Remarks Of

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"Various Securities Issue Developments"

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"Various Securities Issue Developments"

I. Introduction

I appreciate the opportunity to address this APIC conference concerning some current issues involving the investment consultant community. I plan to touch upon such diverse issues as the need for continuing investment consultant education, wrap fee programs, a recent development in the mutual fund area, derivative securities, and the Commission's enforcement program.

Given the upcoming Commission management change, it is difficult to be particularly forward looking concerning the Commission, although I will do my best. Obviously sound predictions in this area are elusive, and, at a minimum, one should remember the source when considering any predictions.

II. Education

The securities industry has witnessed and enjoyed the phenomenal growth of investor interest in the securities marketplace in recent times. Studies indicate that many new securities investors have different characteristics than more seasoned investors -- they are younger, with lower household income, less financial assets, and presumably less financial experience. This circumstance raises concerns regarding investor protection, investment suitability, and market liquidity.

The continuing education effort currently underway by the securities industry self-regulatory organizations should help alleviate these concerns to some extent. The development of a continuing education program for securities industry registered representatives and principals could help ensure the clear, understood communication of the risks of securities products to investors seeking both higher returns and safety. Certainly as securities firms expand sales activity into the area of derivative securities, the need for special training and qualification standards, sales and supervisory procedures, and adequate disclosure to investors becomes much greater.

I wish to challenge you today to stop and think about how best to educate your clients about the risks, as well as the rewards, of investing in various products, particularly the potential impact of interest rate changes on these investment products. By continuing to educate yourself, it should be much easier to educate your clients, which should help avoid future problems.

I suspect that this is why you are attending this conference today. I applaud you for attending and encourage the APIC to continue to hold such conferences. In the long run, I believe that it will redound to your benefit. More importantly, it is also the right thing to do.

III. Wrap Fee Programs

Since I understand that some of the members of this audience utilize wrap fee programs, I plan to take advantage of the moment to add my two cents on the subject. As you know, these programs are sponsored generally by broker-dealers who "wrap" together asset management, financial planning, and brokerage services together for one fee. Portfolio managers provide the actual asset management. These programs have already attracted between $80 and 90 billion in assets and appear to be growing at a steady pace.[1] In addition, these programs have attracted the attention of both the Commission and the Congress.[2]

The primary issue confronting the Commission is whether a wrap fee program is a de facto investment company that should be subject to the registration provisions of the Investment Company Act of 1940. Secondary issues involve conflicts of interest, whether customers are receiving appropriate disclosure, and whether the programs are being marketed to suitable investors.

In determining whether a wrap fee program is actually an investment company, and that participation in a wrap fee program is tantamount to a security, the critical factor is the individualism of the particular program. The failure to differentiate

among advisory clients, coupled with the general solicitation of advisory clients, could cause the program interests offered to be unregistered securities. If clients do not retain all the incidents of ownership of the securities purchased for their accounts (i.e., the ability to vote or pledge securities), the pool of nominally separate client accounts could be an unregistered investment company. One important aspect of individualized advice is the client's ability to place investment restrictions on his or her account.

Apart from the issue of whether wrap programs are de facto investment companies, there are concerns that wrap accounts present heightened conflict of interest situations, involving best execution requirements and principal transaction prohibitions. Unless clients receive disclosure and consent to directed brokerage, can an investment adviser satisfy the duty to obtain the best execution if its order flow is required to be sent to an affiliated broker-dealer? There is also the possibility of "double-dipping" when a portfolio manager places money with in-house mutual funds.

Another concern is suitability. First, wrap accounts are not suitable necessarily for all clients, especially those that want low turnover of their securities inventory. Second, the portfolio manager should have a reasonable basis for believing that the sponsor is sending suitable clients to the manager. To accomplish this, a manager could review the customer questionnaire on a periodic basis to insure that the customer's investment objectives are being satisfied by the manager.

The bottom line is that there are plenty of questions and not many ready answers. In my opinion, the Commission should provide greater guidance in the way of an interpretive release on the subject. Hopefully, such a release will be published in the near future. There may be some regulatory changes necessary as well, such as amendments to Part II of Form ADV which would require specific disclosure about wrap accounts. I anticipate that the Commission and its staff will continue to monitor

developments in the wrap fee area with interest until some formal guidance has been provided.

IV. Mutual Fund Developments

I also understand that some members of this audience have some interaction with the mutual fund industry. Given that interest, I thought I would take the opportunity to comment on a recent development in the mutual fund area involving one of your investment competitors -- bankers.

There has been tremendous growth in the bank proprietary mutual fund area. Bank-managed investment companies now contain about 15% of the investment company industry's total assets. It even has been reported recently that banks accounted for a whopping 30% of all mutual fund sales in the first six months of last year.[3]

The recent development I wish to mention is that the Federal Reserve Board ("Fed") has recently approved by order an application of Mellon Bank to acquire Boston Group Holdings and its subsidiaries. The order permits Mellon to provide administrative services to mutual funds through their subsidiaries. While this is the first time that the Fed has permitted a bank affiliate to provide such services to a fund, it is my understanding that banks have been providing these services for several years since the Comptroller by letter has permitted national banks to provide such services. The more significant issue raised by the Mellon order, however, was the discussion in the order of a fund's board of directors "controlling" the fund.

The Glass-Steagall Act currently prohibits a member bank from being affiliated with an entity (such as a mutual fund) that is engaged principally in the business of issuing, underwriting, or distributing securities.[4] A member bank subsidiary of a bank holding company is affiliated with any entity that the bank holding company controls "through stock ownership or otherwise."[5] Apparently the Fed has stated in the past, or

has at least implied, that a bank holding company that sponsors a fund, or underwrites or distributes its shares, controls that fund.[6] As a result, the Fed has not permitted bank holding companies or their subsidiaries to date to sponsor funds, or to underwrite or distribute fund shares.

The Fed noted in the Mellon order that a fund's board of directors, not its investment adviser or administrator, controls the fund. The Mellon order does not discuss the question of whether a fund's sponsor, underwriter, or distributor also controls the fund. Chairman Greenspan, in a recent letter to Chairman Dingell, stated that the Fed was not asked to, and did not, address the question of whether a mutual fund's distributor controls the fund or whether a Section 20 bank subsidiary can underwrite shares of a mutual fund.[7] Whether it will be easier for bank holding companies and banks to sponsor mutual funds, or to underwrite and to distribute fund shares, will depend on whether the Fed takes the position that the fund's board of directors exclusively controls the fund. While that remains to be seen, if the Fed were to take the position that the board of directors exclusively controls a mutual fund, then a bank holding company that sponsors a fund or underwrites or distributes the fund's shares would not control the fund. The bank holding company then would be free to sponsor funds and to underwrite or distribute fund shares through a subsidiary, provided that the subsidiary is not engaged principally in distributing, underwriting, or issuing securities.

As I have stated in the past, I believe that if bank holding companies and banks are permitted to sponsor mutual funds, or to underwrite or distribute their shares, and I believe that they should, the Investment Company Act of 1940 and the Investment Advisers Act of 1940 should be amended to address certain conflicts of interest.[8] The amendments that I have suggested as appropriate in the past include limits on the following investment company activities: (1) borrowing from affiliated banks, (2)

purchasing securities in an underwriting, the proceeds of which are to be used to retire debt owed by the issuer to a bank affiliated with the investment company, (3) using an affiliated bank as a custodian, and (4) retaining as investment adviser a bank which, acting as trustee for trust clients, owns a controlling interest in the investment company. In addition, the banks and bank holding companies acting as investment advisers to registered investment companies should be required in my opinion to register under the Advisers Act.

Assuming these potential conflict of interest situations are addressed satisfactorily, I welcome full bank entry into the mutual fund business. Thus far, in my view, bank presence in the mutual fund area has added more competition to that area which is a plus for investors as well as for the mutual fund industry. The securities marketplace has thrived as a result of securities industry competition. Assuming the issue of complete entry is handled appropriately, I see no reason why banks cannot contribute positively to that competition. In any event, I anticipate that bank involvement in the mutual fund area will continue to increase.

V. Derivative Securities

Explosive growth is not limited to the mutual fund area but is found in other investment areas as well. The fertile minds of market innovators have spawned a host of derivative securities bearing names such as PACs, TACs, IOs, POs, jump z bonds, inverse floaters, ricochet floaters, Strips and Pieces, and Tigrs and Cores. As one may expect, regulatory concern often accompanies securities industry innovation, especially when the result may be that complex securities are sold to retail customers.

With retail customers, the immediate concern with derivatives is in the area of suitability. When it is reported that sophisticated financial giants such as Merrill Lynch, Salomon Brothers, and J.P. Morgan lose millions of dollars trading in stripped mortgages, it makes one wonder whether some derivative securities have any business

in retail hands. I encourage the members of this audience to scrutinize carefully the placement of any potentially volatile derivative securities with retail customers. In the current low interest rate environment, many of these securities look attractive; however, should trends change abruptly in the future, there will invariably be some unhappy customers claiming that they should not have been sold these securities in the first place. The better your adherence to sound disclosure practices and to the appropriate suitability standards, the better off your firm will be when, and if, that day comes.

VI. Enforcement

Let me close with an overview of the Commission's enforcement priorities in the future. Of course, enforcement actions are often driven by external, unforeseen events, such as was the case with the line of government securities enforcement cases conducted last year. It is difficult to predict the next scandal lurking around the corner.

I do anticipate that the Commission will continue to focus on failure to supervise actions. The Salomon Brothers Section 21(a) Report issued last year by the Commission should have delivered that message. It also should be clear that the systemic abuse of retail investors, as has been demonstrated by the securities industry in the past, will not be tolerated by the Commission and will result in a failure to supervise enforcement action.

Along these lines, I do wish to mention something specifically about franchised securities industry branch offices. I continue to have concerns with the growth and formation of branch offices acting independently from the main office under so-called "Franchised Arrangements". These types of independent operations generally lack any real supervision and control by the registered broker-dealer, and because of the nature of their business activities (e.g., making markets independent of the registered broker-dealer, and paying commissions or salaries directly to salespersons), concerns are raised

about their legality and the need for these franchise operations to be registered as broker-dealers with the Commission. As a result of these concerns, I suspect that franchised branch offices will be the focus of some Commission enforcement attention in the future.

Moving on to the municipal bond area, I imagine that everyone here is aware of the numerous recent reports in the press of allegations that certain registered broker-dealers or their employees have made political contributions or entered into certain business ventures for the purpose of influencing the naming of their firm as an underwriter for municipal bond offerings.[9] The Commission's Division of Enforcement is analyzing specific situations, as well as the issue in general, consistent with the Commission's obligation to enforce the federal securities laws. Where possible violations of those laws may be indicated, it can be anticipated that the Division of Enforcement will request relevant information and pursue appropriate inquiries.

Potential issues in this area include the possible need for disclosure of payments made to obtain underwriting business, the allocation of underwriting business, and the resulting cost of the underwritings. This review is just beginning, so it is of course much too early to know even whether any federal securities law violations have occurred, much less the extent of the practices in question. However, I do anticipate that some enforcement activity will be generated from the municipal bond area.

In addition to the usual array of insider trading cases and cases involving misappropriation of client funds, I expect that the Commission will continue to expend enforcement resources ferreting out financial accounting fraud cases, like the MiniScribe action, and, to a lesser extent, on serious accounting violations not involving fraudulent conduct, such as those recently pursued by the Commission in the financial institution and investment company area. I also expect that the Commission will continue to bring scattered enforcement cases involving management, discussion, and

analysis disclosures when the facts so warrant. Further, under the appropriate facts and circumstances, I anticipate that the Commission will continue to pursue a handful of enforcement cases in the corporate bond area and in the government securities area.

I am sure that you are aware that the Commission has stepped-up its enforcement activity with respect to investment advisers and investment companies, especially now that the Commission has civil penalty authority. I expect this activity to continue, particularly if investment adviser legislation is passed since the Commission will then add a significant number of examiners to the staff.

In its enforcement program, the Commission has attempted to be tough and aggressive on the one hand while fair and reasonable on the other. That is a difficult balance to maintain and often results in actions that are thorough and effective but rather slow. However, I can assure you that the Commission strives to "do the right thing" in its enforcement program.

VII. Conclusion

With the arrival of a new chairman, the Commission's agenda of course will change. However, one thing that will not change is the Commission's commitment to monitor market innovations and industry practices with a view to ensuring investor protection.

For almost 60 years, the Commission has attempted to protect investors without unnecessarily impeding the natural progression of market forces. The result to date has been a vibrant, active securities market, second to none. I intend to work with my colleagues on the Commission and with the APIC, among others, to perpetuate that result. While there may be differences in the approach taken from time to time, I know that everyone is committed to such a goal. I look forward to working with each of you in the future toward that objective.

ENDNOTES

1. Schultz, "How to Unwrap a Wrap Account," The Wall Street Journal, (February 5, 1993), at C1; and Rogers, "Costs Are Dropping Fast on Wrap Accounts," Investors Business Daily, (Dec. 3, 1992), at 21.

2. See Letter from Hon. Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance, House Energy and Commerce Committee, to Richard C. Breeden, Chairman, Securities and Exchange Commission (January 11, 1993).

3. See Cope, "As Mutual Fund Industry Meets, Bankers Take a Seat at the Table," American Banker (May 27, 1993), at 1.

4. Section 20 of the Glass-Steagall Act, 12 U.S.C. 377.

5. See Section 2(b)(2) of the Glass-Steagall Act, 12 U.S.C. 221a(b)(2).

6. See Section 225.125 of Regulation Y, 12 C.F.R. 225.125; Letter from William W. Wiles, Secretary of the Board of Governors of the Federal Reserve System, to C. T. Conover, Comptroller of the Currency (Dec. 14, 1982).

7. Letter from Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, to Congressman John D. Dingell, Chairman, House Energy and Commerce Committee, (May 19, 1993).

8. Roberts, "Banks and Mutual Funds: Addressing Conflicts of Interest," Remarks delivered to the American Bankers Association Legislative Liaison Advisory Committee, Naples, Florida (Feb. 11, 1993).

9. See, e.g., Dickson, "Merrill Reports 'Irregularities' On Trades Tied to U.S. Probe," The Bond Buyer (May 4, 1993), at 1; Fuerbringer, "U.S. Inquiry Into a New Jersey Bond Deal Highlights a Business Dominated by Politics," The New York Times (May 5, 1993), at B8; Mitchell and Vogel, "Illegal Payments Mar the Muni Market," The Wall Street Journal (May 5, 1993), at C1; and Pressman and Monsarrat, "SEC and State Board Are Now Scrutinizing New Jersey Turnpike Over Bond Refunding," The Bond Buyer (May 6, 1993), at 1.