Remarks Of

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"What's Hot And What's Not"

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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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"What's Hot And What's Not"

I. Introduction

During the past two and a half years that I have been a member of the Securities and Exchange Commission (the "Commission"), I have witnessed significant growth and development in the capital markets. With low interest rates, bullish stock and bond markets, deeply liquid capital markets, and record Wall Street profits, it is fair to say that things are booming for the securities industry, federal budget deficits notwithstanding. As a member of an agency entrusted by Congress to watch for pitfalls on the path, recent success notwithstanding, I appreciate the opportunity today to discuss with you some of the issues confronted by the Commission last year and confronting the Commission this year.

Today, I intend to focus on what is "hot" and what is "not" in the capital markets and the corporate community. Rather than focus on any single issue, I will touch upon a medley of these issues that hopefully appeals to the broad cross-section of interests represented by this audience. II. Mutual Funds

Perhaps the hottest securities segment in recent times has been the mutual fund industry. About 15 years ago, mutual funds held less than $50 billion in assets. By the time I came to the Commission in 1990, that number had reached $1 trillion; whereas now, mutual fund assets have grown another 60% to $1.6 trillion.[1] If insurance products and unit investment trust funds were

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1 "The Power of Mutual Funds" Business Week (January 18, 1993) at 62.

included, this number reaches approximately $2 trillion. Investors are now investing roughly $1 billion a day as names such as Fidelity, Merrill Lynch, Vanguard, Dreyfus, T. Rowe Price, and Franklin become some of the best known among the more than 3500 investment companies registered with the Commission.

A burgeoning mutual fund industry has many collateral benefits. The most important probably being the massive amount of capital these funds pour into our securities markets. It may be fair to say that the growth of these institutional investors is what has fueled the bull market for most of the past decade. For example, in the first half of 1992, I understand that mutual funds provided 96% of the money that went into the stock market.[2] Mutual funds have further provided great liquidity to otherwise illiquid assets and securities. They are the largest investors in municipal securities, and they are also large purchasers of government securities and asset-backed securities.

By providing such deep markets, mutual funds lower the cost of raising capital, which benefits both issuer and investor. They have facilitated the return of the individual investor to our capital formation system. They have also provided alternatives to traditional bank financing, which has struggled in recent times. Not surprisingly, the banking industry has entered the mutual fund business and is interested in increasing its mutual fund presence.

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[2] Id. at 64.

One of the more remarkable aspects of the mutual fund industry, at least from a regulatory viewpoint, is the fact that this industry has enjoyed great success relatively scandal-free. The Investment Company Act has remained virtually intact since its passage in 1940. In May 1992, the Commission published a study entitled "Protecting Investors: A Half Century of Investment Company Regulation," that entailed a comprehensive review of the regulatory scheme and staff suggestions for legislative and rulemaking changes to improve the system. The study concluded, though, that the basic statutory and regulatory structure remain sound. The Commission has already moved forward on many of the recommendations contained in this study and will move on others during the course of 1993.

III. Structured Financing

Another "hot" capital market area is the asset-backed, or structured, financing market. Like mutual funds, asset-backed financing performs a valuable service in transforming otherwise illiquid assets into liquid assets.

Twelve years ago, there were only about $1 billion in structured finance issues. In 1991, the Commission received approximately 188 filings registering over $110 billion of such securities. Last year, the Commission received approximately 225 filings registering over $175 billion. The largest issuers were the Resolution Trust Corporation, accounting for over $21 billion last year, Sears, accounting for $9 billion, and the General

Motors Acceptance Corporation issuing approximately $8.5 billion of such securities.

While mortgages account for the vast majority of these financings, in recent years there has been significant growth in the securitization of credit card and other receivables, airline equipment trust certificates, as well as participation certificates in pools of manufactured housing and recreational vehicle sales contracts. In 1991, non-mortgage asset-backed securities accounted for almost $51 billion. As of the end of last year, asset-backed offerings combined accounted for approximately half of all debt and equity public securities offerings.[3]

One potential regulatory impediment to the future growth of structured financing was removed last November when the Commission adopted changes to Rule 3a-7 conditionally exempting structured financings from the Investment Company Act. Issuers engaged in the business of acquiring notes and loans covering specified merchandise and services or interests in real estate have always enjoyed a statutory exemption from this Act; but as I noted, the universe of asset-backed financings has expanded to other assets.

While acknowledging that a special purpose entity holding the pool of assets, commonly in trust form, does not fit easily into the mold of a traditional investment company, at the

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3 Derived from "How Sweet it Was!" Inv. Dealer's Digest (Jan. 11, 1993) at 14.

November meeting, I expressed concern over the loss of the investor protection provisions contained in the Act posed by new Rule 3a-7. I continue to worry as asset-backed issues may be offered to unsophisticated customers, especially complex securities such as "stripped" mortgage securities, with dire consequences certain to follow.

Some mortgage-backed securities have become more and more complex, spawning an alphabet family that includes PACs, TACs, IOs, POs, Z-PACs, jump Z bonds, inverse floaters and ricochet floaters, all of which subject investors potentially to considerable volatility. In April 1987, for example, it was reported that Merrill Lynch, not a firm known as financially unsophisticated, lost $250 million in stripped mortgages. Likewise, in March 1992, it was reported that J.P. Morgan lost $50 million investing in IOs. More recently, many investors in mortgage-backed securities have taken it on the chin as long rates have dropped and prepayments have increased.

In my opinion, the best investor protection measure in this area is a vigilant adherence to customer suitability requirements. Some of these securities have no business in retail hands in my judgment. That is not to say, however, that mortgage-backed or asset-backed securities offerings in general are inappropriate. They do provide valuable investment and hedging alternatives to appropriate investors, while enhancing the capital and mortgage markets with greater liquidity. In sum, I applaud the growth in structured financing, but I caution issuers and brokers to target the appropriate pool of investors with these products.

IV. Small Business Initiatives

Another "hot" topic at the Commission and elsewhere is the area of small business. The Commission still is hopeful that structured finance will take hold in the small business area as a result of new Rule 3a-7. Also, last year the Commission revamped its registration and periodic reporting system to simplify the process for small business issuers (revenues and public float each less than $25 million).

While the rule changes adopted removed significant federal impediments for small offerings, small business issuers will not receive the full benefit of these rule changes because the Commission implemented these changes independent from the states. Although I realize that it is difficult to convince 50 states to act in harmony, I am of the view that more of an effort could have been made to convince the states that parallel changes in their disclosure systems would be appropriate and not detrimental to investors. The Commission may make such an effort this year.

V. Rule 144A

While exemptions from the Securities Act of 1933 have not been as useful to small business issuers as potentially they could have been because of the reluctance of some states to provide similar relief, large domestic and foreign issuers have benefitted greatly from the Commission's decision to adopt Rule 144A in 1990. This Rule provides a complete exemption from the registration provisions of the Securities Act for issuers selling privately to large sophisticated investors, known as QIBs.

After a slow start, Rule 144A offerings are becoming increasingly popular. In 1990, $3.4 billion of equity and debt was issued under this provision. In 1991, $10.5 billion was raised and, in 1992, $11.2 billion was issued. For the first two months of 1993, there has been almost $4 billion issued.

The number of Rule 144A offerings and dollars raised are roughly equal among foreign and domestic issuers. The success story in the international area is that nine foreign companies using Rule 144A have subsequently become reporting companies under the Securities Exchange Act and five companies (two Mexican, one French, one British, and one Venezuelan) have elected to list on the New York Stock Exchange.

The foregoing discussion should demonstrate that Rule 144A has been "hot," and I expect it to get even hotter. So far, the market also remains scandal-free.

In a somewhat related development, the new Commission rules adopted last year that permit issuers to file so-called universal shelf-registration statements are beginning to be utilized in convertible preferred offerings and are becoming something of a "hot" market item. Under these rules, an issuer can file a "universal" shelf-registration statement covering the entire spectrum of equity and debt financing but without specifying the amounts allocated to each type of security. Some recent successful universal shelf offerings have demonstrated that the public market, and not only the Rule 144A private market, is a viable alternative for issuers that place a premium on consummating a transaction as quickly as possible. It will be interesting to observe how "hot" universal shelf offerings will become in the convertible security area in the future.

VI. Market 2000

While the primary capital markets are "hot," so are the secondary markets. It is my understanding that Bill Heyman addressed this group at its last meeting. Thus, I will spare you another discussion of the Market 2000 Study underway. I will only observe that this Study likely will be the roadmap for the future regulatory direction over the equity secondary markets.

VII. Proxy Rule Changes and Executive Compensation

While Market 2000 is likely to be controversial, not much has been more controversial than the Commission's changes to the proxy rules and to the executive compensation disclosure requirements. Remarkably, in the months since the October adoption of these changes, the controversy has died down; and the rule changes appear to be enormously popular. The proxy rule changes have made it easier for shareholders to express an opinion about management and the direction of publicly held companies without triggering the massive proxy regulatory scheme. This should be of benefit to everyone.

It is too early to determine the reaction to the enhanced executive compensation disclosure requirements, other than that the chart comparing company performance with the S&P 500 and a peer group index appears to be quite popular with shareholders. The Commission will continue to observe the quality and effect of these disclosures and to grapple with interpretive questions. Everyone should know more in this area after the end of the current proxy season.

VIII. Stock Option Valuation

The new executive compensation disclosure rules contain a requirement to disclose the value of employee stock options either on the basis of an assumed increase in stock price, or a present valuation using a model such as Black-Scholes. This provision was not especially popular with the corporate community at the time, but such unhappiness was nothing compared to the current unhappiness with the Financial Accounting Standards Board's ("FASB") nine year project to require a present valuation of employee stock options either on the date granted or on the date vested. Once this value is determined, it would be required to appear as a compensation expense on the company's income statement.

This is quite a departure from the present day accounting treatment contained in APB 25. Under the current accounting treatment, nothing needs to be expensed unless the option exercise price is lower than the present market price of the underlying common stock.

I have difficulty articulating how a grant of a stock option represents a company expense. Even if an option is ultimately exercised, it appears that the company simply is selling stock to an individual at a predetermined price. This is more akin to a capital transaction in my view rather than an expense transaction. It has been argued that the true cost to shareholders is the dilution experienced with the issuance of new shares.

Supporters of the FASB project argue that the present treatment of option awards is inconsistent with the treatment of stock awards, which is expensed. They argue that options have inherent value as of grant date and are given to executives as a replacement for cash bonuses, which would require expensing. Although these are valid points, experts could debate the best present value methodology until the turn of the century without reaching a consensus. The Commission had a not so pleasant taste of this controversy in its own executive compensation disclosure project.

While arguments are plentiful in this area, solutions are not. That is part of the reason it has taken the FASB so long to move forward. While the FASB project may achieve accounting theoretical purity, the effect of such a change in accounting treatment would be to punish, through the income statement, companies that rely heavily upon stock options as a compensatory device. That would seem inconsistent with the policy of linking executive pay to company performance. Nevertheless, the FASB is entering the final stage of its project amid heavy criticism.

Although the FASB project is "hot," in my opinion it appears that it may "not" be going anywhere. The support for the project, outside of the FASB, appears to rest largely with Senator Carl Levin of Michigan. While Senator Levin's support is formidable, the opposition includes the corporate community, the Council of Institutional Investors, and now Senator Don Riegle, also of Michigan, the Chairman of the Senate Banking Committee, who wrote the FASB last month to express his reservations. While I do not rank with these heavyweights, I have reservations about the FASB's current direction as well.

Congress has conferred on the Commission statutory responsibility for defining the content of accounting principles for companies filing with the Commission or making public offerings of securities. Since the inception of the FASB, however, the Commission has looked to the private sector to establish and to improve accounting principles. I believe that this historical relationship should be maintained. It is my hope, however, that as the FASB nears the end of this project, it will be flexible in considering possible compromise solutions.

One such compromise solution would be disclosure based. The present value of executive stock options awarded could be reflected through disclosure in a footnote to the income statement. Thus, those persons advocating that options should be an expense item could easily deduct that number from net income, while others could view the earnings independent of the putative present value expense. I am inclined to support this alternative and urge its strong consideration by the FASB.

IX. Shareholder Proposal Process

Another area that is "hot" but is "not" working well is the area of shareholder proposals. Plagued by controversy over whether a company's proxy statement is the appropriate vehicle to air political and social issues, some of the judgments evidenced in staff no action positions are highly subjective and defy consistency. The judgments in this area are very difficult ones. I suppose that is because society's views on different issues often fluctuate and evolve over time. It is easy to "second guess" the decisions made but almost impossible to construct a standard that will withstand the test of time without flooding issuers and shareholders with expensive, time-consuming, well-intentioned, but generally ineffective, shareholder proposals.

Given time, a standard of "let my conscience be your guide" quickly finds itself on a slippery slope resulting in the inclusion of virtually all cleverly drafted shareholder proposals. Such a circumstance inevitably produces proxies stuffed with shareholder proposals, issuers stiffed with considerable expenses, and annual meetings sounding like day time talk shows. There are ample more appropriate forums to ventilate such issues in my view. I believe that the vast majority of shareholders are interested predominantly in a reasonable return on their investment. When the shareholder proposal process strays from that shareholder interest, it becomes meaningless and aggravating to most shareholders and is not beneficial to our capital formation system in my judgment. If the process cannot be improved, I argue that it should be abandoned.

The Commission has been wrestling with the most controversial of social and political issues in connection with the shareholder proposal process for about 20 years and is not winning many friends with its efforts. I submit that the Commission should either attempt clarity in this area through a rulemaking project or through an interpretive release, or should withdraw altogether from serving as a referee with respect to these issues, thereby leaving them for issuers, shareholders, states, and courts to decide. In my opinion, it is neither fair nor reasonable to expect securities experts to deduce the prevailing wind on public policy issues that have yet to be addressed by Congress in any decisive fashion.

X. Conclusion

Two broad "hot" market areas that I have not mentioned today are the municipal bond market and the corporate bond market. Low interest rates have triggered the activity in these areas, although the prospect of higher tax rates has also been a major factor in the municipal bond activity. I have discussed those areas recently in other forums and did not have time to do so today. I am certain that there are other areas that are "hot" and many more that are "not" that I neglected to mention today.

In any event, it was pleasure to visit with you today; and I look forward to working with you toward resolving whatever issues confront the Commission during the remainder of my term.