Remarks Of

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"Examinations: A Cooperative Effort"

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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 of the Commission.

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"Examinations: A Cooperative Effort"

I. Introduction

I appreciate the opportunity to participate in this 1993 Examiner Training Program which is co-sponsored by the North American Securities Administrators Association ("NASAA") and the Florida Department of Banking and Finance. I am impressed with the attendance for this program. It is my understanding that program attendees include examiners from throughout the United States, the Canadian provinces, Thailand, Malta, and Puerto Rico. Your presence and participation in this program emphasizes to me the importance of cooperation between state regulators, self-regulatory organizations ("SROs") and the Securities and Exchange Commission ("SEC/Commission"). When Congress passed the Omnibus Small Business Capital Formation Act of 1980, it added Section 19(c) to the Act, which calls for "greater Federal and state cooperation in securities matters." This program is exactly the type of cooperative effort that the drafters of the legislation envisioned. I intend to work during my Commission tenure to expand the cooperative spirit which already exists between NASAA and the SEC with respect to examination and enforcement matters to all phases of SEC operations. Given the forthcoming management change at the Commission, I anticipate that a much greater spirit of cooperation will indeed exist between NASAA and the Commission in the future.

I would like to spend a few minutes this morning discussing several topics of interest, including the importance of the examination process. I will touch upon the issues of broker-dealer sales practices and penny stock fraud in general and, more specifically, on the issues of "networking" arrangements and "franchising" operations. I will also discuss briefly the political contribution issue which has developed in the municipal securities market.

II. Increased Scrutiny of Broker-Dealer Sales Practices[1]

I believe that we all know that today's low interest rates create an environment in which small investors, many of whom are elderly, may be susceptible to investment fraud or abusive sales practices as they try to increase their rate of return on investments. The Commission is sensitive to the fact that, in such an environment, brokers may try to market more speculative investment instruments to small investors without disclosing the increased risks associated with such instruments.

In response to these developments, the Commission has taken a number of steps to strengthen the safeguards against abusive sales practices. Because broker-dealer firms are the "first line of defense" against sales practice abuses by their employees, the Commission has made special efforts to work with broker-dealers, state regulators, and the SROs to strengthen firms' supervisory and compliance functions. The examination process plays an important role here. The Commission also has sought to stimulate and facilitate communication with and among broker-dealers, the SROs, and state regulators regarding trends in potentially abusive sales practices.

In the enforcement area, the Commission is bringing cases against supervisory personnel, such as branch office managers, in firms where sales practice abuses are shown to be a systemic problem, and is addressing systemic supervisory problems through remedial sanctions. The aim here is not only to address the misconduct of individual employees, but also to renew, unambiguously, the message that securities firms are expected to provide for the effective supervision of their employees. The SROs and state regulators also are bringing increasing numbers of disciplinary actions against firms with systemic sales practice problems and against supervisory personnel. Sanctions in these cases and limitations placed on business have increased in number and severity.

Finally, the SROs have made important efforts in recent years to improve the quality of information available to investors regarding the disciplinary histories of securities personnel. The National Association of Securities Dealers, Inc. ("NASD") now operates an "800" number hotline which allows investors to obtain information about the disciplinary and civil liability records of broker-dealers' registered representatives. The NASD is in the process of improving the hotline by adding to its system information regarding final arbitration awards, pending NASD disciplinary actions, and pending indictments. The Commission believes that the information the hotline provides will assist small investors in protecting themselves against unscrupulous registered representatives.

III. Penny Stock Fraud[2]

As everyone here is aware, the penny stock market has drawn adverse publicity and increasingly close regulatory scrutiny for several years now, and as a result, the Commission has taken specific steps to protect investors against fraud involving "penny stocks." In 1988, the Commission established a Penny Stock Fraud Task Force ("Task Force") in response to increasing concerns that serious violations of the federal securities laws were occurring in the penny stock market -- with elderly and other small investors most often the targets of such fraud. The Task Force has focused its efforts in the following areas: (1) increased enforcement activities, including criminal referrals when appropriate; (2) targeted regulatory solutions; (3) increased coordination and information sharing with other federal, state, local, and international regulators and prosecutors; and (4) investor education. The Commission has made significant progress in each of these areas.

The Commission brought 388 penny stock enforcement actions during fiscal years 1988-1993. The Commission's enforcement effort in this area has included an awareness that civil sanctions are not always the most effective deterrent against illegal

activities in the sale of low priced securities. For this reason, penny stock activities are routinely referred to the appropriate law enforcement agencies when the conduct involved appears to warrant criminal sanctions. Commission staff has worked closely with U.S. Attorneys' offices and the FBI, providing technical advice when requested. The Commission also has worked closely with state regulatory authorities and the NASD in carrying out the Commission's enforcement program and broker-dealer examination program efforts directed at the problem of penny stock fraud. This close coordination and cooperation between law enforcement authorities in addressing the problem of penny stock fraud has enhanced the overall effectiveness of the Task Force's work.

In 1989, the Commission adopted a new rule designed to protect investors from high pressure "cold calling" frequently used to sell penny stocks. Rule 15c2-6 under the Exchange Act requires broker-dealers selling certain low priced securities through unsolicited phone calls to obtain fundamental customer financial information, make a written suitability determination, and secure a new customer's written authorization prior to executing the transaction.[3] In 1990, Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (the "Act"), which granted the Commission new enforcement powers and directed the Commission to adopt new disclosure rules to regulate the penny stock market and strengthen investor protection. In April 1992, the Commission adopted rules implementing certain provisions of the Act.[4] These rules define what constitutes a penny stock and require, among other things, that before effecting transactions in penny stocks, investors are to be given a risk disclosure document and information about the penny stock's bid and ask price, remuneration paid to the brokerage firm, and salesperson remuneration. Investors also must be given a monthly statement showing the value of penny stock holdings in their account.

In tandem with the Commission's enforcement and rulemaking efforts, the Task Force has sponsored numerous regional meetings around the country for state and federal securities regulators and prosecutors for the purpose of sharing information and discussing strategies for dealing with penny stock fraud. The Commission has also conducted securities fraud training sessions for staff from other federal and state agencies, with a view to enhancing the number of civil and criminal penny stock cases brought by other securities law enforcement authorities. Again, this meeting today serves as an excellent example of such an effort.

Lastly, the Commission firmly believes that one of the best tools against investor fraud is increased investor awareness. Customer complaints have always been a major source of investigative leads for the Commission. Since the creation of the Task Force, the Commission has published several brochures intended to alert investors to the types of abusive and high pressure telephone sales practices often used in connection with fraudulent penny stock sales. These brochures have been widely disseminated to thousands of investors since their publication. For example, the Commission's Miami Branch Office, in cooperation with the state of Florida, arranged for over 1.8 million copies of one of the brochures to be distributed by banks and major utility companies in Florida with their monthly account or billing statements.

IV. Networking Arrangements

Another area where examinations play a key role is in the financial institution area. Financial institutions often enter into "networking" arrangements with a broker-dealer whereby the broker-dealer agrees to provide securities services to the customers of the financial institution on the premises of that institution in exchange for a percentage of the commissions earned. Where these arrangements involve financial institutions other than a bank that is covered by the bank exclusion, such as a savings and loan association or a credit union ("financial institutions"), the broker-dealer and

financial institution must comply with certain conditions in order for the institution to avoid registering as a broker-dealer. Of course, I am in favor of eliminating the bank exclusion, but that does not appear likely in today's legislative environment.

These conditions, which are set forth in a series (over 150) of Commission staff no-action letters, are designed to ensure that customers of financial institutions that purchase securities on the premises of the institution do not erroneously assume that the securities are federally insured or that the securities represent obligations of the institution. Furthermore, these conditions are intended to assure that broker-dealers fulfill their obligation to supervise their registered employees, and that unregistered employees of the financial institution do not participate in the sale of securities to customers.[5]

To ensure compliance with the terms of these no-action letters, during the last fiscal year, the staff of the Commission conducted examinations of several financial institution networking arrangements, focusing on the broker-dealer's branch office review procedures, supervision of registered and unregistered employees, and advertising and sales practices. I am pleased to report that these examinations revealed substantial compliance with the provisions of the Exchange Act and the terms of the individual no-action letters. However, I anticipate that the Commission will continue to monitor this area closely.

V. Franchised Branch Offices

Since I have mentioned the subject of "networking" arrangements between financial institutions and broker-dealers, I also should cover the topic of "franchised" broker-dealer operations. In 1991, the Commission and the NASD together conducted a number of examinations of identified franchise branch offices. Those examinations resulted in a number of formal actions taken by the NASD for sales practices abuses

and lack of adequate supervision. Additionally, the Commission discovered a franchise branch office dealing with an unregistered broker-dealer.

Both the Commission and the NASD continue to have concerns with the growth and formation of branch offices acting independently from the main office under so called "Franchise 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 (i.e., 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 them to be registered as broker-dealers with the Commission.

Inasmuch as branch offices must be registered in those states that they are conducting business, I encourage state regulators to identify franchise branch offices operating in their states, to examine these branch offices in order to assure that there is proper supervision being exercised from the main office of the registered broker-dealer, and to advise the Commission of those situations where it appears that the franchise branch office's operations may require full registration with the Commission. I expect that the Commission will continue to be alert to developments in this area.

VI. Municipal Securities

Finally, moving 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. The Commission's Division of Enforcement is analyzing certain 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 underwriting. 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.

I participated in a meeting earlier this week with representatives from the NASD and the MSRB to discuss, among other things, possible coordination of examination efforts, and I anticipate that examiners will play a key role in ferreting out possible violations in the municipal securities area. Even before the political contribution controversy, the Commission and the NASD had stepped up their collective examination and enforcement efforts in the municipal securities market. I expect that some enforcement activity will be generated from the municipal bond area in the future.

I further anticipate that rulemaking activity will be undertaken in the municipal bond area as a result of the political contribution controversy, and I wish to comment on this rulemaking aspect briefly.

At least initially, this rulemaking activity would be conducted by the Municipal Securities Rulemaking Board ("MSRB), and the MSRB recently has announced an intention to move forward with a rulemaking project in this area.[6] Any such rule would most likely require some form of disclosure of political contributions. This approach makes sense, at least to me. However, in my view, the disclosure should not be limited to political contributions but also should cover other payments of money or anything of value over a de minimis amount and should encompass appointed as well as elected officials.

The MSRB could limit any disclosure requirement to cover only payments to those officials who are (directly or indirectly) responsible for underwriter selection decisions. Of course, as a result of the Tower Amendment, the MSRB may have to limit any direct disclosure requirements to municipal securities dealers and their associated persons.[7]

I believe that the MSRB does have the authority to adopt a rule requiring underwriters to disclose political contributions and/or other payments.[8] The rule would have to address the manner and content of disclosure and should not conflict with existing disclosure requirements of the states. The rule could require an underwriter to report such payments when it is required to deliver official statements pursuant to Rule G-36.[9] The MSRB could make the information available to interested parties through the MSRB's Municipal Securities Information Library ("MSIL") system.[10]

Such a rule may not deter political contributions in light of the current disclosure by the political candidates. Such a rule also may duplicate state regulation of campaign financing. I wish to point out, though, that an MSRB payment disclosure rule would provide an alternate method of disclosure directly to the marketplace that is not currently available through disclosure by political candidates. Rule G-36 requires that underwriters file a final official statement within ten business days after the final agreement to purchase, offer, or sell the securities. Thus, information regarding political contributions and other payments could be available to investors while reviewing the disclosure documents.

As a supplement to the MSRB disclosure rule, the Commission could consider a rulemaking action to enhance disclosure of these payments. For example, Exchange Act Rule 15c2-12 governs municipal securities disclosure. The Commission could amend this rule to require disclosure in the final official statement of payments keyed to the locality of the offering similar to the MSRB alternative discussed previously.

The MSRB does not currently have the authority to accomplish such official statement disclosure.

By requiring underwriters to disclose certain payments when filing a final official statement and requiring those payments relevant to an offering to appear in the final official statement, the information would be available to the marketplace when reviewing disclosure documents and making investment decisions. This approach appears to me to be a reasonable regulatory response to the concerns that are currently being raised regarding political contributions and other payments by the municipal securities industry.

VII. Conclusion

While in the interest of time I did not mention the investment company and investment adviser areas, I believe that it goes without saying that the examination process will play an increasingly prominent role in those areas as well.

In conclusion, I wish to point out that the Commission, NASAA, and the SROs have formed a vibrant, successful partnership. This partnership is more vibrant and successful in the examination area than in any other area, and I hope that that atmosphere can be extended to other Commission operational areas. Certainly, our objectives are the same -- to safeguard investors, to maintain the integrity of our securities markets, and to improve the efficiency of those markets. During my tenure on the Commission, it is my intention to encourage and promote this successful partnership that has developed; and I look forward to working with each of you in that endeavor.

ENDNOTES

1. This material is derived from a letter from Mary L. Schapiro, Acting Chairman, SEC, to the Honorable David Pryor, Chairman, Special Committee on Aging, United States Senate, to be dated June 18, 1993.

2. Id.

3. Exchange Act Release No. 27160 (August 22, 1989).

4. Exchange Act Release No. 30608 (April 20, 1992).

5. It may be helpful to describe briefly these conditions. Specifically, broker-dealers and financial institutions that enter into networking arrangements are required to represent that:

   (1) Registered employees of the broker-dealer will inform each customer at the time he or she opens an account that all purchases and sales made through the account are not guaranteed by the financial institution or insured by the Federal Deposit Insurance Corporation or any other state or federal deposit guarantee fund relating to the financial institution.

   (2) The securities of a participating financial institution or its affiliates may not be sold on any part of the premises of the institution that is generally accessible to the public. Further, customers of that institution will not be solicited by the broker-dealer in connection with the sale of securities of the institution or its affiliates, regardless of the location of the solicitation.

   (3) Securities transactions will be effected only by employees of the broker-dealer that are registered and qualified under the rules of the NASD. In accordance with its obligations under the federal securities laws, the broker-dealer will control, supervise, and be responsible for all securities activities of the employees.

   (4) Employees of the financial institution that are not registered representatives of the broker-dealer only may perform clerical and ministerial functions. Unregistered employees therefore are prohibited from recommending any security, giving any form of advice, describing investment vehicles such as mutual funds, discussing the merits of any security with a customer, or handling any questions that might require familiarity with the securities industry or the exercise of judgment regarding securities matters.

   (5) The broker-dealer will provide conduct manuals to its employees and the unregistered employees of the financial institution describing, among other things, the operation of the program and the restrictions on the activities of the unregistered employees. The broker-dealer will conduct reviews to

ensure that its registered employees, as well as the financial institution and its employees observe the requirements of these manuals.

6. Ferris, "MSRB to Adopt Rule In July on Donations," The Bond Buyer (June 10, 1993), at 22.

7. State and local governments of course are exempt from the MSRB's rulemaking authority. See Exchange Act Section 15B(d)(2); [15 U.S.C. § 78o-4(d)(2)] (so called "Tower Amendment").

8. Such a disclosure rule should be within the broad authority and purposes enumerated in Section 15B of the Exchange Act, and in particular, could be seen as promoting just and equitable principles of trade. Such a rule would also promote one of the principal goals of the 1975 Exchange Act Amendments -- to raise the level of conduct and integrity in the municipal securities market. See Senate Committee on Banking, Housing, and Urban Affairs, Report to Accompany S. 249; Exchange Act Amendments of 1975, S. Rep. No. 75, 94th Cong., 1st Sess. 7-9 (Comm. Print 1975), reprinted in [1975] U.S. Code Cong. & Ad. News 179, 224.

9. Rule G-36 requires that brokers, dealers, and municipal securities dealers that act as underwriters of municipal securities deliver to the MSRB, among other things, copies of final official statements if such documents are prepared by or on behalf of the issuer.

10. MSIL is an electronic library through which information collected pursuant to Rule G-36 is made available electronically to market participants and information vendors. Securities Exchange Act Release No. 29298 (June 13, 1991), 56 FR 28194.