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News Release

Remarks of

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A CHANGING ENVIRONMENT FOR INVESTMENT COMPANIES

The views expressed herein are those of Chairman Ruder and do not necessarily reflect those of the Commission, other Commissioners or the staff.

I. The Investment Management Industry

Good Morning! It's a real pleasure to be here, in sunny Tucson, at the 23rd Annual Mutual Funds and Investment Advisers Conference. As the size and great success of this conference shows, the investment company and adviser industry has grown enormously over the past 23 years. Today, it is one of the largest and most successful sectors of the financial services industry, with responsibility for managing the pension and other investments of many millions of Americans.

Investment management is a unique business under the law. It is a business of trust, and those in the business are held to the highest standards of loyalty and care to their clients. Investor confidence in the investment management industry is high, and this confidence has been earned through many years of hard work, excellent service, and strict adherence to fiduciary standards.

As you are well aware, the services provided by investment companies and professional money managers are extremely important to individual Americans who don't have the sophistication, information, or access needed to represent themselves effectively in today's markets. Mutual funds, unit trusts, variable life insurance, and closed-end investment companies have become the vehicles through which more and more ordinary people choose to participate in the securities markets. They also give small investors a chance to participate in investment opportunities previously limited to large investors, such as municipal bonds, money market instruments, and foreign securities.

The environment in which investment companies and advisers operate has changed dramatically, and will continue to change and become more competitive. The trading markets both here and abroad have also undergone major changes, with the introduction of new products and new trading techniques. Our awareness of the scope of those changes was brought home forcefully last October. The securities markets are now international markets. This means increased investment opportunities in foreign securities for U.S. money managers and an opportunity to reach new customers overseas. It also means increased competition from foreign firms for U.S. investors' dollars. An additional development is that it now appears likely that commercial banks will become full fledged competitors in the securities industry, as Congress moves to eliminate the last vestiges of the Glass-Steagall Act. All of these changes provide both challenges and new opportunities. These three developments - (1) the October market break and its aftermath, (2) internationalization, and (3) proposed repeal of Glass-Steagall - seem to me to be of particular significance.

II. The October Market Break

I know that the stock market break of last October, as well as market conditions since then, are of great concern to all of us. The Commission staff has completed a detailed study of the events of last October and the Commission is engaged in efforts to make our markets more efficient and orderly. If you have been reading recent press reports, you may think that all we have done is to launch a hostile takeover for the CFTC. Let me assure you that our primary endeavor is to seek cooperative solutions to our regulatory problems.

Understanding our current markets requires an understanding of recent changes in institutional investment activity. During the last decade, institutions, including investment companies, have amassed ever larger portfolios of equity securities. Increasingly, institutions want to trade all or a portion of their portfolios, not just individual securities. The creation of index options and futures made it possible, and relatively cheap, to buy or sell the equivalent of a portfolio of securities. Use of the New York Stock Exchange's automated Designated Order Turnaround system, called DOT, has also made it possible to directly buy or sell at the same time an entire portfolio or "basket" of stocks.

Prior to October 19th, some institutions were using sophisticated index arbitrage and portfolio insurance strategies. Index arbitrage is the purchase (or sale) of stocks that comprise an index and the simultaneous sale (or purchase) of futures or options on that index. The purpose is to capture the difference between the value of the index and the collective value of the portfolio of stocks comprising the index. Arbitrage usually reduces differences in prices between the stock index futures and stock markets by pushing up prices in the market where the buying occurs and pushing down prices where the selling occurs. By helping to achieve closer price correlations between the stock index futures and stock markets, arbitrage facilitates the use of futures to protect or "hedge" the value of stock portfolios. The most obvious hedging techniques involving futures is the sale of a stock index future by the owner of a portfolio of stocks. The stock index futures position will increase in value as the prices of the underlying stocks decline, thus protecting the portfolio owner against market decreases without requiring the sale of the portfolio securities.

"Portfolio insurance" is a hedging strategy that was in widespread use before the October market break. Under one version of this strategy, stock index futures are sold when the value of the portfolio decreases a certain percentage. The sales of futures are thought to be less costly and quicker than the sale of stocks, offering a way of controlling risk for a broad-based portfolio in a declining market. If the futures markets become congested and too costly, some portfolio insurance plans call for the sales of stock instead of futures.

With this as background, let me describe the markets of last October. During the week before October 19, so-called Black Monday, the Dow Jones Industrial Average dropped 250 points. On Friday, October 16, the stock market had its first triple-digit loss, as the Dow declined 108 points on then-record volume of 344 million shares. Then, on Monday, October 19, the Dow fell 508 points on volume of more than 600 million shares. On October 20, volume also exceeded 600 million shares, in an extremely volatile market. On the 20th, the market rallied to close up 103 points, but only after a mid-day crisis during which the Dow dropped to a 1987 low of 1,708, more than 1,000 points and 37 percent below the August 25, 1987 all-time high of 2,722. During this mid-day period, a large number of blue chip stocks were closed for trading on the New York Stock Exchange, with large imbalances on the sell side.

What caused the market break? According to the Presidential Task Force on Market Mechanisms, selling during the week of October 12th was triggered primarily by "disappointingly poor merchandise trade figures, which put downward pressure on the dollar in currency markets and upward pressure on long term interest rates; and the filing of anti-takeover tax legislation...." 1/

These factors, with other economic news and the Friday stock price decline, created great selling pressure on Monday, October 19th. This pressure was exacerbated on the 19th and 20th by large stock and futures sales by institutions pursuing a variety of arbitrage and portfolio insurance strategies. During certain critical trading periods on the 19th and 20th, index arbitrage or portfolio insurance, or both, accounted for between 30% and 65% of total New York Stock Exchange volume in the stocks that comprise the S&P 500 index. These figures lead to the conclusion that on October 19th and 20th, institutions holding multi-billion

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1/ Report of Presidential Task Force on Market Mechanisms, p. 29 (January 1988).

dollar portfolios simultaneously pursued similar strategies in a declining market, causing a rush for the exits that accelerated the decline and most probably extended it beyond levels that can be accounted for by fundamental economic factors alone.

Extreme stock price volatility continued through the end of October. While the markets are more stable now than last October, they remain more volatile than before the market crash, as the 140 point loss on January 8, 1988, vividly demonstrated.

Based on the detailed study of the market break made by our Division of Market Regulation, the Commission believes that our securities market is a linked market, formed by stock index futures, stock index options, and stocks. Further, we believe that, under current conditions, new institutional trading mechanisms and strategies in this linked market can cause extraordinary peak volume and volatility.

The Commission has recommended three broad approaches for reform of the markets: (1) expanding the capacities of the markets; (2) increasing the coordination among the markets; and (3) retarding the volatility and volume of trading during crisis periods.

We intend to emphasize the first two: that is, expanding the capacities of our markets and increasing intermarket coordination in order to make the interlinked market more efficient. We believe that, in normal times, the derivative index markets perform an important economic function. They provide a means by which institutions may adjust their portfolio positions quickly and efficiently. We do acknowledge, however, that steps need to be taken in the near term to decrease liquidity demands and avoid the selling excesses that have caused such unusual volume and volatility.

What specific steps can we take to expand the capacities of this new unified, and often turbulent, market? First, we can enhance the ability of our markets to handle trading volume surges.

The key to this improvement will be the expansion of the stock exchange systems that receive orders electronically from brokerage firms and in some cases execute these orders automatically, so that markets do not falter during peak volume periods due to lack of physical capacity.

In a sense, the advent of automated trading systems for stocks has increased risks for our markets, because when automation breaks down the entire market is affected. I am pleased to report that a number of the stock exchanges already have increased the number of trades their automatic order routing and execution systems can accommodate. Newly established communication links between the stock, options, and futures exchanges also will enhance information exchange about market conditions.

At the same time, investment companies must take steps to improve their communication systems. Investor complaints about inability to communicate with funds during the week of October 19th are well known. Improvements are being made in investor communication facilities in your industry, and I applaud this progress.

A second important step is to increase the amount of market making capital available in the securities markets. Among other measures in this area, the Commission is:

1) Examining the need to increase minimum specialist capital requirements;

2) Encouraging market participants, including specialists, to review with their bankers the availability of additional liquid funds in emergency situations;

3) Consulting with the Federal Reserve Board and the CFTC regarding capital availability for the stock, options, and futures markets; and

4) Suggesting that the New York Stock Exchange consider creating special areas on its floor for the trading of entire baskets of stocks in order to relieve some of the strain on the specialists responsible for trading individual stocks.

Even after the capacities and capital of our integrated markets are enhanced, there still may be times when market mechanisms are under severe strain. The Commission is considering measures designed to retard the increased velocity and concentration of inter- and intra-market trading that in turn has increased the probability of wild price swings.

One approach to the volatility problem is to recognize that the increased intensity of market trading is due in part to the greater leverage of futures products. With low margins, large stock index futures positions can be established with a relatively small capital infusion, and then can be liquidated very quickly. In addition, the futures markets do not require physical settlement and do not have the short sale restrictions that exist in the stock markets.

One method of slowing the futures market, retarding excessive accumulations of futures positions, and reducing liquidity expectations would be to raise initial margins on stock index futures for non-market makers. The Commission has recommended that, at least temporarily, these margins be raised to levels harmonious with stock margin levels applicable to stock market professionals. This would mean initial futures margins of 20 to 25 percent instead of the current level of approximately 13 percent.

Other means of coping with market volatility have been suggested. The Commission currently has before it a rule proposal giving the New York Stock Exchange power to close its DOT systems to program trading in volatile markets. Other solutions suggested in the various reports include imposing price limits in the futures markets, establishing procedures for coordinated inter-market trading halts, and delaying futures market openings until the stock markets are open. These topics and others offer a broad range of choice to deal with market problems. I fervently hope that voluntary solutions can be achieved by interagency cooperation.

III. International Markets

Thus far, I have discussed only our domestic markets. The October market turbulence was not limited to the U.S., but was a worldwide phenomenon. The world's major stock markets all experienced downturns similar in scale to those in the U.S. The October market break pointed clearly to the emergence of a truly global market, and any examination of the extent to which today's markets are interconnected must include recognition that those connections also extend across national boundaries.

International automation of quotation, routing, execution, clearance, and settlement systems are inevitable, and the time has come to increase efforts toward a coordinated global market regulatory system.

Two weeks ago I was in London where I had constructive conversations with U.K. regulatory officials about the need for greater coordination, and participated in a conference on international clearance and settlement. In February I travelled to Tokyo where I had similar conversations with Japanese officials about cooperation and coordination. I believe the key to sound international capital markets is to adapt the best rules and policies of all nations to new market structures and trading strategies. In that regard, I believe that international market regulation should address questions regarding: disclosure standards; prohibitions against fraudulent activities; availability of quotation and price information; efficient and compatible national and international custody, clearance and settlement systems; broker-dealer qualifications and conduct; capital adequacy; and international surveillance and enforcement agreements. All of these areas are of current concern to the Commission.

Within an international framework it is, of course, also true that investment companies and investment advisers play a key role in the increasing global securities markets. Today, there are over 100 U.S. funds, both open and closed-end, with more than $22 billion in assets, that invest principally in foreign securities. These funds have made foreign investing practical and popular with individual investors. We are also witnessing the growth of foreign competition within the United States. More than 200 foreign firms are registered with the Commission as investment advisers. Many advise ERISA accounts regarding foreign portfolio investments and some act as advisers or subadvisers to our new foreign portfolio funds.

So far, only five foreign investment companies proper are registered for sale to investors in the U.S., perhaps because Section 7(d) of the 1940 Act continues to serve as a barrier to entry. That section prohibits any investment company not organized in the U.S. from publicly offering securities unless it first obtains a Commission order reciting, among other things, that the provisions of the Investment Company Act can be effectively enforced against the foreign fund. This standard has been especially difficult for funds organized in civil, as opposed to common law, countries. In 1984 the Commission recommended legislation to amend Section 7(d) in order to make it easier for foreign funds to enter our markets. 2/ We are also exploring informally with Canada and members of the European Community the possibility of bilateral treaties for the reciprocal sale of investment company shares, a concept favored by the European Federation of Investment Companies and also of interest to the Japanese.

In the meantime, we are continuing to work closely with foreign regulators to share information, coordinate our rules, and cooperate in performing our regulatory oversight and enforcement tasks.

IV. Glass-Steagall Reforms

Major changes are also underway here at home through proposals to modify or repeal the Glass-Steagall Act. These changes are likely to affect your industry by permitting banks to engage in securities activities. I am pleased to say that it seems likely that if Glass-Steagall reform occurs, compromises reached with the banking regulators will result in continuance of investor protections.

The walls of Glass-Steagall have been under assault for some time and banks have made many inroads into the securities business without being subject to regulation under the securities

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2/ *See* Memorandum of the Securities and Exchange Commission in Support of the Operating Foreign Investment Company Amendments Act of 1984, submitted to Congress with the approval by the Commission in conjunction with the issuance of Investment Company Act Release No. 13691 (December 23, 1983). Although submitted to Congress, the proposed legislation has not been introduced.

laws. For example, banks are now underwriting and dealing in commercial paper, U.S. government securities, and asset-backed securities. They are sponsoring real estate investment trusts (REITs), and engaging in private placements of corporate debt, loan participations and sales, and interest rate and currency swaps. Moreover, Glass-Steagall applies only to activities within the United States. Banks are aggressively pursuing securities activities abroad, such as underwriting and dealing in corporate debt and equity. In the area that concerns you the most, banks, as a practical matter, are already widely marketing mutual funds and unit trusts to their depositors. Glass-Steagall once was thought to be a complete barrier to such activities, but today it is a barrier full of gaping holes.

In December, I testified before the House and Senate Banking Committees regarding proposed legislation that would repeal the Glass-Steagall Act. I stated that the Commission could not support repeal of the Glass-Steagall Act unless the investor protection concerns arising from increased bank securities activities are simultaneously addressed. To ensure investor protection, I said that bank securities activities must be subject to Commission regulation.

I also testified that if banks are permitted to underwrite and distribute investment company securities, the Investment Company Act and the Investment Advisers Act must be amended so that the protections of those acts are applied to banks. Because those two acts were drafted in the context of the separation between banking and securities mandated by Glass-Steagall, they do not adequately address the investor protection concerns that will arise if banks are permitted to engage generally in the investment company business.

At Senator Proxmire's request, the Commission staff met with the Federal bank regulators to draft legislative language addressing the Commission's investor protection concerns. The compromise reached was included in the version of S.1886, the Glass-Steagall reform bill sponsored by Senators Proxmire and Garn, that was approved on March 2nd by the Senate Banking Committee.

Under the compromise, banks would be required to conduct securities activities through broker-dealer subsidiaries or affiliates, with certain exceptions:

First, a bank could conduct primary private placements, so long as sales were limited to certain types of institutions and to individuals with a net worth over $5 million.

Second, a bank could effect transactions for its traditional trust accounts unless it both solicited brokerage and received transaction-related compensation. For other bank fiduciary accounts, such as managed agency accounts, securities safekeeping accounts, and self-directed IRAs, a bank could provide brokerage only if it neither solicited brokerage nor received transaction-related compensation.

Third, a bank could engage in municipal revenue bond activities, but a bank with a securities affiliate would be required to conduct both general obligation and municipal revenue bond underwriting in a registered broker-dealer.

Fourth, there would also be exceptions from securities regulation for networking arrangements with broker-dealers, sweep accounts, transactions for employee benefit plans and for a bank's affiliates, and for banks that effected fewer than 1,000 transactions per year.

In the investment company area, the compromise contains the following provisions:

First, banks that advise mutual funds would be required to register with the Commission as investment advisers and to be subject to Commission regulation and inspections. A bank, however, could register a separate department or division as an adviser.

Second, banks' custody and lending arrangements with affiliated investment companies would be permitted only in accordance with rules adopted by the Commission.

Third, investment companies would be precluded from purchasing securities in an underwriting where some or all of the proceeds would go to repay a borrowing from an affiliated bank entity, except that such activity could take place in conformity with Commission regulations.

Fourth, the standards for eligibility as independent directors would be tightened by defining affiliated bank officers, directors, and employees of banks that provide services to a fund as "interested persons."

Fifth, the Commission would be given express additional authority to require disclosure concerning the absence of Federal deposit insurance for mutual funds.

The Commission now supports repeal of the Glass-Steagall Act, if it is accompanied by the investor protection amendments to S.1886 worked out in the compromise between the Commission and the Federal banking agencies. Under these conditions, the Commission believes Glass-Steagall reform will lead to increased competition in the financial services industry, without diminishing important investor protections.

Now you may wonder why in the world the SEC Chairman supports repeal of Glass-Steagall. Well, for starters, we think investors will be better protected with the compromise legislation we worked out than by continuation of the _de facto_ circumvention and creative regulatory interpretation that has eroded Glass-Steagall. To my mind, it has not been a healthy development for the Commission to lose control over the banking segment of the securities industry -- not healthy, that is, if you want securities regulation to do the job intended by Congress.

In short, either with us or without us, with the blessing of the Congress or without it, Glass-Steagall is likely to crumble. The Commission is seeking to have the event occur in a sensible way, for the benefit of investors. I urge you to do the same -- to focus on the larger, public policy issues, and help to make sure that the changes are sound and provide protection to investors.

V. Conclusion

Changed market conditions and increased competition at home and abroad will increase both the opportunities and challenges faced by the investment company and adviser industry. As the securities markets become more complex and international in scope, as trading and investment strategies become more sophisticated, as information processing and analysis become dominated by automation and expertise, investors will continue to seek out professional money management services. They will look to investment companies and advisers to help them cope with today's volatile markets, where speed and immediate access are critical.

This industry has an enviable record of innovation and quality service to investors. It is a well-run industry, and we like to think it is well-regulated, too. It is well positioned to meet and beat the competition in the coming years. The key will be maintenance of investor confidence and trust. That is best achieved, as it has been to date, by hard work, excellent service, and strict adherence to fiduciary standards.