Remarks Of

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# "SEC Update on Investment Company" Issues & on Derivatives

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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

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"SEC Update on Investment Company"
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## I. Introduction

I appreciate the opportunity to participate in the State of Wisconsin's Eighth Annual SEC Update conference. It is my understanding that earlier, there were conducted panels on the subjects of investment companies and derivatives. I will continue pursuing those subjects with my discussion today. Hopefully, I will be covering some different ground as well.

## II. Investment Company Issues

### A. Commission Investment Company Oversight Resource Shortage

I probably should begin by indicating that the area of investment company oversight is one area where Commission resources are glaringly sparse. Investment adviser oversight is another such area, but I will address that in a few minutes.

The Commission resources to oversee the $2.1 trillion investment company industry have lagged far behind the growth of the industry itself. All aspects of Commission oversight have been affected -- not only the inspection of funds, but also the reviewing of prospectuses, and the handling of exemptive, interpretive, and no-action requests.

The investment company industry, to a great extent, rests on public trust and confidence. There is no governmental safety net. Nevertheless, Commission resources for investment company supervision have been far more scarce than resources available to other financial regulators. Even though the investment company industry is two-thirds the size of bank, thrift, and credit union assets, the entire Commission had only 214 staff members for its 1992 investment management program, compared to almost 21,000 staff members available for the oversight of banks, thrifts, and credit unions. Thus, there was a ratio of $8.9 billion in investment company assets per staff member,

as compared to $150 million in bank, thrift, and credit union deposits per staff member.

I believe that these figures reveal a dangerous shortfall in the Commission's resources to oversee one of the fastest growing and most important segments of the financial services industry. While the Commission has an extremely dedicated and resourceful investment company staff, if nothing is done to add to or to supplement their ranks, the task they face may become too great to provide any real measure of deterrence or investor protection.

One solution would be to increase dramatically the size of the Commission staff. While that solution would be an improvement over the status quo, increasing substantially Commission bureaucracy may not represent the most cost effective solution. Possibly, it is time to consider, or rather reconsider, other alternatives to address the shortage of Commission oversight resources that currently exists in the investment company area. I suggest that these other alternatives include a self-regulatory approach, an enhanced self-reporting approach, an enhanced self-compliance approach, or a combination of the latter two approaches.

B. Commission Investment Adviser Oversight Resource Shortage

(1) General

Of course, a similar Commission resource shortage, due to similar exponential growth, exists in the investment adviser area. The solution advocated in this area to date has been legislation to increase investment adviser registration fees that would enable the Commission to fund an enhanced investment adviser inspection program. Legislation of this nature has passed the House and is expected to pass the Senate soon.

Again, while this approach would be an improvement over the status quo, increasing the Commission bureaucracy, even if limited to upgrading the current inadequate investment adviser inspection program, may not be the most cost effective

approach. In fact, I am presently inclined to be of the view that at least two other approaches may be superior to the current legislative solution from both an efficiency and an effectiveness standpoint. I will mention briefly these two alternatives.

(2) SROs

In 1989, legislation was introduced in Congress, at the behest of the Commission, which would have authorized the Commission to register one or more national investment adviser self-regulatory organizations ("SROs") subject to Commission oversight. Interestingly enough, the investment adviser legislation which recently passed the House contains a somewhat similar provision. Under the 1989 legislation, approved SROs would establish qualification and business practice standards, perform inspections, and enforce compliance with the law. Such self-regulation systems have been authorized in the past to regulate the activities of broker-dealers, municipal securities industry professionals, and futures industry professionals. Under the current House approach, the Commission would have the authority to delegate to an SRO certain inspection responsibilities. Either SRO approach would generally require mandatory SRO registration for all Commission registered investment advisers.

It is my understanding that neither the Commission's 1989 SRO legislative proposal nor the current House SRO language has been received warmly. Most commenters indicated that they objected to subjecting advisers to another layer of regulation and preferred instead direct Commission regulation. I do not share the confidence of these commenters that direct Commission regulation is the most cost effective regulatory approach of supervising the investment advisory industry. While I have some sympathy with the regulatory duplication objection, at this time, I am inclined to resurrect the SRO proposal and to support, with a view to implementing, the SRO language presently contained in the House bill.

(3) Increase State Involvement

Another regulatory alternative in the investment adviser area would be to involve the states to a greater degree in investment adviser regulation but to do so in a coordinated federal-state fashion. In 1988, the Commission proposed amendments to its rules under the Investment Advisers Act that would have exempted from Commission registration and most Commission regulation, certain "intrastate" and "small" advisers.[1] While these proposed exemptions were flawed to some degree, the rationale underlying that approach has always appealed to me.

The statistics concerning the adviser industry suggest that a federal oversight program focusing on medium and large investment advisers would obviate the need to police the majority of advisers, while, at the same time, preserve the oversight of the vast majority of the assets and client accounts under management. The small advisers, having little or no national relevance, could better be overseen by state regulators who may be more cognizant of the activities of local advisers.

This is not the only area where state and federal jurisdiction concerning securities regulation overlap. Business individuals raising capital or providing securities-related services are often frustrated in that they are subject to redundant regulation. These regulatory costs are especially burdensome on small entities. In responding to the needs of small business issuers, the Commission last year adopted a set of rules that included a blanket exemption for all offerings under $1 million.[2]

A similar $1 million threshold for investment advisers in the form of an exemption from registration makes more sense to me than the current legislative approach of requiring federal oversight of all registered investment advisers. Such a

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1 Investment Advisers Act Rel. No. 1140 (Sept. 16, 1988) [53 FR 36997 (September 23, 1988)].

2 Securities Act Release No. 6949 (July 30, 1992).

program would subject the largest 6000 investment advisers to federal oversight, while the remaining 13,000 advisers would be divided among the various states. The Commission then would have the resources to closely monitor the significant advisers, without the need for doubling or tripling its investment adviser inspection staff, and would be vigorously protecting 99% of all assets under management. Such a program arguably would be more cost-effective than the current legislative approach.

Of course, in exempting small advisers, there should be a condition that the adviser has registered with each of the states in which it does business. Further, such a small adviser would no longer receive the Commission's registration certificate, which has been utilized in the past as a sort of "good housekeeping" seal of approval. Therefore, in no case should an adviser be free from regulatory oversight. In addition, I believe it is important for the Commission to retain jurisdiction to bring anti-fraud cases against small advisers. This was the approach utilized in the small business issuer $1 million exemption from the Securities Act. To facilitate the detection of fraud, it also would be important for the Commission to retain the ability to conduct "cause" examinations of exempted small advisers.

The net effect of this program would be to focus federal attention upon national advisers and state attention upon local advisers. The Commission, with greater resources from increased fees, would be able to conduct frequent and comprehensive inspections of these national entities, which account for virtually all of the assets under management. Further, the Commission would be in a better position to more effectively enforce the adviser registration requirements. In addition, the staff should have sufficient resources to conduct "cause" inspections on an as-needed basis, where customer complaints or state regulators suggest evidence of fraud.

There is no doubt that investment adviser oversight would be improved under the current legislative approval; but to monitor effectively the present 19,000 or more

investment advisers, many of whom are small and disappear before an effective inspection regimen can be instituted, appears to me to be spreading the Commission, even with massive additional resources, too thin to be fruitful. The Commission will probably not meet any proposed inspection schedule for small advisers anyway.

Obviously, states face budget problems similar to that of the federal government. However, there is no reason why state securities regulators could not attempt to develop, on a state level, a flow-through fee concept similar to that being considered by the Commission to enhance its investment adviser inspection program. This approach would enable the applicable state authorities to acquire the resources sufficient to regulate effectively exempt small advisers.

As I indicated earlier, an objection historically to the exempt small adviser approach has been that the states would then subject all advisers, exempt or not, to direct, heavy state regulation, thereby unnecessarily increasing the regulatory burden on large advisers and undermining the goal of uniform regulation. I too am concerned about such a prospect. However, I understand that some 30 plus states already have in place an investment adviser registration scheme, so the regulatory duplication problem exists now in any event. I am confident that consultations between the North American Securities Administrators Association ("NASAA"), the Congress, the Commission, and the investment advisory industry could avoid such a result through the enactment of appropriate legislation. The exempt small adviser approach, with its federal-state partnership implications, appears to be attractive from a cost efficiency standpoint and should, in my judgment, be given serious consideration in addition to the SRO alternative previously discussed.

C. Potential Rulemaking Actions

Changing gears to some extent, there exist a number of investment company rulemaking initiatives that could receive Commission attention in the reasonably near future. I will mention several potential ones that appeal to me.

(1) Tax - Exempt Money Market Funds -- The Commission should propose amendments to Rule 2a-7 dealing primarily with tax-exempt money market funds. These funds were not made subject to all of the risk-limiting conditions that the Commission has imposed on taxable money market funds. In my view, certain additional restrictions should be imposed on tax-exempt money market funds that will minimize the risk that these funds will not be able to maintain a stable price and will take into account the unique features of these funds and the markets in which they invest.

(2) Proxy Rules for Investment Companies -- The Commission also should propose amendments to the proxy disclosure rules applicable to registered investment companies. The current rules, adopted under Section 20 of the Investment Company Act, address certain issues expressly required by the Act to be submitted for shareholder approval and have not been amended since 1960. The amendments proposed should update the disclosure requirements to reflect current matters on which fund shareholders are commonly asked to vote, as well as to reflect changes in the industry since 1960.

(3) Wrap Fees -- The Commission should engage in a rulemaking action to propose a safe harbor from registration and regulation under the Investment Company Act for wrap fee programs that provide legitimate individualized treatment to clients. An interpretive release is probably necessary too in order to address other securities regulatory issues that wrap fee programs raise, including their suitability for small investors, and the issues of best execution and principal transactions with clients.

Changes also may be necessary to the investment adviser registration form to improve disclosure concerning fees and services.

(4) Direct Marketed Mutual Fund Sales -- In my view, the Commission should move forward and adopt the off-the-page mutual fund sale proposal. I believe that the disclosure concerns in this area can be appropriately addressed. Along similar lines, I hope that substantial progress is made soon toward encouraging a more simplified, comprehensible mutual fund prospectus.

(5) Self-Directed Defined Contribution Pension Plans -- The Commission should scrutinize carefully the disclosure requirements applicable to investment companies to ensure that such disclosures reach self-directed defined contribution pension plan participants and do not stop somewhere along the way. The investment decisions that these individuals make with respect to the funding of their pension plan may be the most important investment decisions that they will make. Thus, I believe that it is critical that the quantity and quality of information that these individuals receive is sufficient to enable them to make a timely, informed investment decision.

(6) Standardizing Unit Investment Trust ("UIT") Performance Data -- This project, the work on which I understand is well under way, would propose adoption of a formula, for use by UITs that hold fixed-income securities, to calculate performance quoted in prospectuses and advertisements. In 1988, the Commission adopted formulas for the calculation of performance information by open-end investment companies. Similar rules for UITs have never been proposed or adopted, although the staff of the Commission has attempted to restrict some egregious practices through the Commission's registration and enforcement processes. However, these attempts do not obviate the need to specify an accurate and uniform method for

calculating UIT performance. In my view, there is a need to adopt a uniform method of calculating yield in this area.

(7) Investment Adviser Disclosure -- On the investment adviser side, the Commission probably should initiate rulemaking action to enhance the disclosures required of investment advisers concerning their receipt of "soft dollars." At the same time, the Commission should scrutinize closely the disclosures presently required of investment advisers concerning the existence of certain potential conflicts of interests. As the press recently has indicated, at least in the municipal securities area, the current requirements may not be sufficient for those municipal securities professionals that are investment advisers.

## III. Derivatives

Moving on to the subject of derivatives, I would like to provide you with a brief update on the Commission's work in this area.

While the explosive growth of derivatives is not cause for panic, it is cause for concern for at least a couple of reasons. First, the regulators have yet to catch up to the knowledge of the regulatees with respect to the subject of derivatives. Secondly, no one to my knowledge has a good handle on how these instruments will perform during stressful market conditions. Thus, the staff of the Commission has been working diligently with those two concerns in mind.

The staff of the Commission has been working for some time now on several projects designed to address the potential risks to the nation's equity markets that might flow from activities in derivative products, particularly derivative products based upon equity indexes. Some of these concerns, such as the adequacy of current margin levels for index futures contracts, pertain to exchange-traded products. I know that the Commission staff continues to work with the staff of the Commodity Futures

Trading Commission ("CFTC") concerning the adequacy of futures margin levels in the current market environment.

The staff of the Commission is particularly concerned, however, with equity market risks associated with the growing, yet difficult to quantify, market in over-the-counter ("OTC") derivative products. Little reliable information is available to regulators currently concerning the risk of this OTC market, because the vast majority of this activity is conducted by entities outside of regulated broker-dealers.

The staff of the Commission currently is attempting to analyze the likelihood of two types of potential risks to the nation's equity markets. One risk would involve a default in OTC derivatives by one or more key market participants (e.g., a large broker-dealer or bank), that might result in counterparty risks spreading throughout the equity markets in a "domino" effect. Another type of risk might result from the need for many large providers of OTC equity derivatives to "dynamically hedge" by selling massive amounts of index futures or stock baskets during a future sharp swing in stock prices. Such concentrated selling possibly could strain the liquidity of the futures and securities markets in much the same way as did "portfolio insurance" strategies in the 1987 Market Break.

With respect to derivatives, the Commission issued a concept release last May soliciting public comment on a broad range of issues relating to the appropriate capital treatment of derivative products under the Commission's net capital rule. The purpose of the Commission's release was to explore and to evaluate whether the net capital rule should be modified with respect to derivative products in general and, in particular, with respect to OTC derivative products.

In examining the treatment of derivative products, the Commission's concept release focused primarily on the market and credit risk to which participants in the derivative products market are exposed and presented several alternatives to the

current treatment of these instruments under the net capital rule. The comment period on this concept release was recently extended to December 17, 1993. After Commission staff has received and evaluated the comments to this release, I understand that the staff will then consider what, if any, changes to the net capital rule may be appropriate.

Additionally, the staff of the Commission is presently working towards the development of a theoretical pricing model for exchange traded options. This pricing model apparently would be used to determine haircuts for broker-dealers' listed options positions under the net capital rule. The approach would be to require broker-dealers to take a capital charge on a portfolio of options on a given underlying instrument equal to the difference between the closing market prices and the options' theoretical prices after applying assumed adverse market movements. If the portfolio contains related underlying instruments, the charge for those positions would be equal to the market movement assumed for purposes of calculating the options' theoretical prices.

As I am sure that everyone here is aware, last July, the Global Derivatives Study Group of the Group of Thirty published a study entitled Derivatives: Practices and Principles. The focus of this study was on the development of guidelines for sound risk management practices for dealers and for end-users of OTC derivatives. I understand that the staff of the Commission is analyzing and evaluating these recommendations.

This study also provided some useful statistics, compiled by the International Swaps and Derivatives Association ("ISDA"), that attempt to quantify, among other things, the current size of the market in OTC equity derivatives, such as equity swaps and OTC equity options. The staff of the Commission will continue to work with the securities industry, among others, to obtain more information concerning the size and scope of these markets and the systemic risks that they pose for our nation's equity markets.

Finally, under the recently adopted risk assessment rules, the Commission receives information regarding the financial activities of material associated persons ("MAPs") of registered broker-dealers. This includes information concerning the notional amounts and the replacement costs of derivative products.

I understand that the staff currently is analyzing the quarterly risk assessment filings, which are being received from approximately 250 broker-dealers, with a total of about 700 MAPs. However, the number of affiliates involved in any significant derivative product activities apparently is far fewer. The staff is analyzing these risk assessment filings, with a view toward ascertaining the potential risks to which regulated broker-dealers are exposed, and the potential systemic risk posed, by the activities, particularly in derivatives, of a broker-dealer's company or affiliates.

I believe that it is safe to say that the staff of the Commission has been working hard in several areas with respect to the subject of derivatives. I suspect that this trend will continue if not intensify. I further am of the opinion that future regulatory developments in the derivatives area will continue to remain interesting.

## IV. Conclusion

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 believe that this will remain the case even though the exponential growth of the investment company industry and the explosive growth in the use of derivatives will continue to pose thorny and troublesome regulatory problems for the foreseeable future. I intend to work with Chairman Levitt and my other colleagues on the Commission, and with the members of this audience, among others, toward the most appropriate regulatory solution for the current and future problems in these areas.