Memorandum

NYSE
New York
Stock Exchange, Inc.

Date: December 12, 1988

To: Senator Dole

From: Sheila Bair SB

Subject: Exchange Visit/Issues That May Be of Interest

Attached is the schedule for your visit to the Exchange this Thursday and a biography of John Phelan, who will be your host. We will have a preliminary guest list to you by tomorrow.

The coffee will be informal and off-the-record. John Phelan will introduce you and invite you to make remarks which can be on any issue of your choosing. After your remarks, he will turn to questions and discussion from the group.

The group will in all likelihood focus on general questions concerning economic policy such as:

- o prospects for deficit reduction;
- o tax policy, particularly, proposals for a value added tax, gas tax, oil import fee, and changes in the capital gains tax rate;
- o leveraged buyouts; and
- o the FSLIC crisis.

They may also want to hear your thoughts on President-elect Bush's staff and cabinet appointments and about the new Democratic Leadership in the Senate. The Q&A will be followed by a brief tour of our trading floor, which will conclude at 11:15 a.m.

I will meet you at the Exchange's main entrance at 11 Wall Street upon your arrival and accompany you throughout your visit. Please let me know if there is anything else I can do to be helpful to you in preparation for your visit.

SB:kmk
0058K

ATTACHMENT

cc: Betty Meyer
Morrell Taggart

10-181A

BOB DOLE
KANSAS

United States Senate

OFFICE OF THE REPUBLICAN LEADER
WASHINGTON, DC 20510

909
~~929~~
5th Ave

December 13, 1988

TO: SENATOR DOLE

FROM: DAVID TAYLOR

SUBJECT: Information for New York Stock Exchange Event

I spoke with Sheila Bair about Thursday's event with the New York Stock Exchange. The prominent issues concerning those in the audience will likely be LBOs, FSLIC, deficit reduction and taxes. The primary focus will be on your predictions for the future.

When Sheila asked what your likely focus would be, I indicated that you would probably focus on the prospects for deficit reduction.

The attached packet of information contains the following:

- -- a copy of your schedule at the Exchange
- -- a brief biography on John Phelan, Chairman of the Exchange
- -- two memos on tax issues
- -- talking points and a memo on leveraged buyouts
- -- talking points on FSLIC and banking reform

EVENT SCHEDULE

Schedule for Senator Robert Dole (R-Ks.)
Visit to the New York Stock Exchange
Thursday, December 15, 1988

10:00 a.m.	Sheila Bair will meet Senator Dole in the Exchange's 11 Wall Street entrance lobby and proceed to the Office of the Chairman.
10:00 a.m. - 10:15 a.m.	Exchange Chairman John Phelan will greet Senator Dole in Chairman's Office (Room 604, 6th Floor) to visit briefly before joining other guests.
10:15 a.m. - 11:00 a.m.	Messrs. Dole and Phelan will join other guests in Room 632. Mr. Phelan will introduce Senator Dole, who will make remarks, followed by informal discussion.
11:00 a.m. - 11:15 a.m.	Visit Trading Floor to observe and discuss current technology of trading systems.
11:20 a.m.	Depart Exchange.

* Senator Dole will be accompanied by Stephen J. Paradise, Senior Vice President - Congressional and Regulatory Relations, and Sheila Bair, Counsel - Legislative Affairs, throughout his visit.

Should there be any scheduling or other inquiries, please call Phyllis Benison (212-656-8248) or Deneen Houser Bernard (202-293-5740).

NYSE
New York
Stock Exchange

JOHN J. PHELAN, JR.
CHAIRMAN AND CHIEF EXECUTIVE OFFICER

John J. Phelan, Jr. is chairman and chief executive officer of the Exchange. He was president and chief operating officer of the Exchange from July 1980 through his election as chairman and CEO in May 1984.

He was an active member on the trading floor from 1957-80, and served as a floor official, governor, and a member of the 1974 nominating committee. He has been on the NYSE board since July 1974, and served as vice chairman from 1975 to 1980.

In addition to his chairmanship of the New York Stock Exchange, he is currently serving as chairman of the Presidential Board of Advisors on Private Sector Initiatives.

Mr. Phelan is a director of the Metropolitan Life Insurance Company and Eastman Kodak Company. He also serves as a member of the board of trustees of the Asia Society, New York Medical College, the Committee for Economic Development and is a member of the board of the Business Council of New York State.

He is on the advisory board of the Center for Law and Economic Studies at Columbia University, the Business-Higher Education Forum and the U.S. advisory committee to INSEAD. He is also a member of the New York City Korean War Veterans Memorial Commission, The Rockefeller University Council, and recently served as a member of the State Temporary Commission on Banking, Insurance, and Financial Services, by appointment of Governor Mario Cuomo.

Mr. Phelan served in the U.S. Marine Corps from 1951 to 1954. He graduated magna cum laude from Adelphi University and is a past chairman of their board of trustees. He holds honorary Doctor of Law degrees from Adelphi, Notre Dame, Hamilton College and Niagara University.

He is a Knight of Malta, a Knight of the Holy Sepulchre, and a member of the board of councilors of the Holy Sepulchre. He is a member of the New York Archdiocese Cardinal's Committee of the Laity, the Finance Council of the Archdiocese and also serves on the board of trustees of Catholic Charities. Long active in educational, philanthropic and community affairs, Mr. Phelan has twice served as Wall Street division chairman of the National Association of Christians and Jews, and is a recipient of its Brotherhood Award.

TAX ISSUES

December 12, 1988

M E M O R A N D U M

TO: SENATOR DOLE

FROM: RICH BELAS
DAVID TAYLOR

SUBJECT: TAX ISSUES FOR NEW YORK STOCK EXCHANGE SPEECH

Assuming that Congress will need to pass a deficit reduction package approaching $50 billion to meet the Gramm-Rudman-Hollings target for FY 1990, a tax increase will likely be discussed as an option next year.

It is too early to know how this will play out and what the details will be, but we can certainly expect a Democrat-controlled Congress to demand that any deficit reduction package include a tax component. Chairman Rostenkowski has indicated a willingness to consider an increase in taxes to reduce the deficit.

A VAT continues to generate a lot of interest in the business community, but there is little evidence of substantial interest on the Hill.

Last week, Chairman Rostenkowski indicated that he is willing to consider an excise tax on gasoline and diesel fuel as a potential revenue-raiser. He is expected to face opposition from the Speaker, Chairman Bentsen and the Bush Administration on this issue.

The Vice President proposed tax incentives for oil and gas extraction, child care, and college savings during his campaign. (Education savings bonds were enacted as part of the technical corrections bill last year).

Corporate Interest Deductions

Federal Reserve Board Chairman Greenspan has spoken out against the increasing debt in corporate America. In addition, Treasury Secretary Brady is reportedly very concerned about the increase in junk bond issues. Concern over the increasing size of leveraged (i.e., debt-financed) buyouts has also become a prominent issue. (A separate page of talking points on leveraged buyouts is attached.)

These factors suggest that some limitations on the interest deduction may be proposed again. As you recall, the 1987 Ways and Means Committee bill included limitations on the interest deduction for debt-financed takeovers. This was dropped from the 1987 bill after Black Monday (October 1987).

Stock Transfer Tax

Last year Speaker Wright proposed a stock transfer tax as a way of helping to reduce the deficit. Chairman Rostenkowski ignored the proposal, but it may be proposed again as a way to pay for a reduction in the capital gains rate.

Capital Gains Rate

The Vice President has proposed reducing the maximum rate for capital gains to 15%. Because 75% percent of Americans are already taxed at this rate, few would actually be helped by this proposal. On the other hand, people with incomes over $200,000 a year earn over half the capital gains, even though they represent only 2 percent of the returns that show capital gains.

This proposal would likely create a revenue problem. Although the Treasury Department contends that there may be little revenue loss, it is very likely that the Joint Tax Committee will give a more substantial revenue loss estimate.

There are other alternatives that may be more palatable. For instance, going to a percentage exclusion of capital gains would help individuals in every bracket.

Secretary Brady has reportedly asked the Treasury staff to study alternatives, evidently including pegging the capital gains rate to the length of time an asset is held.

Mortgage Interest Deduction

Several Democratic members of the Ways and Means Committee have suggested futher limits on the mortgage interest deduction. Although this does not seem very likely, it may be considered as a way of funding a bailout of the thrift industry.

The Homebuilders and Realtors are already beginning a defense, while the lobbyists for the thrift industry are quietly suggesting that they would accept this as a way to fund a bailout.

December 13, 1988

M E M O R A N D U M

TO: SENATOR DOLE

FROM: RICH BELAS

SUBJECT: CORPORATE INTEREST PAID DEDUCTIONS

There is some risk that the issue of LBO interest deductions will become partisan, with Democrats such as Wright, Rostenkowski, and Bentsen arguing that something must be done and hoping that they will be able to portray themselves as populists in contrast to the Republican supporters of the wealthy investment bankers.

However, the LBO issue is just one part of a very substantial potential revenue problem. Regardless of the one-time capital gain benefits involved in a takeover, there is a great risk that there will be a revolution in corporate America to get the tax advantages of interest for what is essentially dividends in the ordinary course of business.

The attached article from last Sunday's New York Times describes a new device being marketed by Shearson Lehman Hutton.

The specifics of how they are designing their product is not really that important. What is important is that they have designed recapitalizations for American Express, Dow Chemical, Pfizer, and Sara Lee to convert up to 20 percent of their stock into a security which will, in effect, turn dividends into deductible interest.

These companies are not being taken over. They are just changing their capital structure to take advantage of the tax laws. If this catches on throughout corporate America, which it probably will, the effects on the Treasury will be very substantial.

NYT 12/11/88
section 3 page 1

Shearson's Financial Alchemy

The new plan cuts corporate taxes, but raises many questions.

By FLOYD NORRIS

FOR years, it has been the corporate raiders and the leveraged buyout masters who have captured most of the attention in the financial arena. Suddenly, though, other kinds of financial innovators are in the limelight.

The product that caught Wall Street's imagination last week was christened with an unprepossessing name — unbundled stock units — but it has the potential to have a big impact on the financial world. It is too early to say how this new technique, designed by Shearson Lehman Hutton Inc., will fare, but four blue-chip corporations — American Express, Dow Chemical, Pfizer and Sara Lee — have already signed on to convert up to 20 percent of their common stock, and other Wall Street houses are racing to analyze the plan and possibly create their own.

In effect, the approach transforms each share of ordinary common stock into three different securities — a bond, an unusual type of preferred stock and a long-term option on the company's stock at a set price.

The logic behind this technique has caught the attention of corporate officials. Although a company will be paying out the same amount of cash to investors as it is now, by turning dividend payments on stock into interest payments on debt, the company will be able to save millions of dollars in taxes each year because interest payments to bondholders are tax deductible, while dividend payments are not.

"As we were evaluating how much each of the securities might be worth, we found we were looking at companies in much the same way that leveraged buyout firms do," said Ronald Gallatin, a managing director of Shearson who led the team that developed the securities. Indeed, the same tax advantages are a big incentive for such buyouts.

Investors, on the other hand, will be able to fine tune their portfolios more closely. Investors who are interested in growth and appreciation, for example, could opt for the equity certificates or combine them with the preferred, while those interested in steady income who wanted to avoid the risk of the stock market, could buy the bonds.

But while there is a logic — and elegance — to the scheme, slicing common stocks into these component parts raises many questions for investors, for corporations and for the economy.

One of the most obvious posed last week was the loss of tax revenue for the United States Treasury. If only a few companies follow this route, the tax loss will be sizable, but limited. It is estimated, for example, that Sara Lee will save more than $15 million on taxes the first

Continued on Page 21

Shearson's Alchemy

Continued from Page 1

year, an amount that would rise to more than $83 million in the final year the bonds are outstanding, for a total of more than $1 billion over the 30-year period. If corporate America embraces this technique, the sums could mount quickly, putting pressure on Congress to deal with the differing tax treatments of debt and equity.

There are less obvious issues too. One is the ownership of the corporation. The companies now proposing to make the swaps plan to exchange the new units for up to 20 percent of their shares, but there are no obvious reasons why that could not go higher. At some point, the excess debt would overwhelm the remaining equity, but somewhat higher ratios appear possible. Depending on the level chosen, the number of common shares could shrink considerably, making ownership more concentrated.

THERE are questions for corporations, too. If all goes as planned, 30 years from now the units would, in effect, be recombined into shares. If that happens, a company will have benefited from some very large tax savings. It also will have posted increases in reported earnings per share during those 30 years, since it will have fewer shares outstanding. But if its share price has not risen high enough to make it worthwhile for investors to redeem the warrants, the company would face a huge bill.

A corporation's responsibilities to its investors seem to grow more complicated, too, under this plan. Its traditional fiduciary responsibility is to maximize shareholder interest. It also has contractual obligations to pay interest to bondholders.

Its obligations under the new plan are less clear, particularly with respect to the holders of the new preferred and the equity certificates. If a company raises its dividends rather than investing more money in the corporation, the preferred holders benefit, but share prices may not rise as fast, and neither will the equity-appreciation certificates. The reverse would hold if it keeps dividend growth small.

One thing the securities probably won't do, at least directly, is affect takeover bids. Under the provisions of the securities, someone who wanted to take over a company would have to buy the new package of securities at the same price as the stock.

But, as one rival investment banker put it, "This is a first-generation product." If these succeed, he said, the next round of similar recapitalizations could include strong anti-takeover language in the provisions of some of the securities.

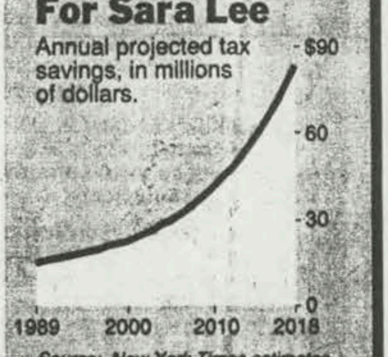
Nonetheless, these securities could make raids on companies more difficult in another way. Those shareholders who exchange their shares for the new units will give up their votes in corporate elections. It is institutions, the very shareholders who are most likely to vote against management in proxy fights, who are expected to make the switch. Since individual investors generally vote with management, some incumbent managements might survive when they would have been ousted.

As for investors, small shareholders are not likely to exchange their shares for the units, largely because they would have to pay taxes on the switch. And owners of the bonds would face heavy tax bills, which is one reason the bonds are expected to be held by tax-exempt institutions like pension funds.

But even institutional money managers may not rush to convert shares into these new units. Despite their attractions, they have no track record, and no one knows how they will trade in the marketplace. If there is not active trading, such investors might find it difficult to buy or sell when they want to, or to do so without pushing the market price up or down sharply. "Liquidity is critically important," said Mary Ellen Johnson, the treasurer of Sara Lee, who believes efficient markets will develop.

Whatever the questions, Shearson has stolen a march on the rest of Wall Street. Even if others introduce similar instruments, Shearson's innovativeness will remain in people's minds for some time to come. If the product catches on — still a big if — it would be the first big financial innovation since the birth of organized trading in options and financial futures contracts in the 1970's.

Perhaps significantly, the unbundled stock units are to be traded on the New York Stock Exchange. The last waves of innovation were pioneered by exchanges in Chicago, which were able to act in part because New York was haughty and confident that only stocks and bonds were real investments. That confidence is now shaken.



A Sweet Deal For Sara Lee

Source: New York Times estimates

The New York Times/Dec. 11, 1988

Valuing Sara Lee's Preferred

Small changes in expectations about interest rates and about the growth in dividends in years ahead dramatically affect the value of the incremental dividend preferred shares Sara Lee plans to issue.

Interest Rate	Annual Dividend Growth Rate 5%	10%	15%
10%	$8	$26	$67
12%	6	19	47
14%	5	14	33
16%	4	10	24

Source: New York Times estimates

FOR Shearson, last week was the culmination of a year-long development effort by investment bankers. They persuaded four blue-chip companies to adopt it, and other corporations are said to be considering similar steps.

Shearson was just one of the firms looking for ways to carve up the attributes of a share of stock into different securities. Mr. Gallatin, who headed Shearson's team, was already known as an innovator for his invention of money-market preferred stock.

At first, the team, which also included Richard P. Roelofs and Anthony T. Garcia, tried to divide shares into two components, one representing dividends and the other capital appreciation. But in January, E. Philip Jones, a former associate professor of finance at Harvard University's business school, who had recently joined Shearson, suggested that shares really had three attributes that attracted investors: the current dividend, possible dividend increases and possible capital gains. That perception led to the new proposal. Once the proposal was shaped, the next job was to assure that it would pass regulatory muster. That task fell to Raymond W. Wagner, a partner in the law firm of Simpson, Thatcher & Bartlett.

In a world where gossip is endemic, Shearson did remarkably well in keeping the plans from the rest of

PUTTING A VALUE **ON SARA LEE'S SECURITIES**

TO see how the new securities would work, consider the Sara Lee plan. Sara Lee proposes to take back up to 22.2 million shares of stock, or 20 percent of the shares now outstanding. Its shares closed last week at $45.25, up 75 cents in part on positive reaction to the plan.

The first security, the bond, will pay annual interest of $1.44, the current dividend of Sara Lee stock, and be redeemed for $120 at maturity in 30 years. The second security, known as the incremental dividend preferred, will pay the same amount as any dividends Sara Lee pays on its common stock, less the current $1.44 payout. So if the company raised its annual payout to $1.54, the incremental dividend preferred would collect 10 cents a year. After 30 years, the company can buy back the preferred for $3 a share.

The last security, known as an Equity Appreciation Certificate, gives the holder the right, in 30 years, to buy a share of stock for $123, the value of the two other securities at that point. If all goes well, shares retired in 1989 will be reissued in 2019.

For the company, the advantages of the securities compared with common stock are clear. The $32 million in dividends that Sara Lee has been paying each year on the shares it proposes to reacquire is not tax deductible. When it pays the same amount as interest on the bonds, that will count as a corporate tax deduction. At the corporate rate of 34 percent, it saves $10.9 million a year.

In fact, the savings are much greater than that, and they will grow each year. That is because the biggest value in the bonds stems not from the annual interest payment but from the growth in the value of the bond, as it approaches being worth $120 in 2019. Each year, Sara Lee is allowed to deduct the estimated increase in the bond's value as if it had paid that amount in interest. In the first year, that increase would amount to about $13.5 million, saving Sara Lee another $4.6 million in taxes. The amount will gradually grow, and for the entire 30 years, Sara Lee will save about $1.1 billion in taxes. (Conversely, each year the I.R.S. would expect an investor to pay taxes on the same amount. But the bonds are expected to be held by pension funds, which are exempt from taxation, so the Government will lose revenue.)

Moreover, the accounting rules are such that Sara Lee will be able to compute earnings per share — a key figure watched by investors and securities analysts — as if those shares had vanished. The result will be higher reported earnings per share. Some accountants have protested that that treatment is misleading, but they concede that it conforms to accounting rules.

The risk for the company is also clear. What if, in 2019, its shares sell for less than $123? Then Sara Lee must come up with $2.7 billion to redeem the bonds. But it would not get a similar cash inflow since the holders of the equity appreciation certificates would not opt to redeem their warrants.

Will Sara Lee shareholders line up to swap their shares for this new package of securities? For tax reasons, most individuals are not expected to do so. But those tax problems don't apply to institutions, like pension plans, and it is to them that the marketing effort is being directed.

A big question for such institutions will be how the new securities will trade. While it is clear that by the year 2019, the package of securities will be worth at least as much as a share of stock, there is no guarantee that they will trade for as much in the meantime. They could trade for more or less, depending on how investors view them. Moreover, if trading is inactive, then the markets could be illiquid, subject to big fluctuations if any investor wanted to buy or sell a large quantity of securities.

THE bonds would appeal primarily to tax-free institutions because taxable investors would have to pay tax on the bonds' price appreciation, even though they would have minimal cash income. Some Individual Retirement Accounts might find them attractive, however.

The other securities could find a retail market, however. The incremental dividend preferred would provide a way to bet on a company raising its dividend. Speculative buyers who believed that Sara Lee stock was sure to rise could get more bang for their bucks by buying the equity-appreciation certificate rather than common stock.

How much will the securities be worth? The computers were calculating all through Wall Street last week. The bond is the easiest to value, at about $20. As for the preferred, estimates vary widely, depending both on how fast one assumes Sara Lee will raise its dividends, and on what interest rate one uses to discount future payments. Over the last decade, it raised its dividend at an annual rate just over 13 percent, but during the preceding five years, the figure was less than 4 percent. One guess is that the preferred will trade for about $17. If the equity-appreciation certificate traded for $8 or $9, the package would be priced similarly to the shares it replaces. *F. N.*

Wall Street. The idea was presented to 40 companies several months ago, but word of how the deals would be structured leaked out only a few days before the formal announcement.

Now that the product is public, its future is by no means assured. The first big test is whether it can clear Securities and Exchange Commission scrutiny. Two Columbia University law professors, Jeffrey Gordon and Bernard Black, say it violates an S.E.C. rule aimed at limiting recapitalizations designed to reduce shareholders' voting rights. The N.Y.S.E., which is supposed to enforce the rule, is asking the S.E.C. to modify it, but will not say if the securities could be listed without changing the rule.

Those who are issuing the securities would love to see the parts of the puzzle trade at a total price higher than the shares they replaced, and would like it even more if the market valuations of the pieces helped to push up the prices of the remaining shares. If that does happen, it would no doubt stimulate more companies to take similar steps. ■

LBOs

December 12, 1988

M E M O R A N D U M

TO: SENATOR DOLE

FROM: RICH BELAS
DENNIS SHEA

SUBJECT: LEVERAGED BUYOUTS -- UPDATE

Attached is a Washington Post article highlighting Congressional concern about the increasing number and size of leveraged buyouts. According to the article, this concern is bipartisan, although no clear consensus has emerged about the actual effects of these buyouts on the national economy or about what actions, if any, Congress should take to discourage them.

The article does suggest that two approaches are now receiving serious consideration. The first approach involves changes to the federal tax code that would seek to encourage equity financing by equalizing the tax treatment of debt and equity. The second approach is perhaps less far-reaching and politically explosive, involving changes to the federal securities laws that would be designed to expand existing protections for shareholders and corporate bondholders and to give the Securities and Exchange Commission greater regulatory authority over the tender offer process.

The Tax Code

As you know, the following changes to the tax code have been suggested:

- limiting the deductibility of interest on debt used in takeovers;
- granting to corporations a broad-based deduction for dividends paid to shareholders; and
- granting a corporate deduction only for dividends on stock that raises new capital -- i.e., either new public offerings of stock or additional stock issued by corporations to raise new funds.

The Federal Securities Laws

The following changes to the federal securities laws are also under consideration:

- o requiring the Securities and Exchange Commission to examine any tender offer for its potential impact on the viability and competitiveness of the target company after the tender offer is completed;

- o revising the insider trading laws to exclude corporate management from participating in a leveraged buyout of their own company;

- o revising the tender offer regulations to require that fairness opinions be provided by experts whose compensation is not related to whether the tender offer is ever carried out; and

- o requiring companies to provide more detailed disclosure to holders of existing corporate bonds on the potential impact of a leveraged buyout on the market value of these bonds.

Studies by the Securities and Exchange Commission

David Ruder, Chairman of the Securities and Exchange Commission, has instructed his staff to prepare a report on the use of high yield "junk bonds" in leveraged buyout transactions. This report should be released sometime in late December or early January.

Chairman Ruder has also asked his staff to investigate the effects of leveraged buyouts on the holders of existing corporate bonds. As you know, the market value of these bonds often drops precipitously as a result of the additional debt undertaken in a leveraged buyout. For example, the market value of RJR Nabisco's $5 billion in highly rated corporate bonds has dropped by 20%.

Shaky Leveraged Buyouts

The Wall Street Journal recently published a list of 10 "shaky leveraged buyouts." According to the Journal, financial analysts believe that the companies acquired in these buyouts could default on their existing debt if the economy were to fall into a recession. The companies cited by the Journal include Trans World Airlines, Allied Stores Corp., and Southland Corporation.

Washington Post
Sunday, December 11, 1988

Puzzled Lawmakers Set Their Sights on LBOs

Question of What to Do, If Anything, Troubles Hill

By Albert B. Crenshaw
Washington Post Staff Writer

Fred L. Hartley, the chairman of Unocal Corp., is sending out Christmas cards with an unusual end-of-the-year message: He wants leveraged buyouts to take a permanent holiday.

"If Christmas in the year 2000 is to be as joyful as those you and I have shared, this country must curtail LBOs and other destructive business activities," the card says. "There is no worse gift we can leave our children and grandchildren than to mortgage American's economic future with this sort of shortsighted activity. Best wishes for the coming year."

It's a message many in corporate America, from the executive suite to the factory floor, are sending out to all who will listen. And, not surprisingly, it is reaching ears on Capitol Hill, where many have noticed the recent wave of takeovers, mergers and LBOs.

"It would be difficult to overstate the amount of concern there is in Washington about leveraged buyouts, junk bonds and the pace of replacing corporate equity with debt," House Ways and Means Committee Chairman Dan Rostenkowski (D-Ill.) said last week.

In the view of Rep. Edward J. Markey (D-Mass.), chairman of the telecommunications and finance subcommittee, "There is something seriously wrong when there is more of an incentive for corporate managers to liquidate their own companies for their own personal gain than there is for them to make the company more competitive."

But on the question of how to stop the wave of mergers—indeed, even whether it is desirable to do so—the rhetoric is no more specific than Hartley's. The members are plainly puzzled.

After noting the intense concern in Washington, Rostenkowski quickly backpedaled: "At the same time, it would be equally difficult to define that concern with any precision." At the moment, he said, there is only "a general sense of uneasiness, a feeling that

See LBOs, K4, Col. 3

LBOs, From K1

very big, perhaps irreversible, events are now occurring that will have an undetermined major impact when interest rates rise or the economy starts to sag."

Rostenkowski's tax-writing counterpart in the Senate, Finance Committee Chairman Lloyd Bentsen (D-Tex.), is similarly worried about the proliferation of debt-laden deals, but is also "well aware of the difficulty of devising a solution that doesn't create a worse problem," an aide said.

Legislators are well aware of the jumpiness of the financial markets, and no one on Capitol Hill wants to cause a rerun of last October's stock market crash—or worse, be blamed for one if it happens. They recall only too clearly that a tax bill passed by the Ways and Means panel just before the crash included a provision designed to limit tax breaks for mergers and LBOs—a provision that was blamed by some for the slump.

Consequently, lawmakers are proceeding very gingerly. Hearings too numerous to count are being scheduled for the early days of the 101st Congress, and to a much larger extent than usual, the senators and representatives holding them really want whatever wisdom the witnesses may be able to supply.

Rep. Byron L. Dorgan (D-N.D.), a Ways and Means Committee member, said he and Rep. Michael G. Oxley (R-Ohio) of the telecommunications and finance panel are attempting to put together a forum of members of Congress interested in the subject, with an eye to coordinating the normally independent-acting panels.

Said Dorgan, "My hope is get a group of people who are concerned together and analyze what our alternatives are, and maybe bring in some . . . business folks and academics and really understand what to do and how to do it. I don't think we ought to rush off and do something that might make matters worse."

In the meantime, staffs on both sides of the Hill and both sides of the aisle are hard at work playing "what if" games with law and regulation.

The main avenues being explored are the tax system and the nation's securities laws. In addition, the banking panels on both sides of Capitol Hill are examining the role of banks in the megadeals, worrying that widespread defaults by debt-burdened companies could endanger the banking system.

On the tax side, two broad options are being explored:

- Limiting the deductibility of interest on debt used in takeovers;
- Allowing some type of deduction to corporations for stock dividends paid to shareholders.

There is general agreement that, as Rostenkowski put it, "tax policy is subsidizing this troubling trend." By allowing corporations to deduct interest costs but not dividend payments, the system creates a bias toward debt financing, according to this reasoning. Thus, it is thought, equalizing tax treatment of the two might do much to reduce the attractiveness of debt to corporate managers and raiders.

In the securities law area, a variety of approaches is being discussed. Among them:

- Placing new restrictions on tender offers;
- Expanding protections for existing stockholders and bondholders;
- Requiring the Securities and Exchange Commission to review all deals over a certain size for their potential impact on the companies involved and the overall economy.

And on the banking side, ideas under scrutiny include requiring the Federal Reserve Board, the Federal Deposit Insurance Corp. or the Comptroller of the Currency to review banks' participation in heavily leveraged deals to try to make sure that neither individual banks nor the system as a whole become overloaded with that kind of debt.

THE WASHINGTON POST

Legislators in Quandary Over LBOs

Concern about LBOs cuts across both parties and from liberal to conservative. Sen. William L. Armstrong (R-Colo.), generally opposed to government interference with business activities, said he doesn't "believe the system is seriously out of kilter," but added that "some reforms are needed."

Nonetheless, several members said they expect any attempt to restrict these deals to meet fierce opposition.

Dorgan said he has figures showing that $225 billion worth of mergers and acquisitions last year generated $7 billion in fees and commissions, so "these dealmakers have got seven billion reasons why they want Congress not to do anything."

The restriction on interest deductions in the House's 1987 tax bill, for instance, was the object of intense business lobbying against it before it was removed during negotiations with the Senate.

Nonetheless, using the tax code to curb the deals is getting the most public attention, perhaps because it seems easier to understand.

Viewed through the prism of the tax system, the problem is a built-in slant in favor of debt financing. Corporate dividends are paid by corporations from after-tax income, and then are taxed again when the stockholder receives them and reports them as income. Interest, on the other hand, is deductible to the corporation (though taxable to the lender).

To ease the difference, one congressional expert said, "you can level the playing field up or you can level it down," meaning that Congress could restrict the interest deduction or, instead, it could grant some deduction to corporations for dividends paid.

Restricting the interest deduction has much conceptual appeal, and it would raise some revenue. But there are some important practical and political problems.

Staff members studying this approach note that Congress does not want to interfere with corporations that borrow for constructive purposes. A restriction that is too broad might do just that, but anything less might not be effective, given Wall Street's ingenuity, they said.

In addition, this kind of restriction might give an unfair advantage to foreign investors, who could still deduct their borrowing costs at home, thus further fueling the acquisition of U.S. assets by foreigners.

To go the other way—granting some deduction for the payment of dividends, an approach favored by Armstrong—meets those objections, but would cause a large loss of revenue for the Treasury. The figures being used in these discussions show that for every 1 percent of dividends that become deductible, $500 million disappears from federal revenue.

A less costly proposal would grant a corporate deduction only for dividends on stock that raises new capital—either new public offerings or additional stock issued by corporations to raise new funds. In one approach, both new equity and debt would be deductible but only for a certain period, allowing a company time to achieve a reasonable rate of return but without granting a permanent benefit.

Changes in securities law or regulation have the advantage of not threatening to increase the federal deficit.

Requiring SEC review of deals over a certain size is an idea getting serious thought. Under one version, the SEC would be required to examine any tender offer for its potential impact on the resulting company's viability and competitiveness, as well as its treatment of existing stockholders and bondholders.

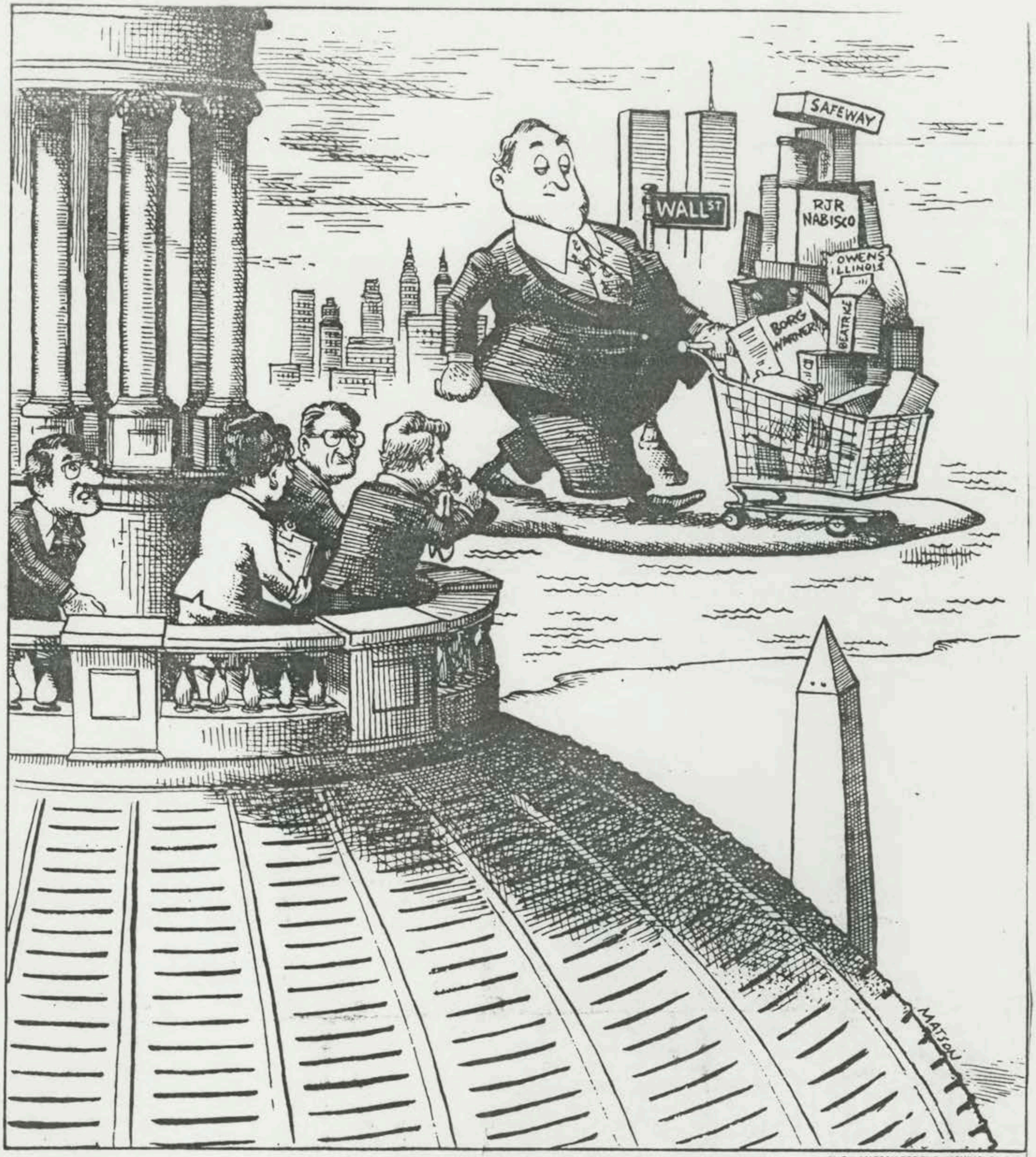
There have been complaints that when companies load up on high-risk debt, holders of corporate bonds issued previously, which may have been very highly rated, are hurt as their bonds become riskier and their prices fall. Earlier this month, SEC Chairman David S. Ruder said he has ordered the agency's staff to investigate whether bondholders have been getting adequate warnings about what could happen to their investments in the event of a buyout.

Another idea would be to revise insider trading laws so as to exclude management from participating in LBOs. The theory here is that management always knows far better than anyone else what a company is worth, so that it always has an unfair advantage in bidding for the concern.

Other, less sweeping, changes might produce the desired effect without overdoing it.

Revising the requirements for "fairness letters" would help, according to some thinking. These are letters from investment banks retained by the company to stockholders affirming that an offer is fair. But the investment banks writing them usually get a bigger fee if the deal goes through—an irreconcilable conflict of interest, some say.

Such conflicts might be eased if the government required that fairness opinions be provided by experts not involved in the deal, and whose compensation is not related to whether the deal works out, experts said.



BY R.J. MATSON FOR THE WASHINGTON POST

December 12, 1988

M E M O R A N D U M

TO: SENATOR DOLE

FROM: DENNIS SHEA

SUBJECT: TALKING POINTS ON LEVERAGED BUYOUTS

In preparation for your upcoming meeting with John Phelan, Chairman and Chief Executive Officer of the New York Stock Exchange, I have prepared the following talking points on leveraged buyouts.

- LAST WEEK, RJR NABISCO CO., MAKERS OF OREO COOKIES, ANIMAL CRACKERS AND OTHER POPULAR FOOD PRODUCTS AND ONE OF AMERICA'S GREAT COMPANIES, WAS SOLD TO THE LEVERAGED BUYOUT FIRM OF KOHLBERG KRAVIS ROBERTS & CO. FOR A MIND-BOGGLING $25 BILLION.

- THE STAGGERING AMOUNT OF DEBT INVOLVED IN THE RJR NABISCO BUYOUT -- OVER $22 BILLION BY SOME ACCOUNTS -- HAS FOCUSED CONGRESSIONAL ATTENTION ON LEVERAGED BUYOUTS AND ON THE RISING LEVELS OF DEBT UNDERTAKEN BY AMERICAN COMPANIES.

- THE SO-CALLED "LEVERAGING OF AMERICA" HAS ALSO BEEN WIDELY DOCUMENTED IN BOTH THE FINANCIAL AND POPULAR PRESS: OVER THE PAST SIX YEARS, FOR EXAMPLE, TOTAL OUTSTANDING CORPORATE DEBT HAS CLIMBED FROM ABOUT $1 TRILLION TO ALMOST $1.8 TRILLION. IN THE SECOND QUARTER OF 1988 ALONE, NET INTEREST EXPENSE ATE UP MORE THAN 20% OF CORPORATE CASH FLOW. ONLY TWICE SINCE THE END OF WORLD WAR II HAS THE INTEREST BURDEN BEEN GREATER: IN 1972 AND 1982, WHEN INTEREST RATES SOARED TO UNPRECEDENTED LEVELS AND THE U.S. ECONOMY WAS BOGGED DOWN IN A RECESSION.

- I BELIEVE THAT CONGRESS, CORPORATE AMERICA, AND THE AMERICAN PEOPLE SHOULD BE CONCERNED.

o BECAUSE OF THIS CONCERN, I RECENTLY SUGGESTED THE POSSIBILITY OF LIMITING THE INTEREST DEDUCTION ON CERTAIN TYPES OF CORPORATE DEBT. ALTHOUGH SOME OF US WOULD DISAGREE WITH THIS SUGGESTION, IT IS CLEAR THAT THE INTEREST DEDUCTION HAS HAD THE EFFECT OF MAKING DEBT CHEAPER THAN EQUITY AS A MEANS OF FINANCING CORPORATE ACQUISITIONS. NOT ONLY DOES EXCESSIVE DEBT FINANCING DISCOURAGE EQUITY INVESTMENT IN AMERICAN COMPANIES BUT IT MAY ALSO RESULT IN HUGE CORPORATE TAX SAVINGS AT THE EXPENSE OF THE U.S. TREASURY AND THE AVERAGE AMERICAN TAXPAYER.

o MANY ON WALL STREET JUSTLY FEAR THAT CONGRESS WILL ACT HASTILY, ENACTING ILL-CONCEIVED LEGISLATION WHOSE CURE WOULD HURT, RATHER THAN HEAL, THE PATIENT.

o BUT THESE FEARS SHOULD NOT DISCOURAGE CONGRESS FROM SEEKING ANSWERS TO THE FUNDAMENTAL QUESTIONS THAT HAVE BEEN RAISED BY CORPORATE AMERICA'S RECENT INFATUATION WITH THE LEVERAGED BUYOUT: ARE THE DEBT BURDENS UNDERTAKEN BY AMERICAN COMPANIES GOOD OR BAD FOR THE HEALTH OF THE AMERICAN ECONOMY? WHAT EFFECT WILL AN ECONOMIC DOWNTURN HAVE ON THE ABILITY OF HIGHLY LEVERAGED COMPANIES TO SERVICE THEIR DEBT PAYMENTS?

- I DON'T KNOW THE ANSWERS TO THESE QUESTIONS AND I THINK THAT THERE ARE FEW OF US IN CONGRESS OR ON WALL STREET WHO DO. BUT THIS SHOULD NOT DETER US FROM SEEKING OUT ANSWERS TO THESE AND OTHER QUESTIONS, AND FROM FINDING LEGISLATIVE SOLUTIONS IF SUCH SOLUTIONS ARE INDEED APPROPRIATE.

- ALTHOUGH I WOULD NOT ADVOCATE ANY SPECIFIC PROPOSALS AT THIS TIME, I BELIEVE THAT THE NEXT CONGRESS SHOULD SPONSOR HEARINGS ON LEVERAGED BUYOUTS IN ORDER TO DETERMINE THEIR ACTUAL AND POTENTIAL EFFECTS ON OUR ECONOMY.

FSLIC

December 13, 1988

TO: SENATOR DOLE

FROM: DAVID TAYLOR

SUBJECT: Talking Points on FSLIC and Banking Reform

FSLIC:

O WITH THE ELECTION OF A NEW SENATE MAJORITY LEADER, NEW CHAIRMEN APPOINTED TO BOTH BANKING COMMITTEES -- DON RIEGLE IN THE SENATE AND HENRY GONZALEZ IN THE HOUSE -- AND A NEW CHAIRMAN ON THE FINANCIAL INSTITUTIONS SUBCOMMITTEE IN THE HOUSE (FRANK ANNUNZIO), IT MAY TAKE SOME TIME BEFORE CONGRESS IS PREPARED TO DEAL WITH THE FSLIC ISSUE.

O THE BUDGETARY TREATMENT OF ANY FINANCING MECHANISM PROPOSED TO DEAL WITH THE SAVINGS AND LOAN ISSUE WILL BE A MAJOR ISSUE IN THE MONTHS AHEAD. ON THE SENATE SIDE, BOTH THE BUDGET COMMITTEE AND THE FINANCE COMMITTEE ARE EXPECTED TO PARTICIPATE IN THIS DEBATE.

O WITH RESPECT TO THRIFTS, IT SEEMS TO ME THAT CONGRESS HAS TO ANSWER TWO BASIC QUESTIONS. 1) HOW DO WE FINANCE AID TO THE SAVINGS AND LOAN INDUSTRY, AND 2) HOW CAN WE PREVENT THE RECURRENCE OF ANOTHER FSLIC CRISIS?

- O BECAUSE THE FSLIC PROBLEM CONTINUES TO GROW AT SUCH AN ALARMING RATE -- $1 BILLION PER MONTH, IT SEEMS TO ME THAT DECIDING HOW TO FINANCE FSLIC SHOULD BE OUR FIRST PRIORITY. LEGISLATION DESIGNED TO PREVENT THE RECURRENCE OF ANOTHER CRISIS INVOLVING FEDERALLY-INSURED DEPOSITS WILL PROBABLY TAKE MORE TIME.

- O THIS IS NOT TO SAY THAT THE SAVINGS AND LOAN INDUSTRY CAN EXPECT FEDERAL MONEY WITH NO STRINGS ATTACHED. THERE IS A GROWING CONSENSUS ON CAPITOL HILL THAT SOMETHING MUST BE DONE TO LIMIT THRIFT ACTIVITIES IN CERTAIN AREAS, AND IT IS REASONABLE TO EXPECT THAT SOME RESTRICTIONS WILL BE INCLUDED IN ANY THRIFT AID PACKAGE.

- O A NUMBER OF POTENTIAL FINANCING MECHANISMS ARE BEING DISCUSSED AS OPTIONS. THOSE RECEIVING THE MOST ATTENTION ARE DESIGNED TO REMAIN AT LEAST PARTIALLY OFF-BUDGET. RIGHT NOW, WE ARE WAITING FOR THE TREASURY DEPARTMENT TO UNVEIL ITS PLAN FOR FSLIC. IT IS MY UNDERSTANDING THAT SECRETARY BRADY'S TIMETABLE PROJECTS RELEASE BY EARLY FEBRUARY.

- O LAST WEEK, CHAIRMAN ROSTENKOWSKI ANNOUNCED THAT THE HOUSE WAYS & MEANS COMMITTEE WILL SCHEDULE HEARINGS ON THE BUDGETARY IMPLICATIONS OF THE PROBLEMS FACING THE SAVINGS AND LOAN INDUSTRY. THESE HEARINGS WILL LIKELY DRAW ATTENTION TO THE AMOUNT OF TAX SUBSIDY CURRENTLY USED BY THE BANK BOARD IN RESOLVING CASES INVOLVING TROUBLED OR INSOLVENT THRIFTS.

- IN MY VIEW, THE ADMINISTRATION'S PLAN WILL BE THE STARTING POINT OF ANY LEGISLATIVE SOLUTION TO THE FSLIC PROBLEM. MY HOPE IS THAT THE TREASURY DEPARTMENT WILL MOVE QUICKLY SO THAT WE CAN BEGIN DISCUSSING POSSIBLE SOLUTIONS IN THE NEAR FUTURE.

BANKING REFORM:

- AS YOU ALL KNOW, BANKING REFORM RESURFACED AS THE 100TH CONGRESS DREW TO A CLOSE. WITH NEW LEADERSHIP AT THE COMMITTEE LEVEL IN BOTH HOUSES AND THE THRIFT INDUSTRY SPLATTERED ALL OVER THE FINANCIAL PAGE, IT SEEMS TO ME THAT BANKING REFORM WILL HAVE TO TAKE A BACK SEAT TO THE S&L ISSUE, AT LEAST FOR A WHILE.

- WITH FSLIC SUCH A PROMINENT CONCERN THIS YEAR, BANKS SHOULD NOT RELY ON THE HILL AS A SOURCE OF EXPANDED BANK POWERS. IN FACT, THE FSLIC ISSUE MAY EVEN GENERATE LEGISLATION THAT ACTUALLY LIMITS BANK POWERS.