities Exchange Act of 1934. Mesa argued that SEC proposals requiring tender offers to be "open to all" supported its interpretation, even though these proposals were never adopted. The federal court concluded that "Congress never intended to substantively regulate tender offers and in the face of the SEC's apparent acceptance of that interpretation, it is unnecessary to debate the cases which are claimed tangentially to touch on this issue."¹⁷

Mesa also sought to enjoin the offer under Delaware law. The Delaware Supreme Court disagreed with Mesa's position. The court found that the Board acted in the proper exercise of sound business judgment in determining that the Mesa offer was inadequate and coercive. Furthermore, the court concluded that "the selective exchange is reasonably related to the threats posed" and therefore did not violate the fairness requirements of Delaware corporation law.¹⁸

The SEC responded with proposed rule makings designed to accomplish two goals: (i) to conform the regulations governing issuer tender offers to those governing third-party tender offers and (ii) "to codify the Commission's position that an issuer tender offer must be open to all holders of the class of the securities subject to the tender offer, and that all security holders must be paid the highest consideration offered to any security holder."¹⁹ The proposed all-holders rule, which would effectively overrule the Delaware Supreme Court, is discussed in the SEC release proposing a new rule 14d-10 applicable to third-party tender offers.²⁰ The Commission, despite the contrary conclusion of the federal and state courts and despite its failure to adopt earlier proposals of the all-holders rule, asserts "the all-holders requirement is a widely known and generally accepted tender offer practice . . ."²¹ Citing sections 13(d), 13(e), 14(d), 14(e), and 14(f) of the Exchange Act, the Commission claims that

17. *Unocal Corp. v. Pickins*, 608 F. Supp. 1081, 1082 (C.D. Cal. 1985).

18. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956 (Del. 1985).

19. SEC Securities Act Release No. 6596, SEC Exchange Act Release No. 22,199, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,798 (July 1, 1985).

20. SEC Securities Act Release No. 6595, SEC Exchange Act Release No. 22,198, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,797 (July 1, 1985).

21. *Id.* at ¶ 87,560. For earlier Commission proposals of an all-holders rule, see SEC Exchange Act Release No. 14,234, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,380 (Dec. 7, 1977) and SEC Exchange Act Release No. 16,112, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,182 (Aug. 16, 1979), with respect to issuer tender offers regulated under § 13(e). See SEC Exchange Act Release No. 16,385, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,374 (Nov. 29, 1979), with respect to issuer and third-party tender offers under § 14(e) of the Exchange Act.

“implicit in these provisions . . . are the requirements that a bidder make a tender offer to all security holders of the class of securities which is subject to the offer and that the offer be made to all holders on the same terms”²²

In substance, proposed new rule 14d-10, applicable to third-party offers, and revised rule 13e-4, applicable to issuer tender offers, would prohibit selective cash or exchange offers and require payment of the best price, that is, the highest amount offered at any time during the tender-offer period.

Because of the recent trend of U.S. Supreme Court decisions, the Commission’s position led members of the bar and Congress to express serious reservations about the SEC’s authority to promulgate the proposed rules.²³ Less than a month before the SEC proposals were issued, the U.S. Supreme Court ruled in *Schreiber v. Burlington Northern, Inc.* that “manipulative acts under § 14(e) require misrepresentation or nondisclosure.” The Court continued:

The purpose of the Williams Act, which added § 14(e) to the Securities Exchange Act, was to ensure that public shareholders who are confronted with a tender offer will not be required to respond without adequate information. Nowhere in the legislative history is there any suggestion that § 14(e) serves any purpose other than disclosure, or that the term “manipulative” should be read as an invitation to oversee the substantive fairness of tender offers²⁴

Although SEC staff members indicated that prompt adoption of the proposed rules should be expected following the end of the comment period on September 9, 1985, the Commission decided on January 9, 1986, to defer adoption of the proposal for ninety days.²⁵ At the same time, the Commission proposed for public comment a regulation that would permit a corporation to make exclusionary tender offers if approved in advance by its shareholders. In effect, the

22. See SEC Exchange Act Release No. 6595, *supra* note 20, at ¶ 87,559. See also *id.* nn. 2 & 3, at ¶ 87,559. Section 13(d) provides for reporting beneficial ownership of more than five percent of registered equity securities of another company; § 13(e) prohibits an issuer from repurchasing its own equity securities in violation of SEC regulations adopted to define fraudulent, deceptive, or manipulative acts; § 14(d) requires filing a disclosure form with the Commission before making a tender offer for more than five percent of the registered equity securities of another company; § 14(e) prohibits making material, untrue statements or omissions in connection with a tender offer; and § 14(f) regulates assumption of control of a board of directors in connection with a tender offer.

23. See Letter from R.M. Phillips and R.T. Lang, on behalf of the ABA Federal Regulation of Securities Committee, to the SEC (Sept. 9, 1985); Letter from Timothy E. Wirth, Chairman of the House Subcommittee on Telecommunications, Consumer Protection and Finance, to Chairman John S.R. Shad, SEC (Oct. 3, 1985); and 131 Cong. Rec. S14,642-43 (daily ed. Nov. 1, 1985) (colloquy concerning the SEC proposals among Senators Spector, Rudman, and D’Amato). Senator Spector said, “I believe that if the Federal Government is to take the extraordinary step of modifying State corporate law, it should be by Congress, not the SEC.” Senator D’Amato responded, “In the past, the SEC has promulgated rules that govern the tender offer process and I do not question their authority to do so in this area. However, I can assure him that the Banking Committee’s Subcommittee on Securities, which I chair, will devote attention to the ‘all-holders’ rule.”

24. 105 S. Ct. 2458, 2459 (1985).

25. N.Y. Times, Jan. 10, 1986, at D-1, col. 1.

proposal would give shareholders the option to limit applicability of SEC regulations to some corporate transactions. Earlier, Senator D'Amato, Chairman of the Senate Banking Committee's Subcommittee on Securities, had already introduced a comprehensive bill that would prohibit the use of exclusionary tender offers.²⁶ If passed, the proposed bill would supersede the decisions of the Delaware Supreme Court and the Federal District Court in California discussed earlier.

BROKER-DEALER REGULATIONS

RULE 3b-9: BROKER-DEALER REGISTRATION OF BANKS

The SEC, in a controversial move, adopted rule 3b-9 under the Exchange Act. New rule 3b-9 requires a bank engaged in certain securities-related activities to register with the Commission as a broker-dealer.²⁷ With certain exceptions, the new rule, which becomes effective January 1, 1986, will require a bank to register as a broker-dealer if it (i) publicly solicits brokerage business for which it receives transaction-related compensation; (ii) receives transaction-related compensation for providing brokerage services to trusts, a managing agency, or other accounts to which the bank provides advice; or (iii) deals in or underwrites securities. The major exception provided in the rule is for a bank that enters into an arrangement with a registered broker-dealer pursuant to which the broker-dealer will provide the brokerage services (the networking exception). The rule also provides seven additional exceptions for banks that engage in certain activities that will not require broker-dealer registration.

The reason given by the Commission for the new rule was its concern that, due to dramatic expansion in the scope of securities activities now engaged in by banks and the number of banks involved, these activities were not covered by the rules and regulations designed by the SEC and the self-regulatory organizations to assure investor protection and promote fair and orderly markets. Banks are no longer merely accommodating existing customers but are engaged in activities functionally indistinguishable from those offered by registered broker-dealers. The Commission did not believe that existing and proposed rules offered by the banking industry were sufficiently broad to achieve complete functional regulation.

26. S. 1907, 99th Cong., 1st Sess., 131 Cong. Rec. S17,096-17,102 (daily ed. Dec. 6, 1985). The proposed bill would also (i) prohibit large open-market purchases of a target company's stock after the bidder withdraws its tender offer; (ii) require bidders who acquire five percent of a company's stock to report their holdings to the SEC within 24 hours, rather than 10 days, and wait two business days before resuming stock purchases, thereby closing the 10-day window; (iii) extend the minimum offering period for tender offers from 20 business days to 30 calendar days, and to 40 calendar days for partial and two-tier tender offers; (iv) prohibit golden parachutes during takeover attempts; and (v) prohibit the payment of greenmail unless all shareholders were offered the same premium above market price or the majority of shareholders approved the repurchases.

27. SEC Exchange Act Release No. 22,205, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,800 (July 1, 1985).

According to the Commission, the new rule will not affect existing arrangements between banks and broker-dealers whereby the bank advertises the broker's services, the broker-dealer performs all the brokerage functions, and the bank and the broker-dealer share the customer's commissions. When the bank has internalized certain brokerage functions, however, in connection with securities transactions, the Commission feels that regulatory concerns are raised.

The first activity to trigger the registration provisions, absent the networking exception, is the public solicitation of brokerage business with transaction-related compensation. This provision contemplates a bank that publicly promotes the availability of internalized brokerage services and receives "monetary profit in excess of cost recovery for brokerage execution services."²⁸

The rule does not define the term "public solicitation." The Commission stated in the release adopting rule 3b-9 that a bank that does not fit within the networking exception and that sends out literature to its customers promoting the availability of its brokerage services or engages in certain other broadly disseminated advertising of these services will be deemed to be a publicly soliciting brokerage business.

The networking exception to rule 3b-9 provides that registration as a broker-dealer is not required of a bank that enters into a contractual or other arrangement with a registered broker-dealer pursuant to which the broker-dealer will offer brokerage services either at the bank or at a separate location, and (i) the broker-dealer is clearly identified as the person performing the services, (ii) bank employees perform only clerical and ministerial services in connection with the brokerage activities,²⁹ (iii) bank employees do not receive compensation for the brokerage activities, and (iv) such services by the broker-dealer are fully disclosed.

The second activity to trigger the registration requirement is receipt of transaction-related compensation for providing brokerage services to trust, managing agency, or other accounts to which the bank provides investment advice.³⁰ Investment advice includes advice to individuals as well as investment seminars and certain research disseminated generally to covered accounts. In adopting this provision, the Commission felt that generating profits from transactions that require investment discretion or providing investment advice to the covered accounts presents the possibility, as with broker-dealers, of sales practices inconsistent with the protection of investors' interests. Its rules, and those of the self-regulatory organizations, will supplement banking regulation of these transactions.

In an effort not to impinge unnecessarily on traditional trust activity of banks, the Commission has excepted certain transactions from the coverage of the

28. Rule 3b-9, 50 Fed. Reg. 28,385 (1985) (to be codified at 17 C.F.R. § 240.3b-9(d)).

29. It is the Commission's position that a registered broker-dealer's handling of customer funds or securities in connection with securities transactions would not be clerical or ministerial functions.

30. Bank employees may receive such compensation if they are qualified as registered representatives. Additionally, a portion of the commissions generated by the bank's customers could be paid to the bank.

foregoing portion of the rule. Specifically, the rule does not apply if (i) each customer independently chooses the broker-dealer, (ii) the bank's personnel do not receive transaction-related compensation based on the number of accounts that decide to use the registered broker-dealer, and (iii) the executing broker-dealer carries the account on a fully disclosed basis.

The third activity in the rule to trigger the registration requirement is dealing in or underwriting securities. The Commission interprets the term "underwrite" to be consistent with the definition of "underwriter" in section 2(11) of the Securities Act. Therefore, a bank engaging in such activity would be required to conduct both "best efforts" and "firm commitment" underwriting through a subsidiary or affiliate registered as a broker-dealer.

Rule 3b-9, in addition to permitting a bank to avoid registration by acting through a registered subsidiary or affiliate, also sets out a number of exemptions. The rule does not apply to banks that (i) effect transactions in exempt securities (as defined in the Exchange Act), municipal securities, or in commercial paper, banker's acceptances, or commercial bills; (ii) effect no more than 1000 securities transactions each year; (iii) effect transactions for the investment portfolios of affiliated companies; (iv) effect transactions as part of a program for investment or reinvestment of bank deposits and account funds in investment companies registered pursuant to the Investment Company Act of 1940; (v) effect transactions as part of any bonus, profit-sharing, or similar plan for employees or shareholders; (vi) effect transactions pursuant to sections 3(b), 4(2), and 4(6) of the Securities Act; and (vii) are subject to section 15(e) of the Exchange Act. In addition, subsection (c) provides that the Commission may exempt a bank if it determines that the bank's activities, while technically within the meaning and letter of the rule, are not within the intended purpose of the rule.

RULE 3a4-1: SAFE HARBOR FROM BROKER-DEALER REGISTRATION FOR ASSOCIATED PERSONS OF THE ISSUER

On June 27, 1985, the SEC adopted rule 3a4-1, which provides a nonexclusive safe harbor from broker-dealer registration for certain associated persons of an issuer.³¹ Associated persons of an issuer are defined in the rule as any natural person who is a partner, officer, director, or employee of the issuer, of a corporate general partner of a limited partnership that is the issuer, or of a company or partnership that controls, is controlled by, or is under common control with the issuer, or employees of a registered investment adviser to an issuer that is an investment company registered under the Investment Company Act of 1940.³² Under the rule, provided certain conditions are met, these associated persons will not be considered to be acting as brokers or dealers when

31. SEC Exchange Act Release No. 22,172, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,792 (June 27, 1985).

32. Rule 3a4-1(c), 50 Fed. Reg. 27,946 (1985) (to be codified at 17 C.F.R. § 240.3a4-1).

they participate in the sale of the issuer's securities and, therefore, will not be required to register as broker-dealers under section 15 of the Exchange Act. The Commission adopted this rule to provide guidance for an issuer that chooses to sell its securities through associated persons.

The rule provides in paragraph (a) that the associated person must meet three preliminary conditions and any one of three alternative conditions to take advantage of the safe harbor. The three preliminary conditions are (i) at the time of participation in the sale, the associated person must not be subject to a statutory disqualification as that term is defined in section 3(a)(39) of the Exchange Act; (ii) the associated person must not receive commissions or transaction-related compensation in connection with the sale of the issuer's securities; and (iii) the associated person of the issuer must not be an associated person of a broker or dealer.

To claim the availability of rule 3a4-1, the associated person must also meet one of three alternative conditions set forth in paragraphs (a)(4)(i)–(iii) of the rule. The first alternative is available if the associated person restricts his participation in the offer or sale of securities to any of the following: offers and sales to various financial institutions and intermediaries, such as registered broker-dealers; transactions exempt from registration under section 3(a)(7), section 3(a)(9), or section 3(a)(10) of the Securities Act; transactions in connection with reorganizations, reclassifications, and acquisitions made according to a plan submitted for the approval of securityholders who will receive securities of the issuer; or sales pursuant to a pension, profit-sharing, or similar employee benefit plan or dividend-reinvestment plan.³³

The second alternative imposes the following three conditions on associated persons seeking the rule's exemption: the associated person must perform substantial duties for the issuer other than in connection with securities transactions; the associated person cannot be a broker or dealer, or an associated person of a broker or dealer, within the preceding twelve months; and the associated person must not have participated in selling a securities offering for any issuer within the preceding twelve months other than in reliance on the alternatives specified in paragraph (a)(4)(i) or paragraph (a)(4)(iii) of the rule. For securities registered under rule 415 of the 1933 Act, this twelve-month restriction begins at the end of the rule 415 offering.³⁴

The third alternative is available to associated persons who conduct only passive sales efforts. Under this alternative, associated persons are permitted to prepare and deliver any written communications through the mail or by other means that do not involve the associated person's oral solicitation of a potential purchaser. The content of the communication, however, must be approved by a partner, officer, or director of the issuer. Additionally, the associated persons may respond to inquiries from potential purchasers in conversations initiated by the purchaser in response to a registration statement filed under the Securities

33. SEC Exchange Act Release No. 22,172, [1984–1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,792 (June 27, 1985).

34. *Id.*

Act or other offering document. Finally, associated persons may perform ministerial or clerical work involved in effecting transactions.³⁵

Compliance with the provisions described above is not the only means by which an associated person may sell the issuer's securities without registering as a broker-dealer, however. Paragraph (b) of the rule provides that no presumption shall arise that an associated person of the issuer has violated section 15(a) of the Act solely because his participation in the sale did not meet the conditions of paragraph (a).³⁶ The Commission stated that the Staff will continue to provide interpretive guidance to those activities not clearly specified in the rule.³⁷

RULE 10b-6: PROPOSED AMENDMENTS OF DISTRIBUTION REGULATIONS

In October 1985, the SEC issued a release requesting comments on proposed amendments to rule 10b-6 under the Exchange Act,³⁸ the principal antimanipulation rule regulating the securities transactions of participants in securities distributions. The proposed amendments cover certain issues, left open by the 1983 amendments, that the SEC believed needed more study and comment, including solicited brokerage transactions, bids and purchases by affiliates of participants in a distribution, the exercise of exchange-traded call options, clarification of the availability of rule 10b-6 exceptions, and a reformulation of cooling-off periods within exceptions (a)(3)(xi) and (xii) of the rule.

Subject to certain exceptions, rule 10b-6 prohibits participants engaged in a distribution of securities, either alone or with others, from bidding for or purchasing such securities, any security of the same class and series as those securities, or any right to purchase any such security, until they have completed their participation in the selling process. The rule also forbids such persons from inducing others to purchase any security until termination of the distribution. The rule currently contains thirteen exceptions to its general prohibitions. These exceptions trace from the time the rule was first adopted in 1955.³⁹ The last amendments to rule 10b-6 in 1983 (the 1983 amendments),⁴⁰ among other things, defined the term "distribution," permitted certain distribution participants to continue trading securities until the commencement of the applicable cooling-off period, and also codified many SEC staff interpretive positions issued over the years.

35. Rule 3a4-1(a)(4)(iii), 50 Fed. Reg. 27,946 (1985) (to be codified at 17 C.F.R. § 240.3a4-1).

36. *Id.*

37. SEC Exchange Act Release No. 22,172, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,792 (June 27, 1985).

38. SEC Securities Act Release No. 6607, SEC Exchange Act Release No. 22,510, [Current] Fed. Sec. L. Rep. (CCH) ¶ 83,924 (Oct. 10, 1985).

39. SEC Exchange Act Release No. 5194, [1954-1957 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,350 (July 5, 1955).

40. SEC Exchange Act Release No. 19,565, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,326, (Mar. 4, 1983).

Solicited Brokerage Transactions

The 1983 amendments permitted solicited principal transactions in certain circumstances, while solicited brokerage transactions remained prohibited from the time a broker became a participant in the distribution through the end of the distribution period.⁴¹

In the release proposing the latest amendments to rule 10b-6, the Commission cited two reasons for treating principal and brokerage transactions differently. First, the Commission felt that because principal transactions require the broker-dealer to put its own capital at risk, this may limit the extent to which the broker-dealer engages in these transactions. The second reason is that principal transactions include active market making and block positioning by the broker-dealer, which provide a liquid market for the security, a benefit to the investing public and the marketplace. Commentators, however, have stated that the market impacts of the two kinds of transactions are indistinguishable.

After studying the matter and reviewing the comment letters received, the Commission stated in its adopting release that the premise underlying the adoption of the two- and nine-business day cooling-off periods for principal transactions may also be compatible with solicited brokerage transactions, "since the market impact of solicited brokerage transactions should dissipate within the cooling-off periods prescribed in Exception (xi)," thereby discouraging manipulative activity.

Transactions by Affiliates

The 1983 amendments to rule 10b-6 also narrowed the coverage of the rule, as it related to issuers and selling shareholders, by adding an "affiliated purchaser" concept and defining that term in the rule. Those amendments did not, however, narrow the affiliate concept as it related to underwriters, prospective underwriters, brokers, dealers, or other persons participating or who have agreed to participate in a distribution (collectively referred to as participants). As a result, all affiliates of participants remain subject to the provisions of rule 10b-6 and are prohibited during the cooling-off period from bidding on or purchasing securities about to be distributed regardless of the business they are engaged in or the absence of any control relationship with the participant.

The Commission's proposed amendments reflect an effort to define more precisely the scope of affiliates that the SEC believes have the means and incentive to facilitate a distribution of securities. At the same time, they recognize that current corporate structures have resulted in brokerage firms with affiliates that, because of the business they are in, have no ability or incentive to condition the market to facilitate a distribution. The rule as proposed to be amended would therefore apply to any person who (i) directly or indirectly acts in concert with a distribution participant; (ii) is an affiliate that,

41. As noted by the Commission in SEC Exchange Act Release No. 19,565, *id.*, when either side of a brokerage transaction is unsolicited, a broker may solicit the other side and still rely on exception (v) to rule 10b-6.

directly or indirectly, controls the purchases by a distribution participant, whose purchases are controlled by a distribution participant, or whose purchases are under common control with those of a distribution participant; (iii) is an affiliated broker, dealer, investment company, or investment adviser; or (iv) is an affiliate that otherwise regularly purchases securities, through a broker-dealer or otherwise, for its own account or for the account of others, or recommends or exercises investment discretion with respect to the purchase or sale of securities.

As a result of this proposed change, affiliates of a participant that are not acting in concert with it and are engaged in a business that does not regularly involve participation in securities transactions would not be subject to the rule.

Exercise of Exchange-Traded Call Options

Rule 10b-6 currently provides for a five-day cooling-off period applicable to the exercise of call options by distribution participants. This provision, adopted with the 1983 amendments to rule 10b-6, reflected the Commission's concern that these exercises presented a potential for market impact and manipulation. Because a certain percentage of these call options are uncovered, the Commission continues to feel that the exercise of call options by a distribution participant could cause others to purchase in the market securities of the same class and series as those being distributed. These exercises, the Commission reasons, would "induce" the option writer to purchase the securities being distributed, the inducement being a violation of the rule.

Weighing the potential for manipulation against the disadvantage imposed on participants by the current provisions of the rule, the Commission has proposed two alternatives and requested comments on its expressed concerns. The first alternative would eliminate the five-business day cooling-off period and replace it with a prohibition period that begins upon the commencement of offers of sales in the distribution. The second alternative would permit distribution participants to exercise call options throughout the distribution period when the option position was established prior to the time the person became a participant in the distribution. When the position is established after the person became a participant, the five-day period would be retained.

Clarifying the Exceptions to Rule 10b-6

As part of the proposed changes to rule 10b-6, the Commission plans to add language to the introductory portion of the subsection that delineates the rule's exceptions and establishes that the exceptions are not available if the transactions involved are done to create actual, or apparently actual, trading in the security or to raise the price of the security. This proposed change would reaffirm that the exceptions are not a safe harbor and would specifically except manipulative conduct from all of them.⁴²

42. Currently, only exceptions (xi) and (xii) of rule 10b-6(a)(3) contain the proposed language.

RULE 10b-5: DISCLOSURE OF PRELIMINARY MERGER NEGOTIATIONS

On July 8, 1985, the SEC published a report of an investigation, conducted pursuant to its authority under section 21(a), concerning the disclosure of preliminary merger negotiations.⁴³ In the Commission's opinion, the issuer violated antifraud provisions when an employee made a statement that there was no corporate development to account for "unusual market activity" in its securities while the company was engaged in negotiations that ultimately resulted in its acquisition. Given the surrounding circumstances, this statement was materially false and misleading even though the employee, the treasurer, was unaware of the negotiations.

Under section 10(b) of the Exchange Act and rule 10b-5,⁴⁴ an issuer is prohibited from making public statements that are false or that fail to include material facts necessary under the circumstances to make the statement not misleading. This prohibition applies to all public statements by persons speaking on behalf of the issuer,⁴⁵ regardless of whether the issuer was required to make the statement or made the statement voluntarily.

In its report, the Commission emphasized that whenever the issuer makes a public statement or responds to an inquiry from a stock exchange concerning rumors, unusual market activity, possible corporate developments, or any other matter, that statement must be materially accurate and complete.⁴⁶ Information concerning an acquisition is material and must be disclosed if the information assumes "actual significance in the deliberation of" and significantly alters "the total mix of information available to the reasonable shareholder."⁴⁷ Therefore, if an issuer makes a statement regarding nonpublic acquisition discussions taking place, it must disclose "sufficient information concerning the discussions to prevent the statements made from being materially misleading."⁴⁸ A voluntary statement, even one in reply to an exchange's inquiry or request, denying information of any corporate development made while the company is engaged in acquisition discussions, could be materially misleading. If the statement does not meet the standards for accuracy and completeness embodied in the antifraud provisions, the company and any person responsible for the statement may be liable under the federal securities law.⁴⁹

43. *In re Carnation Co.*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (July 8, 1985).

44. SEC Exchange Act, 15 U.S.C. § 78(j); rule 10b-5, 17 C.F.R. § 240.10b-5 (1985).

45. SEC Exchange Act Release No. 20,560, 3 Fed. Sec. L. Rep. (CCH) ¶ 23,120B (Jan. 13, 1984).

46. SEC Exchange Act Release No. 22,214, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (July 8, 1985).

47. *Id.* (quoting *ISC Indus., Inc. v. Northway*, 426 U.S. 438 (1976)).

48. *Id.*

49. SEC Exchange Act Release No. 20,560, 3 Fed. Sec. L. Rep. (CCH) ¶ 23,120B (Jan. 13, 1984).

In addition, the SEC, in footnote 8 of its report, expressed its belief that the Third Circuit wrongly decided the case of *Greenfield v. Heublein, Inc.*⁵⁰ In *Greenfield*, the court concluded that a duty to disclose preliminary merger discussions does not exist until a firm agreement on the price and structure of the merger has been reached. Absent an indication that privileged information has been leaked, the issuer's statement that it was "aware of no reason that would explain the activity in its stock," made while the issuer was engaged in merger discussions, was not false or misleading.⁵¹ The SEC disagrees. In its release, the SEC states that anytime the issuer speaks, the statements must be accurate and complete. If the issuer is engaged in merger negotiations and voluntarily makes a statement, it has an obligation to disclose sufficient information to make its statements not misleading.⁵²

The SEC concedes, however, that an issuer that wants to prevent premature disclosure of nonpublic preliminary negotiations can, in appropriate circumstances, respond "no comment" to press inquiries concerning rumors or unusual marketing activity.⁵³ A no-comment response might be appropriate in situations in which an agreement has not been reached and the parties believe that negotiations would be jeopardized by premature disclosure. A no-comment response would not be appropriate when subsequent events make a previous statement misleading or when market rumors are attributable to issuer leaks.⁵⁴ The SEC did not seek to enjoin future violations of the federal securities laws by Nestle (successor to Carnation, the acquired company).

Some commentators have suggested that this SEC ruling will cause companies to adopt strong policies favoring no-comment responses and advising their employees not to make any comments concerning rumors.⁵⁵ Others have suggested that early disclosure of merger negotiations will encourage investors to speculate imprudently on the outcome of negotiations, a job best left to professional arbitrageurs. In addition, early disclosure of preliminary discussions might inhibit such ventures.

SECURITIES MARKET REGULATORY DEVELOPMENTS

Although the Securities Acts Amendments of 1975⁵⁶ were adopted a decade ago, ripple effects from that landmark piece of legislation continued to dominate, either directly or indirectly, the major market regulatory developments of 1985. The regulatory actions taken in 1985 were not associated with initiating

50. 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 105 S. Ct. 1189 (1985).

51. *Id.* at 759.

52. SEC Exchange Act Release No. 22,214, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (July 8, 1985).

53. 17 Sec. Reg. & L. Rep. (BNA) 1229 (1985).

54. SEC Exchange Act Release No. 22,214, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (July 8, 1985).

55. 17 Sec. Reg. & L. Rep. (BNA) 1229 (1985).

56. Known as the Securities Reform Act of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975).

or implementing major structural components of the national market system. Rather, the developments that occurred were, for the most part, reactions to previously established programs—both refinements to and attempts to equalize the impacts of earlier developments.

ONE SHARE, ONE VOTE

A market regulatory development with pervasive ramifications for the securities industry was the New York Stock Exchange's (NYSE) exploration of modifying its corporate listing requirements to permit listing the securities of companies that have classes of common stock with differential voting rights. Of course, state corporation laws generally govern the voting rights of shareholders and permit dual voting rights.⁵⁷

Since 1926, the NYSE's rules have specified that all common stock of listed companies must have equal voting rights.⁵⁸ The NYSE's self-evaluation of listing requirements was motivated at least in part by two significant developments. First, currently listed NYSE companies demonstrated a desire and willingness to issue shares on other than a one share-one vote basis.⁵⁹ This change in corporate capitalization practices was prompted both by some issuers' desire to create classes of securities that would help them fend off hostile tender offers and by others to create classes of securities specifically responsive to business necessities, particularly in structuring corporate combinations. Second, competition from other market centers that do not bar the listing of companies having common stock with disproportionate voting rights encouraged the NYSE's study.⁶⁰

The American Stock Exchange permits the listing of companies with dual voting rights. In addition, with the development of real-time reporting of transactions and quotations in NASDAQ's National Market System securities⁶¹ and the expanded growth in transaction volume of over-the-counter securities, the over-the-counter market's attractiveness as a primary trading market has been significantly augmented. Thus, interwoven with the issue of altering the NYSE's listing standards are intermarket competition and tender-offer defense

57. For example, Delaware provides for one vote for each share "unless otherwise provided in the certificate of incorporation." Del. Code Ann. tit. 8, § 212(a) (1984).

58. New York Stock Exchange rule ¶ 102.00 regarding listing requirements states that "[t]he Exchange is also concerned with such matters as voting rights of shareholders." 2 N.Y.S.E. Guide (CCH) ¶ 2501. A specific basis for terminating a listing on the Exchange is creating a class of nonvoting common stock. New York Stock Exchange rule § 802.00. 2 N.Y.S.E. Guide (CCH) ¶ 2565.

59. By September 1985, a total of 20 companies listed on the NYSE had either issued a class of common stock with limited voting rights or had announced the intention to issue such stock. *Disparate Voting Requires Study, NASD Decides*, Legal Times, Sept. 23, 1985, at 7.

60. See *NYSE Panel to Urge Rules Change*, Wash. Post, Dec. 29, 1984, at B-1, col. 2 (comments of A.A. Sommer, Jr., cochairman of the NYSE Subcommittee on Shareholder Participation and Qualitative Listing Standards).

61. For a discussion of transaction reporting of National Market System securities, see *infra* note 78.

strategies, as well as federal preemption, state corporate law, and corporate democracy.

In 1984, the NYSE's Subcommittee on Shareholder Participation and Qualitative Listing Standards mailed a questionnaire to more than 3200 listed companies, member firms, institutional investors, attorneys, academicians, and state securities administrators. The questionnaire sought input on a number of questions relating to the possibility of the NYSE modifying its one share-one vote listing requirement. The Subcommittee received 425 responses, characterized as "extremely helpful to the Subcommittee in developing its recommendations."⁶² In January 1985, the Subcommittee presented to the NYSE Public Policy Committee of the Board of Directors an initial report recommending certain modifications of the NYSE's listing standards. If adopted by the NYSE and approved by the Commission, the modifications will not require delisting of a NYSE-listed company, even if the company adopts charter provisions creating two classes of common stock with disparate voting rights, provided that: (i) the creation of the stock with disparate voting rights is approved by two-thirds of all shares entitled to vote on the proposition; (ii) the issuer's board has a majority of independent directors at the time the matter is voted upon and a majority of those independent directors approve the proposal, or if the issuer's board has less than a majority of independent directors, then all independent directors approve the proposal; (iii) the voting differential is no more than ten to one; and (iv) the rights of the two classes of stock are substantially the same except for the voting power per share.⁶³

The Subcommittee's recommendations have sparked considerable debate. Some see the proposed change in the Big Board's listing standards as a threat to corporate democracy. Further, the contemplated amendment is perceived as a competitively defensive maneuver that will encourage a race to the bottom in the listing standards of the securities markets.⁶⁴ Proponents argue that the NYSE will not be altering shareholders' voting rights. Rather, those rights can only be amended by a shareholder vote. Proponents argue that to deny NYSE listing for companies with dual voting stock would be to deny shareholders who chose to limit their own voting privileges the opportunity to have their shares traded in the market provided by the Big Board.⁶⁵

62. Letter from Fletcher L. Byron, Chairman of the NYSE Public Policy Committee, to David A. Lipton (Jan. 25, 1985).

63. NYSE Subcommittee on Shareholder Participation and Qualitative Listing Standards, Initial Report, Dual Class Classification (1985).

64. See *Two-Class Common Could Be Harmful*, N.Y. Times, Apr. 7, 1985, § 3, at 2 (comments of Bevis Longstreth, former SEC Commissioner); *Don't Bend the Big Board's Rules*, Fortune, Mar. 18, 1985, at 185 (comments of John Whitehead, former chairman of Goldman Sachs & Co.); *Disparate Voting Requires Study*, NASD Decides, Legal Times, Sept. 23, 1985, at 7 (comments of Michael R. Klein of Wilmer, Cutler & Pickering).

65. See *Drop the 'One Share, One Vote' Rule*, N.Y. Times, Apr. 7, 1985, § 3, at 2 (comments of A.A. Sommer, Jr., former SEC Commissioner and chairman of the NYSE Subcommittee on Shareholder Participation and Qualitative Listing Standards).

Although the Public Policy Committee of the NYSE had sought further comment on its Subcommittee's proposals, by the end of November 1985, it had not yet made a recommendation to the NYSE's board concerning the proposals. Such a recommendation would be a prerequisite for board action and for a proposal of an actual rule change. A rule change proposal would, in turn, need the approval of the Commission before adoption.⁶⁶ In the interim, the Board of Governors of the National Association of Securities Dealers has decided to conduct further studies before deciding its own one share-one vote listing requirement for companies trading in its NASDAQ National Market System.⁶⁷ Legislation introduced in June 1985 would have required most large companies to have a single class of common stock with equal voting rights for all shareholders.⁶⁸ This legislation is stalled in Congress.

SIDE-BY-SIDE TRADING OF OTC OPTIONS

The most significant Commission market regulatory actions taken in 1985 were a series of related decisions that culminated in the Commission's approval of side-by-side exchange trading of options in over-the-counter (OTC) securities along with their underlying securities.⁶⁹ This development involved at least four distinct issues: Should exchanges be granted unlisted trading privileges in OTC securities? Should trading in options in OTC securities be permitted? Should multiple trading of OTC options be permitted? And if trading in OTC options were permitted, should side-by-side trading of such options be permitted both on and off the exchanges (thus requiring a grant to exchanges of unlisted trading privileges (UTP) in OTC securities)? In many respects, the issues confronting the Commission were reactions to its earlier national market system and option-trading policies, effected within the past decade. Also, in some respects, the subsidiary issues (most notably, the question of granting UTP in OTC securities) are more significant than the final question of side-by-side trading of options in OTC securities.

66. Section 19(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78s(b); rule 19b-4, 17 C.F.R. § 240.19b-4 (1985).

67. *Disparate Voting Requires Study, NASD Decides*, Legal Times, Sept. 23, 1985, at 7.

68. *A Bill to Amend the Securities and Exchange Act to Prohibit the Trading on Certain Exchanges and Markets of Non-voting Shares and Shares Carrying Disproportionate Voting Rights*, S. 1314, 99th Cong., 1st Sess., 131 Cong. Rec. (daily ed. June 18, 1985) (introduced by Senator D'Amato June 18, 1985).

69. The Commission provisionally made the decision to permit side-by-side exchange trading of options in over-the-counter securities in SEC Exchange Act Release No. 22,026, 50 Fed. Reg. 20,310 (1985). Before the decision could be finalized, the Commission had to be willing to grant unlisted trading privileges to exchanges in OTC securities. The Commission announced it would grant such privileges in SEC Exchange Act Release No. 22,412, 17 Sec. Reg. & L. Rep. (BNA) 1691 (1985) [hereinafter cited as UTP Adoption Release]. The Commission then finalized its decision to permit side-by-side exchange trading of options in OTC securities. SEC Exchange Act Release No. 22,439, [Current] Fed. Sec. L. Rep. (CCH) ¶ 83,917 (Sept. 20, 1985) [hereinafter cited as Side-By-Side Trading Approval Release].

Unlisted Trading Privileges in OTC Securities

A primary goal of the 1975 Securities Act Amendments was to preserve and encourage competition among securities markets.⁷⁰ In the 1975 amendments, Congress directed the Commission to facilitate the development of a national market system for securities, consistent with certain objectives, including "fair competition . . . between exchange markets and markets other than exchange markets."⁷¹ The legislative history of the 1975 amendments noted the Commission's historical use of the grant of UTP as a means of promoting competitive markets for listed securities. It advised that the 1975 amendments in no way altered the standards or procedures to be followed by the SEC in granting such privileges.⁷² The 1975 amendments authorized the Commission to grant UTP in both listed and OTC securities so long as specified conditions were met. The terms for granting UTP in listed securities were relatively simple, requiring a finding that the extension of such privileges would be "consistent with the maintenance of fair and orderly markets and the protection of investors."⁷³ The conditions for extending UTP in OTC securities were more complex and restrictive, requiring, among other matters, an evaluation of "the impact of such extension on the existing markets for such securities" as well as of "the progress that had been made toward the development of a national market system."⁷⁴

After preliminary hesitation, in 1979 the Commission resumed its traditional liberal posture toward the grant of UTP in listed securities, merely requiring that before the grant can be made (i) the exchange requesting the trading privilege must have the capacity to execute trades in a fair and orderly manner as required by section 6(b) of the 1934 Act, and (ii) transactions in the subject security must be reported in the consolidated transaction reporting system (providing last sale information on a real-time basis).⁷⁵ As for the grant of UTP in unlisted securities, the Commission maintained a restrictive policy pending progress in the national market system.⁷⁶ Consequently, the benefits afforded investors through multiple market trading in securities were not as readily available for OTC securities as for listed securities. The only instances in which the Commission made exceptions to its policy regarding UTP in OTC securities involved OTC securities reported in the consolidated transaction reporting system.⁷⁷

70. See S. Rep. No. 75, 94th Cong., 1st Sess. 8 (1975) [hereinafter cited as Senate Report]. This Senate report accompanied the bill that became the 1975 Securities Reform Act.

71. Section 11A(a)(1)(C)(ii) of the 1934 Act, 15 U.S.C. § 78K-1(a)(1)(c)(ii).

72. Senate Report, *supra* note 70, at 18, 106.

73. Section 12(f)(2) of the 1934 Act, 15 U.S.C. § 78l(f)(2).

74. *Id.*

75. SEC Exchange Act Release No. 16,422, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,385 (Dec. 12, 1979).

76. The Commission described its restrictive policy in SEC Exchange Act Release No. 21,498, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,712 (Nov. 16, 1984), in which the Commission solicited public comments on the appropriateness of altering its policy on granting unlisting trading privileges in OTC securities [hereinafter cited as UTP Comment Release].

77. *Id.*

As substantial numbers of OTC securities became designated National Market System (NMS) securities, and thus subject to the reporting requirements of the consolidated transaction reporting system,⁷⁸ the Commission realized that reviewing its UTP policy toward OTC securities was necessary.⁷⁹ The increased availability of market information for OTC securities designated as NMS securities, in conjunction with already existing enhancements to the NASD's NASDAQ quotation system (such as the dissemination of best bid and offer information to brokers and the investing public), made trading in NMS securities "more compatible with exchange trading."⁸⁰ In addition, the Commission believed order processing and execution in OTC securities were more efficient as a result of the NASD's computer assisted execution system (CAES) and small order execution system (SOES).⁸¹

Finally, the absence of any "significant adverse effects" on the trading markets as a result of the link between the exchange markets' intermarket trading system (ITS) and the NASD's own automatic execution system, CAES, indicated to the Commission that there were opportunities for competition in concurrent exchange and OTC trading of certain securities.⁸²

The proposal to grant UTP to OTC securities was supported by the majority of the regional stock exchanges, among others, and was opposed by the NYSE and the NASD, among others. The proposal's supporters saw it as a means of advancing a goal of the national market system, "fostering exchange and OTC market competition."⁸³ The NYSE, which does not offer trading in unlisted securities, argued for disapproval of any application for a grant of UTP in OTC securities in order to maintain the separate and distinctive features of exchange and OTC markets.⁸⁴ The NASD opposed the proposal because it believed that the exchange trading structure would favor an order flow to the exchange floor, regardless of a superior quotation in the OTC market. Thus, in the eyes of the

78. Rule 11Aa2-1, 17 C.F.R. § 240.11Aa2-1 (1985) [hereinafter cited as National Market System Securities Designation Rule], automatically designated specified categories of actively traded OTC securities as National Market System securities and thus subject to transaction reporting on a current basis, pursuant to rule 11Aa3-1, 17 C.F.R. § 240.11Aa3-1 (1985). Rule 11Aa2-1 also permits specified categories of issuers of less actively traded OTC securities (tier 2 securities) to elect to have their securities designated as National Market System securities. In December 1984, the SEC amended rule 11Aa2-1 to permit a substantially increased number of OTC issuers of tier 2 securities to elect to have their securities designated as National Market System securities. SEC Exchange Act Release No. 21,583, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,721 (Dec. 18, 1984). By the time the Commission approved UTP for OTC securities, more than 2000 OTC securities had been designated as National Market System securities. UTP Adoption Release, *supra* note 69.

79. See UTP Comment Release, *supra* note 76.

80. UTP Adoption Release, *supra* note 69, at 1692.

81. *Id.*

82. *Id.*

83. This is an SEC paraphrase of the Midwest Stock Exchange's position. *Id.* at 1694.

84. The NYSE might well have been concerned that to grant exchanges trading privileges in OTC securities would invite a reexamination by the Commission of exchange prohibitions on off-board trading in listed securities by exchange members. The Commission hinted at a further examination of this issue in its UTP Adoption Release, *id.* at 1699.

NASD, OTC market makers would not be able to compete on an even basis for order flow in OTC securities for which UTP had been granted.⁸⁵

In September 1985,⁸⁶ the Commission announced its decision to extend UTP to applicant exchanges in OTC securities, subject to certain conditions. The privileges would be granted to applicant exchanges only in NMS-designated OTC securities, and only up to twenty-five such securities could be chosen per exchange. The grant of UTP to any exchange is contingent upon the Commission's approving an information reporting plan to be agreed upon by the NASD and the applicant exchanges and to be submitted by December 1, 1985. The plan should provide through NASD facilities for the consolidation of OTC and exchange quotations and transaction reports in OTC securities subject to UTP. This consolidation of information was seen as necessary to foster competition, reduce the possibility of fragmenting markets, and facilitate surveillance of the concurrent trading of the OTC securities both on and off the exchanges. A further condition requires that exchange off-board trading restrictions not apply to OTC securities for which UTP is granted. The satisfaction of this condition is already guaranteed by rule 19c-3,⁸⁷ which provides that off-board trading restrictions may not be applied to securities that either become listed upon an exchange or subject to unlisted trading upon an exchange subsequent to April 26, 1979. As a final condition, the Commission required that exchange and NASDAQ market makers provide to one another comparable telephone access to their respective market centers. This last condition was intended to provide the intermarket communication necessary to ensure competition between OTC and exchange market makers. The Commission also encouraged the NASD and the exchanges to initiate intermarket trading links and rules that would ensure transactions be executed at the best available price.

As of the end of 1985, no UTPs in OTC securities have been granted nor has the plan for reporting consolidated quotation and transaction information been submitted to the Commission. Even when such trading does begin, a number of knotty problems will remain, such as developing an efficient link between the exchange and the OTC markets as well as establishing the best price-execution rules. The Commission's decision, however, carries the potential for establishing a truly national market for those OTC securities to which unlisted trading privileges have been granted. This market would provide increased opportunities for competition, not merely within the exchange or among market makers, but between exchanges and market makers. It would increase the instances in which a trading environment having simultaneously the advantages of both auction and dealer markets would be available in the same securities. Thus, the grant of UTP in OTC securities represents a significant advance in the goals of the 1975 Securities Acts Amendments.

85. *Id.* at 1694.

86. *Id.* at 1691.

87. 17 C.F.R. § 240.19c-3 (1985).

Amendments to the NMS Designation Rule

Contemporaneously with its decision to grant UTP in OTC securities, the Commission also adopted amendments⁸⁸ to its National Market System designation rule, rule 11Aa2-1,⁸⁹ allowing OTC securities to retain their designation as NMS securities in certain situations, even if trading in such securities commenced on an exchange. Prior to the amendments, the commencement of exchange trading in NMS securities, whether listed or unlisted, meant the loss of their NMS status. A number of the regional exchanges argued that the exclusionary impact of the National Market System designation rule discouraged NMS securities from listing on regional exchanges. Permitting unlisted exchange trading in certain NMS securities would create the same problem for NASDAQ, since the grant of UTP would terminate a security's NMS status. The amendments to the National Market System designation rule permit an NMS security to retain its designation, even when exchange trading commences in the security, so long as either (i) the security is exchange-listed but not reported on the consolidated transaction reporting system (such reporting could lead to the confusion of double reporting on both the NASDAQ system and the consolidated reporting system), or (ii) the security is traded on an exchange because of a grant of UTP in that security. The amendments are intended to encourage intermarket competition by encouraging multiple trading of the same security on both OTC and exchange markets.

Approval of OTC Options

The Commission's motivations to resolve the question of granting UTP in OTC securities were in part its approval, in spring 1985, of the trading of options in securities traded exclusively over the counter and its approval in concept of integrated market making of OTC options side by side with their underlying securities.⁹⁰ Once the Commission acted, there was concern that to continue to deny unlisted trading in OTC securities would place exchange options market makers at a disadvantage to their OTC counterparts. Without Commission approval of UTP in OTC options, exchange markets would not be able to provide executions for the stock side of trading strategies employing both stock and option transactions. In the OTC market, however, transactions could be effected both in options as well as in the securities underlying the options. In addition, integrated OTC market makers would be at a competitive advantage over exchanges because they would have immediate access to order-flow information in both OTC stock and options and would be able to adjust their prices accordingly. Thus, the Commission's approval of trading in OTC options and

88. SEC Exchange Act Release No. 22,413, [Current] Fed. Sec. L. Rep. (CCH) ¶ 83,914 (Sept. 16, 1983).

89. See National Market System Securities Designation Rule, *supra* note 78.

90. The Commission announced its decision to permit trading in options in OTC securities in SEC Exchange Act Release No. 22,026, 50 Fed. Reg. 20,310 (1985) [hereinafter cited as OTC Options Release].

its approval in concept of side-by-side trading of OTC options with their underlying securities necessitated Commission consideration of granting UTP in OTC securities.

Proposals to trade listed OTC options had been before the Commission prior to the more recent requests upon which the Commission acted. In the mid-1970s, various exchanges made several proposals to trade standardized options on securities traded exclusively over the counter.⁹¹ These proposals were voluntarily withdrawn to accommodate the Commission, which requested a moratorium on the introduction of new option products during the period in which the Commission staff studied the options markets. The report⁹² of that study stated that “[t]he absence of a real-time last sale reporting of transactions in underlying securities traded exclusively in the over-the-counter market may present questions of fairness if options trading with respect to these securities is permitted.”⁹³ The authors of the report were concerned that the absence of real-time reporting for underlying securities would make it difficult to determine the value of an option at a specific time. The report advised that a “prudent course” would be to defer initiating trading in options in OTC securities until the underlying securities were included in the consolidated transaction reporting system.⁹⁴

Starting in 1982, real-time last sale transaction reports became available for those OTC securities designated as NMS securities pursuant to rule 11Aa3-1.⁹⁵ Between June 1980 and November 1984, six exchanges and the NASD submitted rule-change proposals to the Commission to initiate trading in listed options in OTC securities. In May 1985, the Commission announced that it found trading in options on securities traded exclusively over the counter consistent with the 1934 Act.⁹⁶ Implementation of such trading was to be delayed for up to sixty days, during which time the exchanges and the NASD were to work out adequate surveillance plans for the options trading.

Multiple Trading of OTC Options

At the same time that the Commission approved the trading of options on OTC securities, it also approved multiple trading of such options and approved in principle side-by-side trading of OTC options with their underlying securities.⁹⁷ Multiple trading of options means the trading of the same option in more than one marketplace. The historical concern with multiple trading of a security was that it would lead to market fragmentation: the same security would be traded at different prices at the same time depending upon in which market the

91. For a listing of these proposals, see OTC Options Release, *id.*

92. Securities and Exchange Commission, 96th Cong., 1st Sess., Report of the Special Study of the Options Market (Comm. Print 1978) [hereinafter cited as Options Study Report].

93. *Id.* at 933.

94. *Id.* at 975.

95. See *supra* note 78.

96. OTC Options Release, *supra* note 90.

97. *Id.*

trade occurred. Concern over market fragmentation had deterred the Commission from permitting multiple trading of options on listed securities. As for multiple trading of OTC options, however, the Commission adopted a position that relied more upon market forces, arguing that the benefits derived from multiple trading, notably reduced spreads and increased services, would outweigh the problems resulting from fragmentation.⁹⁸ Further, the Commission reasoned that, unlike the situation in regard to options on unlisted stock, permitting multiple trading in options on OTC securities would not disrupt already existing market structures because no market was yet trading OTC options. Finally, the Commission responded to the argument that the benefits of multiple trading would be short-lived because historically a dominant market has always emerged in multiple trading. The Commission noted that the continued existence of an alternate market “would help encourage the dominant market to continue to provide improved services and facilities and to respond to the needs of market participants or risk losing its market share.”⁹⁹

Integrated Trading of OTC Options

Integration, or side-by-side trading of OTC options with their underlying securities, allows the same market maker, whether over the counter or on an exchange, to trade a specific OTC option and the underlying security at the same time. As in its approach to multiple trading, the Commission had refrained from permitting integrated trading of listed options in exchange-traded securities. Concerns about integrated trading, identified in the Options Study Report,¹⁰⁰ included informational advantages that would inure to the integrated market makers, as well as increased opportunities for manipulation. An integrated market maker would be in a position to trade options on the basis of nonpublicly available information concerning trading activity in the underlying security.¹⁰¹ Similarly, an integrated market maker would have opportunities to manipulate by effecting small price movements in underlying securities. This in turn could cause substantial profits in options positions.¹⁰² Against these concerns the Commission balanced the potential advantages of integrated market making as well as the enticement of more capital into market making, which would produce greater liquidity and depth in the respective stock and options market.

The Commission determined that, for OTC options, the advantages of integrated market making outweighed the drawbacks. Regarding the informational advantages to market makers of side-by-side trading, the Commission reasoned that last sale reporting of OTC securities is “presently adequate

98. *Id.*

99. *Id.*

100. See Options Study Report, *supra* note 92, at 876–77.

101. *Id.* at 880–85.

102. *Id.* at 885–92.

generally to support an options market on NMS stocks as well as to allow integrated market making.¹⁰³

Furthermore, for the most active NMS securities with numerous competitive market makers, each with substantial trading volume, the Commission argued that no single market maker could have a significant informational advantage. Similarly, in regard to potential manipulation, the Commission asserted that, given the deep and liquid markets of the most active NMS securities, it was very improbable that a single market maker could effect a manipulative scheme since manipulation typically requires some degree of market control. In addition, in the highly competitive markets of the most active NMS securities, for which quotation spreads are generally quite narrow, manipulative trading would result in abnormal transaction reports and be detectable, so long as equity and options audit trails were put in place prior to any integrated market making.

Based upon this reasoning, in the spring of 1985 the Commission approved the concept of side-by-side trading in the six most active NMS securities¹⁰⁴ but indicated its belief that such trading opportunities would have to be made available to exchanges as well as to the OTC market. Such integrated OTC options trading on the exchanges was to await a Commission decision to grant UTP in OTC securities. In addition, the Commission indicated that it would not permit integrated trading to begin until adequate equity and options audit trails in the six most active NMS securities were operational. The Commission sought comment on its proposal to initiate a trial program in integrated trading. Specifically, it sought comment on the inclusion of the exchanges in this program (which inclusion the Commission viewed as a corequisite for integrated trading over the counter) as well as the grant of UTP in OTC securities to the exchanges. Final approval of the pilot program in side-by-side trading came in September 1985,¹⁰⁵ immediately following the Commission approval of UTP in OTC securities. The Commission opined that side-by-side trading could commence in January 1986, provided that appropriate audit trail and surveillance enhancements were in place by that time. By the late fall of 1985, it appears that the January 1986 projected start-up time of the trial program would prove to be optimistic.¹⁰⁶

Significance of Regulatory Actions

It is significant to note that for each of these major national market system issues—the grant of UTP in OTC securities, expansion of the number of NMS securities, trading options in OTC securities, multiple trading of OTC options, and integrated trading of OTC options—the Commission was willing to assume

103. OTC Options Release, *supra* note 90.

104. *Id.*

105. Side-By-Side Trading Approval Release, *supra* note 69.

106. As early as mid-October 1985, the NASD had indicated that the audit trail and surveillance enhancements necessary for the commencement of side-by-side trading would not be in place prior to March or April 1986. *NASD Eyes March or April for Side-By-Side Pilot; Amex, PHLX to Join*, Sec. Week, Oct. 14, 1985, at 5-6.

in 1985 a far more permissive posture than it had been as recently as five years earlier. It has yet to assume such a posture in regard to listed options in exchange-listed securities. For some issues, this change in the Commission outlook can be explained by the subject matter itself—OTC options as opposed to options in exchange-listed securities. The altered outlook can also be attributed to the introduction of last sale reporting on a real-time basis to OTC securities. Finally, and perhaps most significantly, this new outlook might also be explained by the Commission's apparently increased willingness to rely on market forces in evaluating the correctness of certain trading modifications.¹⁰⁷

Perhaps in recognition of the potential impact of the Commission's issues for resolution in 1985 on the structure of the national market system and its underlying policy, the Commission, in mid-1985, solicited public comment on the direction of the national market system.¹⁰⁸ The questions the Commission raised in this release focused on the integration of NMS securities into national market system facilities. However, the Commission also engaged a number of the remaining unresolved issues relating to the national market system's evolution—notably, methods of effectively linking trading markets and of insuring the best execution of orders within the national market system. These two thorny matters, always perceived as central to establishing a national market system, will undoubtedly be under consideration by the Commission in the coming years.

TERMINATING THE INTERTWINING DOCTRINE: DEAN WITTER REYNOLDS, INC. V. BYRD

In March 1985, in *Dean Witter Reynolds, Inc. v. Byrd*,¹⁰⁹ the Supreme Court put to rest the "intertwining" doctrine for customer-broker controversies in the securities industry. Although not directly related to either Commission activity or the national market system, this decision may have a significant impact on self-regulatory organizations. Under the intertwining doctrine, customers were able to litigate, in federal court, claims against their brokers so long as any portion of the customer's claims was based upon the federal securities acts. This was true even when they had contracted to bring such claims to arbitration.

When a customer opens an account to execute transactions with a particular broker, they generally agree to arbitrate any controversy between them relating to or arising out of the broker's promised services. The exchanges and the

107. Neither UTP in OTC options nor side-by-side trading in OTC options might ultimately receive an entirely enthusiastic reception from the exchange markets. Industry sources indicated in October 1985 that NYSE participation in the programs was unlikely. In addition, a number of exchanges that had expressed an intent to participate were viewed as having merely reserved rights to participate rather than that they would certainly participate. *See id.*

108. SEC Exchange Act Release No. 22,127, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,786 (June 21, 1985). The original deadline for comments was later extended from September 30 to December 30, 1985. SEC Exchange Act Release No. 22,507, [Current] Fed. Sec. L. Rep. (CCH) ¶ 83,926 (Oct. 4, 1985).

109. 105 S. Ct. 1238 (1985).

NASD each provides arbitration panels to settle these customer-broker controversies. When controversies do arise, customers frequently prefer to litigate rather than arbitrate because of the perceived advantages of avoiding an industry panel, using discovery rules provided in federal litigation, and obtaining in litigation awards for attorneys' fees or punitive damages. (Such awards are typically unavailable in arbitration.) In 1953, in *Wilko v. Swan*,¹¹⁰ the Supreme Court held that the customer protections provided by the 1933 Securities Act, including the ability to seek judicial enforcement of these protections, cannot be overridden by predispute contracts that commit customers to arbitration. The reasoning in *Wilko* was later applied to disputes arising under the Exchange Act.¹¹¹

Customer claims against brokers frequently include causes of action based upon state law as well as causes of action based upon the federal securities laws. When these mixed claims were brought to litigation, several circuits permitted the state claims the same advantages that *Wilko* provided to the federal securities acts claims, and thus to be litigated.¹¹² This practice came to be known as "intertwining." After *Byrd*, customer-broker disputes involving state claims as well as federal securities acts claims are to be bifurcated, with the state claim portion being sent to arbitration. The number of cases each year that will be affected by the *Byrd* decision is still unclear. It is clear, however, that this decision has already increased the number of matters to be resolved by industry arbitration panels, which had already been experiencing a dramatic growth in caseloads even prior to the decision.¹¹³

In addition, a concurring opinion in *Byrd* by Justice White raised speculation that the *Wilko* rule would no longer be mechanically applied to issues arising under the Exchange Act.¹¹⁴ Since most customer-broker disputes arise under section 10(b) of the 1934 Act, Justice White's reservations on the applicability of *Wilko* suggest the possibility of an even further expanded arbitration caseload for the self-regulatory organizations. Indeed, most courts that have dealt with the *Wilko* doctrine since *Byrd* have not permitted Exchange Act litigants to avoid arbitration.¹¹⁵ This increase in matters going to arbitration will require

110. 346 U.S. 427 (1953).

111. See, e.g., *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831 (7th Cir. 1977); *Reader v. Hirsch & Co.*, 197 F. Supp. 111 (S.D.N.Y. 1961).

112. See, e.g., *Belke v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 693 F.2d 1023 (11th Cir. 1982); *Miley v. Oppenheimer & Co.*, 637 F.2d 318 (5th Cir. 1981); *C. F. Dickinson v. Heinhold Sec., Inc.*, 661 F.2d 638 (7th Cir. 1981).

113. Between 1979 and 1984, the number of new customer cases annually brought to arbitration went up 322%. Morgenstern, *The Leaky Umbrella that Is the SEC*, Money, Nov. 1985, at 228.

114. Justice White noted several distinctions between the claim brought in *Wilko* under the 1933 Act and claims brought under the 1934 Act. Most notably, the *Wilko* claim was based upon an express remedy provided by § 12(2) of the 1933 Act, 15 U.S.C. § 77o(2) (1982). Cases brought under the 1934 Act, and specifically § 10(b), 15 U.S.C. § 78j(b) (1982), rely upon implied remedies.

115. Since *Byrd*, "[t]he majority of federal district courts, including the lower *Byrd* court on remand, have interpreted the [Supreme] Court to disapprove of their prior refusal to compel arbitration and have now begun to compel the arbitration of 1934 Act claims." *Peele v. Kidder, Peabody & Co.*, 620 F. Supp. 61 (D.C. Mo. 1985).

the self-regulatory organizations either to increase the resources they devote to arbitration or to devise alternative methods for resolving disputes.

GOVERNMENT SECURITIES REGULATION

The failures of firms that traded government securities (including Bevell Bresler & Shulman Asset Management Corp., ESM Government Securities, Inc., Drysdale Securities, Lombard-Wall, RTD Securities, and Lion Capital Group), as well as the extraordinary losses incurred by Marsh & McLennan in government-bond trading, have raised questions about regulating the markets for these securities. Unless such firms are engaged in other securities transactions, their operations are not presently regulated by any federal (or state) authority, except insofar as they are subject to the general antifraud regulations of the federal securities laws. As a result of these concerns, both houses of Congress, the SEC, and the Treasury Department have all sought comments on the problems or proposed legislation aimed at curing perceived regulatory deficiencies.

In a recent release, the SEC requested comments on oversight of the U.S. government and agency securities markets and dealers.¹¹⁶ Currently, neither the SEC nor the Federal Reserve Board (FRB) has specific statutory authority over firms that deal exclusively in government securities. Two of the key issues on which the SEC sought comment were the possibility of direct federal regulation of this area and the creation of a self-regulatory organization under supervision of the SEC, the FRB, the Treasury, or a combination of the three.

The House of Representatives recently approved a bill creating a self-regulatory organization for government securities dealers.¹¹⁷ This bill would create a government securities rulemaking board, overseen by the FRB, by adding section 15C to the Exchange Act. The rulemaking board would be made up of nine members appointed for two years by the FRB. The board would adopt rules on investor protection; trading practices; use of customer securities, deposits, or credit balances; and the transfer and control of government securities in repurchase agreements and similar transactions. It would also promulgate rules on interpretations, recordkeeping, capital requirements, and other financial responsibility standards.

If the FRB determines that the rulemaking board's rules are inadequate to meet the purpose of the legislation, it would have its own authority under the statute to enact its own requirements for the purchase, sale, or carrying of government securities and for "when issued" trading. The SEC would have authority to enforce rules enacted by the rulemaking board or the FRB. It would also be empowered to censure, suspend, terminate, or revoke the registration of a government securities broker-dealer.

116. SEC Exchange Act Release No. 21,959, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,760 (Apr. 19, 1985).

117. Government Securities Act of 1985, H.R. 2032, 99th Cong., 1st Sess. (1985), 131 Cong. Rec. H1971 (daily ed. Apr. 15, 1985).

Under the bill, government securities dealers would have to register with the SEC. The FRB would have authority to exempt any government securities broker-dealer or any class of broker-dealer (bank) from the registration requirements. It is not known at this time what the Senate's position on this bill will be; a somewhat different bill was introduced in the Senate by the chairman of the Banking Security Subcommittee. The Senate's bill would enable the FRB to regulate directly government securities dealers.

Finally, the Treasury Department is also drafting a bill to give it rulemaking authority over government securities dealers. This bill has not been formally presented to date and of the three appears the least likely to receive favorable treatment.

OTHER DEVELOPMENTS

The following significant market regulatory developments should be mentioned. They have not been listed in any order of importance, and the final resolution of some of these developments has not yet occurred.

First, on January 8, 1986, the Federal Reserve Board adopted by a 3-2 vote an interpretation of its margin regulations that would restrict the use of junk bonds in takeover attempts.¹¹⁸ Under the interpretation, margin requirements will be imposed on debt securities issued by a corporation with no assets of its own when the securities are used to finance the acquisition of margin stock of a target company. The FRB considers debt securities issued to finance such an acquisition indirectly secured by the stock of the target company and, therefore, subject to the margin rules under FRB regulation G. Such debt securities are typically high-yield securities below investment grade, which have been characterized as junk bonds. The revised margin rules will not be applied to a financing by an acquiring corporation if it has substantial assets or cash flow to finance the acquisition, that is, it really is not a shell corporation; if the parent of a shell corporation guarantees the debt securities; if there is a merger agreement between the acquiring corporation and the target, or state law permits a merger without shareholder approval; or if the debt securities are being offered to the public. If none of these conditions is met, shell corporations apparently will no longer be able to finance more than fifty percent of the cost of takeovers with junk bonds and will have to find additional sources of cash. The Reagan administration and investment bankers, which had actively developed financing with such securities, strongly opposed the measure.

Second, the SEC solicited public comment on issues concerning the increasing internationalization of the world's securities markets.¹¹⁹ Both the American Stock Exchange and the Boston Stock Exchange established electronic linkages with the Toronto Stock Exchange to allow orders in dually traded securities to be routed between the Toronto exchange and the two domestic exchanges. The

118. Wall St. J., Jan. 9, 1986, at 2, col. 3; N.Y. Times, Jan. 9, 1986, at D-1, col. 3.

119. SEC Securities Act Release No. 6568, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,743 (Feb. 28, 1985).

NYSE set its opening time one half hour earlier so that its trading hours would be closer to those of the European trading markets.

Third, a joint study by the SEC, the CFTC, and the Federal Reserve Board, released in January 1985, concluded that new financial futures and options markets serve a useful economic purpose and that no additional legislation is now needed to create an appropriate regulatory framework.¹²⁰

Fourth, the SEC approved an amendment to rule 10b-10, which will require dealers, after March 17, 1986, to disclose to customers their markups on trades involving NMS securities.¹²¹

Finally, a number of exchanges have begun to permit diversified brokerage firms to operate specialist units on their floors. The move is designed to increase the capital available for specialist units.

ACCOUNTING REGULATORY DEVELOPMENTS

ACCOUNTING FOR STOCK REPURCHASES AND BUSINESS COMBINATIONS: FASB TECHNICAL BULLETINS

On December 31, 1985, the Financial Accounting Standards Board (FASB) adopted FASB technical bulletin no. 85-6, *Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending Against a Takeover Attempt*. The amounts paid by a company for the purchase of treasury shares at a price significantly in excess of the current market price of the shares, a practice better known as greenmail, should be accounted for by the company according to the substance of the transaction. The excess price creates a presumption that the purchase price includes amounts attributable to items other than the shares purchased. The allocation and treatment of such amount should be disclosed. If no stated or unstated consideration in addition to the capital stock can be identified, the entire purchase price should be accounted for as the cost of treasury shares.

Prior to the new statement, the total amount a company paid for its own shares reduced the equity it reported on its balance sheet, and the company was not required to report any amount in its income statement. The FASB's statement requires companies that buy their own shares at a premium to record part of the cost as an expense. Consequently, the statement may make resisting an unwanted takeover more difficult, as well as reduce the number of share reacquisitions entered into for the purpose of bolstering earnings per share.

120. Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, and the Securities and Exchange Commission, *A Study of the Effects on the Economy of Trading in Futures and Options*, (December 1984).

121. SEC Exchange Act Release No. 22,297, [Current] Fed. Sec. L. Rep. (CCH) ¶ 83,912 (Sept. 11, 1985).

On the same date, the FASB also adopted FASB technical bulletin no. 85-5, which addresses five issues related to accounting for business combinations. This statement provides the following: (i) The costs incurred to close duplicate facilities of an acquiring company should be charged to expense in determining net income. (ii) The legal structure of a specific transaction determines how a parent company should account for a minority interest when a subsidiary, in exchange for all its stock, acquires the stock of another subsidiary of the same parent. When minority shares are party to the exchange of shares, the transaction should be accounted for by the purchase method, but when minority shareholders are not party to the exchange, the exchange of shares should be accounted for at historical cost. (iii) An exchange by a partially owned subsidiary of its common stock for the outstanding voting common stock of its parent (a downstream merger) cannot be accounted for like a pooling of interests. (iv) The issuance in a business combination of common shares identical to other outstanding common shares, except that the issuer retains a right of first refusal to repurchase the shares issued in certain circumstances, precludes the issuer from accounting for the business combination as a pooling of interests. (v) Converting a mutual or cooperative enterprise of stock ownership within two years before a plan of combination is initiated or between the dates a combination is initiated and consummated does not preclude accounting for the combination as a pooling of interests.

Except for the first provision of FASB statement 85-5, which becomes effective for transactions consummated after June 5, 1985, both technical bulletins are effective for transactions consummated after December 31, 1985.

PENSION ACCOUNTING: FASB STATEMENT

In December 1985, the FASB issued a statement entitled *Employers' Accounting For Pensions*. The major issue of legal significance raised by this action relates to part of the implementation provisions. Paragraphs 36-38 deal with recognition of liabilities and assets. Paragraph 76 provides that paragraphs 36-38 shall be effective for fiscal years beginning after December 15, 1988.

These provisions could require recognition of liabilities in situations in which current generally accepted accounting principles do not require recognition. Thus, the implementation provision could prove a serious hardship on any company subject to preexisting financial reporting covenants in indentures or other contracts, such as debt restrictions, debt-to-capital ratios, and minimum equity requirements, that run beyond December 15, 1988.¹²² Consequently, the proposed accounting rules could cause companies to go into default.¹²³

122. Statement of Financial Accounting Standards No. 87 (Dec. 1985).

123. Comment Letter from ABA Committee on Law and Accounting to Financial Accounting Standards Board (June 28, 1985).

CONSOLIDATED FINANCIAL STATEMENTS: PROPOSED S-X AMENDMENTS

On April 23, 1985, the SEC proposed amendments to rule 3A-02 of regulation S-X under the Securities Act and the Exchange Act. These would clarify the considerations involved in a corporation's decision whether to use consolidated statements. Rule 3A-02 currently provides, in part, that "[t]he registrant shall follow in the consolidated financial statement principles of inclusion or exclusion which will clearly exhibit the financial position and results of operations of the registrant and its subsidiaries: *Provided, however*, that the registrant shall not consolidate: (1) Any subsidiary, which is not majority owned"¹²⁴ Many companies have cited this rule as prohibiting consolidation of a controlled entity unless there is majority ownership.

The rule was written at a time when the Commission was attempting to correct abuses by registrants who would consolidate an entity they did not in substance control.¹²⁵ The Commission has stated the necessity to clarify that rule 3A-02 "is subject to the overriding consideration of accounting for the substance of the particular relationship."¹²⁶ Thus, the revised rule would provide that registrants generally should consolidate majority-owned subsidiaries and generally should not consolidate entities not majority owned. "*The determination of majority ownership requires a careful analysis of the facts and circumstances of a particular relationship among entities.*"¹²⁷ The proposed rule seeks to adopt a substance-over-form approach to consolidated statements.¹²⁸

124. 17 C.F.R. § 210.3A-02 (1985).

125. SEC Securities Act Release No. 6577, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,763 (Apr. 23, 1985).

126. *Id.*

127. *Id.* (emphasis added).

128. The SEC already has suggested this approach in litigation. In *In re Coopers & Lybrand and M. Bruce Cohen, CPA*, SEC Exchange Act Release No. 21,520, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,445 (Nov. 27, 1984), the SEC ruled that Digilog, Inc. should have consolidated its statements with Digilog Business Systems, Inc., a corporation in which Digilog, Inc. did not own a majority interest but in which Digilog owned convertible notes pursuant to which it had the right to obtain 90% of Digilog Business Systems' outstanding stock. Although the SEC accepted a consent and settlement in the litigation, it remarked:

There do however, arise situations in which control, apart from actual majority ownership, strongly suggests the need for consolidation in order to accurately depict the economic realities of the relationship between two entities. In deciding on consolidation policy "the aim should be to make the financial presentation which is most meaningful in the circumstances." APB No. 51 ¶ 3. Substance must govern form in the application of accounting principles. APB Statement No. 4. In view of these overriding aims, consolidation may be required in the absence of majority ownership in form where one entity in substance achieves the same effect as majority ownership through control by contract or otherwise.

See, e.g., In re Laventhal & Horwath, SEC Securities Act Release No. 13,976, [1937-1982 Accounting Series Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,249 (Sept. 21, 1977); *In re Atlantic Corp.*, [1961-1964 Decisions] Fed. Sec. L. Rep. (CCH) ¶ 76,949 (Dec. 6, 1963).

OPINION SHOPPING

In the past year, the practice of seeking out or changing to accountants who would be willing to interpret generally accepted accounting principles (GAAP) in a favorable manner, often referred to as "opinion shopping," has begun to receive attention from the SEC. Many members of the accounting community object to this term and believe that the SEC's proposals attempt to regulate practices that are not at all objectionable.¹²⁹

In *In re Broadview Financial Corp.*,¹³⁰ the SEC claimed that Broadview filed a Form 10-Q with materially overstated financial statements and that certain accounting practices of Broadview violated GAAP. The SEC also used the litigation, however, as an opportunity to express its negative view of opinion shopping:

Auditors who condone or assist in an issuer's efforts to circumvent GAAP may themselves violate the federal securities laws.

The independent auditor has the responsibility to maintain a standard of professionalism which assures the public that he will maintain his independence and objectively review the financial statements of his client. Acquiescence to "opinion shopping" taints the professionalism of the auditor and more importantly, erodes the public confidence in the audit function itself.¹³¹

Since *Broadview*, the SEC has attempted to regulate opinion shopping through two releases dated July 1, 1985.¹³² In Securities Act Release No. 6592, the Commission proposes to amend item 304 of regulation S-K,¹³³ item 9(c) of schedule 14A,¹³⁴ and Form S-18¹³⁵ to require disclosure of changes in accountants and of disagreements with former accountants that may have arisen prior to the registrant's becoming subject to the Exchange Act's filing requirements. Currently, this kind of information must be disclosed only when a Form 8-K obligation exists at the time of change. In Securities Act Release No. 6594, the SEC requested comments on possible alternative ways to gain disclosure of opinion shopping by registrants subject to SEC filing requirements. The SEC suggests three possible triggering events: change of accountants, change of accounting principles, and consultation with a second accountant.

On December 6, 1985, the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) issued an exposure draft on

129. Comment Letter from ABA to SEC (Oct. 8, 1985); Comment Letter from American Institute of Certified Public Accountants to SEC (Oct. 17, 1985).

130. SEC Exchange Act Release No. 21,949, 6 Fed. Sec. L. Rep. (CCH) ¶ 73,454 (Apr. 17, 1985).

131. *Id.*

132. SEC Securities Act Release No. 6594, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,804 (July 1, 1985); SEC Securities Act Release No. 6592 [Current] Fed. Sec. L. Rep. (CCH) ¶ 83,901 (July 1, 1985).

133. 17 C.F.R. § 229.304 (1985).

134. 17 C.F.R. § 240.14a-101 (1985).

135. 17 C.F.R. § 239.28 (1985).

reports on the application of accounting principles. The draft proposes performance and reporting standards when additional accountants, other than continuing accountants, are consulted on the application of accounting principles to specific transactions and certain hypothetical transactions.

LIFO FOR INVENTORIES

In a staff accounting bulletin issued March 19, 1985,¹³⁶ the Staff stated that registrants and their independent accountants should look to an AICPA issues paper, *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories*,¹³⁷ “for guidance in determining what constitutes acceptable LIFO accounting practice.” The staff took this action because there was an “absence of existing authoritative literature on LIFO accounting.” A 1981 amendment to the IRS regulations, providing that companies could apply different last in, first out (LIFO) standards for tax purposes than for financial inventory purposes, partially caused the gap in the literature.

The Staff considered the paper “to be an accumulation of existing acceptable LIFO accounting practices which does not establish any new standards and does not diverge from generally accepted accounting principles.” The Staff also stated that when a registrant and the independent accountant decide that their own LIFO practices are preferable under the circumstances, they “should be prepared to justify their position in the event that a question is raised by the staff.” Finally, “the staff does not expect to routinely raise questions about changes in LIFO practices” made in conformity with the AICPA paper.

INDUCED CONVERSION OF CONVERTIBLE DEBT

On March 29, 1985, the FASB issued statement no. 84, *Induced Conversions of Convertible Debt*. The statement amends APB opinion no. 26, *Early Extinguishment of Debt*, to provide that the opinion does not apply to situations covered by statement no. 84.

The statement provides the accounting method required for conversions of convertible debt to equity securities when the debtor induces conversions of the debt by offering additional securities or other consideration to convertible debtholders. It applies to such inducements offered after March 31, 1985. The statement requires the debtor enterprise to “recognize an expense equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of securities issuable pursuant to the original conversion terms” and does not permit the debtor to report the expense as an extraordinary item. Fair value of the securities must be “measured as of the date the inducement offer is accepted by the convertible debt holder.”

136. Staff Accounting Bulletin No. 58, 6 Fed. Sec. L. Rep. (CCH) ¶¶ 74,058, 74,141 (1985).

137. Task Force on LIFO Inventory Problems, American Institute of Certified Public Accountants, *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories* (1984).

The statement was adopted despite the dissent of Robert T. Sprouse, who considered it inadequate for failing to distinguish between two different fact situations: "(a) debt convertible into equity securities whose market values are greater than the conversion price . . . and (b) debt convertible into equity securities whose market values are less than the conversion price."

REAL ESTATE LEASES AND SALE-LEASEBACK TRANSACTIONS

On May 29, 1985, the FASB reversed its May 22, 1985, decision to issue a technical bulletin saying that leveraged leasing treatment for real estate leases and sale-leaseback transactions is not permitted by a literal reading of statement no. 13, *Accounting for Leases*. The action allows current accounting practices to continue.

PROPOSED PROXY RULES REQUIRING DISCLOSURES AFFECTING ACCOUNTANTS

On July 1, 1985, the SEC proposed rules updating and simplifying proxy requirements.¹³⁸ Proposed item 9 to schedule 14A would require registrants in a proxy solicitation relating to an annual or a special meeting for the selection of directors (or a solicitation of consents for the same purpose), or a solicitation for the election, approval, or ratification of the registrant's independent public accountant, to disclose whether the registrant's principal accountant,

participate[s] in a professional organization which has both a peer review program and an independent oversight function, both of which are subject to review by the Commission . . . [and] . . . if a member of such an organization [a statement whether or not the principal accountant] has undergone a peer review, and if so the date of the review report.¹³⁹

The second revision concerning independent public accountants relates to changes of accountants and any disagreements accompanying or preceding such changes. Under the proposed item 9, a registrant would be required to disclose whether a disagreement with the prior accountant over accounting principles has occurred in connection with a change of accountants. The proposal would be applicable only if the change in accountants occurred before the registrant became subject to the Exchange Act's requirements. The proposal would not change the existing requirements for registrants who were required to make periodic reports under the Exchange Act at the time the change in accountants occurred. The proposal would revise item 9, item 304 of regulation S-K, and

138. SEC Securities Act Release No. 6592, SEC Exchange Act Release No. 22,195, [Current] Fed. Sec. L. Rep. (CCH) ¶ 83,901 (July 1, 1985).

139. *Id.* The proposed release also attempts to regulate opinion shopping. See *supra* section entitled "Opinion Shopping." The release would also apply the principles of the integrated disclosure system to proxy statement disclosure and would modify and add certain disclosure requirements.

Form S-18, however, so that disclosure would be required in annual reports to securityholders, proxy statements, registration statements, and periodic reports about changes in accountants that have not previously been reported.

MANAGEMENT MUST PROVE SECURITIES' REALIZABLE VALUE EQUALS CARRYING VALUE

In release no. SAB-59, issued September 5, 1985, the Staff clarified the circumstances under which the cost basis of an individual security must be written down to a new cost basis and the amount of the write-down accounted for as a realized loss. Paragraph 21 of FASB statement no. 12 provides that a write-down and loss realization must occur when market value declines below cost as of the balance sheet date of an individual security, if such decline is "other than temporary."

The staff bulletin states, "the staff believes the FASB consciously chose the phrase 'other than temporary' because it did not intend that the test be 'permanent impairment.'" Consequently, management cannot argue that because it is unable to determine whether its investment is permanently impaired, no realized loss must be recognized even though current market price is below the corporation's average acquisition price. Management must have evidence to show that noncurrent marketable equity securities still have a realizable value. Once management determines that a write-down, recognizable as a loss, is necessary, the actual amount of the loss to be recognized should be determined case by case according to the facts and circumstances.

DISCLOSURE OF INVESTMENTS IN REPURCHASE AND REVERSE REPURCHASE AGREEMENTS

On June 27, 1985, the SEC proposed an amendment to rule 408 of regulation S-X.¹⁴⁰ The proposal would require publicly held companies to provide more information to investors and the Commission about investments in repurchase and reverse repurchase agreements if either (i) the aggregate carrying amount of securities or other assets sold under repurchase agreements exceeds ten percent of total assets or (ii) the amount at risk with one party exceeds five percent of shareholders' equity. If either threshold is met, separate line disclosure in a financial statement would be required of the amount the registrant has invested in repurchase and reverse repurchase agreements. Additional footnote disclosure would be required by the registrants on how they intend to perfect their interests in securities underlying these agreements.

The proposal also sought comments on whether and how the SEC should regulate new forms of financial transactions.

140. SEC Securities Act Release No. 6590, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,791 (June 27, 1985).

THE PROGRESS OF EDGAR

EDGAR is the SEC's electronic data gathering analysis and retrieval project.¹⁴¹ The EDGAR pilot project is currently accepting filings from approximately 150 volunteers. The SEC expects a substantial increase in the number of volunteers before the system's operational stage begins in 1986. Although the pilot project is now being funded by congressional appropriations, the Staff is reviewing proposals to fund the operational system with private-sector fees to make EDGAR partially or wholly self-sustaining. Typical filings currently being accepted by EDGAR include 10-Ks, 10-Qs, 8-Ks, and registration statements under the Exchange Act and the Securities Act. Recently, filings have also been accepted under the Investment Act of 1940 and the Public Utilities Act of 1935.

Documents are filed in one of three ways: direct transmission over phone lines, delivery of magnetic tape, or delivery of a diskette. At this time, over seventy-five kinds of word processors and personal computers are compatible with the EDGAR system. In addition, electronic mail capabilities exist for transmitting comments between filers and the SEC.

The SEC believes that the EDGAR pilot system, as it now stands, is an improvement over the manual filing system for three reasons: (i) acceptance, and in some cases effectiveness, is faster; (ii) review is more efficient since the Staff has quicker access to filings and external data bases (criteria for and probability of review remain unchanged); and (iii) upon acceptance, dissemination of electronic filings to EDGAR terminals in other cities is instantaneous.

Efficiencies in staff review (including eliminating the multiple copies required in manual filings) are being realized today. Although SEC public reference rooms in New York, Chicago, and Washington, and the offices of state securities law administrators in California, Georgia, and Wisconsin, already have access to the EDGAR system, efficient dissemination depends on future linking of the SEC Washington office with more regional offices of the SEC and state securities administrations, exchanges, and private industry. The NASD is expected to obtain access in the spring of 1986.

Efficiencies in filing can be realized once one masters the "Edgarization" process. Edgarization is the process of putting a document in an electronic format acceptable to the EDGAR system. Some users have expressed reservations about the current state of the art for filing substantial documents, like S-1 registration statements. This process usually requires use of a commercial printer with the software to "Edgarize" the document efficiently. A representative of General Motors Acceptance Corporation (GMAC), the most frequent user, suggests that the answer to filing problems is for participants to transmit

141. The information in this section is derived from discussions with volunteers, the SEC staff, and a brochure authored by the SEC, U.S. Securities and Exchange Commission Electronic Filing Has the Potential To Revolutionize the Method Under Which Investment Decisions Are Made and Executed (1985). For additional information, see the testimony of the Commission concerning EDGAR before the House Subcommittee on Oversight and Investigations, House Energy and Commerce Committee (March 14, 1985).

directly, using their own computer software and telephone lines. The Staff is developing procedures to simplify and accelerate filing of complex documents. Recently, in order to assure prompt effectiveness of a registration, the EDGAR branch permitted an issuer filing a Form S-1 registration statement to file the pricing amendment in two parts: part A, the bulk of the registration statement, was filed in advance, and part B, the few pages affected by the pricing information, was filed on the morning of the requested effective date.

Among the more immediate plans for the system are expansion of communications to facilitate acceptance of different kinds of filings; a program to give additional state securities administrators access to filings on the EDGAR system; cooperative efforts with the nation's securities exchanges; and increased access to external data bases to improve efficiency of review and comment.

One-stop filing by registrants is the ultimate goal. The five-year goals are industry-wide implementation, including access by all national securities exchanges; the addition of other Commission filings to the system; the instantaneous availability of all filings to the public; and the availability of raw data from the EDGAR system through vendors who would, for a fee, provide access to all filed data and data analyses tailored to specific investment objectives. By the end of the decade, the Commission expects to make filing by all registrants mandatory.

