Market 2000

Remarks Of

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"What's Left On the Plate from 1993"

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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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"What's Left On the Plate from 1993"

I. Introduction

I appreciate the opportunity to address this NRS conference again concerning some current issues confronting the broker-dealer and investment adviser communities. As some of you may remember, I spoke at last year's conference with the topic of "What's on the Plate for 1993." With the impending arrival of a new Chairman of the Commission last year, there was a great deal of interest in what projects were likely to move forward expeditiously. I discussed such diverse issues as the Commission's Market 2000 Study, wrap fee programs, investment adviser legislation, derivative securities, foreign listings, and the Commission's enforcement program. This year I plan to update you on some of those topics.

First, though I should point out the obvious, the Commission has a new Chairman. In a very short time, Chairman Levitt has emphasized his interest that the Commission concentrate on investor protection issues, particularly on the protection of the individual investor. The formation of a Consumer Affairs Advisory Committee, the revamping of the Commission's Office of Consumer Affairs, and the launching with 11 other securities regulators of a public awareness campaign to educate investors, beginning with the publication of the "Invest Wisely" brochure, should have made this clear. The securities industry would be well advised to heed this emerging investor protection theme. I anticipate that the Commission will intensify its focus on matters such as customer suitability, sales practice training and continuing education, and enforcement of sales practice abuses, among others. I strongly commend Chairman Levitt for his interest in investors and look forward to working with him in this area.

II. Market 2000

Changing gears to Market 2000, as everyone here is aware, the Commission's Division of Market Regulation ("Division") in 1992 embarked upon a long study of our equity markets, entitled Market 2000, to ensure that these markets were protecting

investors while maintaining a fair field of competition. The study began with a concept release published in July of 1992, and the staff report was issued late January of this year. The study identifies three broad themes. First, arrangements between customers and broker-dealers should be as clear as possible. Second, markets should have as much information about supply and demand as is consistent with customer interests. Third, competition and innovation in the provision of trading services should be encouraged. I found the report to be of high quality and compliment the Division for a job well done.

I wish to spend a few minutes today summarizing generally the recommendations contained in the report. Of course, overall, the Division determined that the equity markets are operating efficiently within the existing regulatory framework and that no radical reform is necessary. The areas determined by the staff to need regulatory refinement are the areas of fair treatment of investors, market transparency, competition among markets, and market access.

In the area of fair treatment of investors, the staff identified practices such as payment for order flow, soft dollar arrangements, and order handling procedures. Even before the publication of the Market 2000 report, the Commission issued a proposed rule in October to increase disclosure of payment for order flow on customer confirmation and annual account statements. More specific action in the payment for order flow area is anticipated from the Commission before this year has ended. The study also mentions that soft dollar arrangements between brokers and investment advisers should likewise be disclosed in some enhanced manner to investment adviser clients. It is my understanding that the Commission's Division of Investment Management is currently working on such a proposal, and a Commission proposal in the soft dollar area is expected in the near future.

Another area of interest to me covered by Market 2000 is the recommendation that NASDAQ market makers be prohibited from trading ahead of their customers. As a general proposition, the NASD has moved expeditiously to implement many of the Market 2000 recommendations and should be commended for doing so. In fact, the NASD has even submitted a rule proposal to implement this particular recommendation, but the proposal seemingly contains a loophole for market makers who refer the order to another market maker. The study recommends a total prohibition, and I am inclined to agree with the study's approach.

While some could argue that market makers may then make less money, exchange specialists already live by the rule that customer orders receive a preference; and they appear to be surviving quite well. Without customer order preferencing, an investor's limit order is apt to be ignored until the market has moved and the order then becomes profitable for the market maker to execute. I would like to see the NASD move more aggressively in this area as well as continue to move expeditiously.

In the area of market transparency, the study contained proposals to improve the display of limit orders on both the exchanges and NASDAQ. The staff also suggested lowering the minimum quote variation from 1/8th to 1/16th, with a view of eventually implementing a decimal system. I strongly support the move to a 1/16th quote variation. The study focused also on the NASDAQ SelectNet system, concentrating on methods to improve publication of orders entered into the system and on methods to improve the system's preferencing. I understand that the NASD has already proposed potential action to implement the study's SelectNet recommendations. In addition, the study called for reporting of after-hour transactions, which is another recommendation I support.

With respect to the issue of fair market competition, the study calls for strengthening the surveillance and order handling in the third market. This could be

done, according to the study, by displaying customer limit orders that are better than the ITS quote, affording customer limit order protection, and avoiding dealer interpositioning between two customer orders that could be crossed. All of these recommendations make sense to me.

One of the major areas of controversy in the area of competition is the appropriate regulatory treatment of proprietary trading systems. Some critics argue that these systems operate as automated exchanges and operate at a regulatory competitive advantage to the exchanges. Market 2000 recommended merely a recordkeeping and reporting requirement regulatory approach to these systems.

On February 9th, the Commission implemented the suggestion resulting from the study by proposing new Exchange Act Rule 17a-23. The comment period for this proposal has just been extended. By opting for a Rule 17a-23 approach, the Commission has apparently abandoned its earlier Rule 15c2-10 proposed approach that would have applied to fewer systems, but imposed greater requirements.

Two other competitive proposals contained in the study which I wish to mention are the recommended amendment to accelerate the review of routine procedural and administrative actions of the self-regulatory organizations and the recommended legislation to extend transaction fees to NASDAQ securities. I support both recommendations.

Finally, in the area of open market access, the study made two recommendations that I wish to mention. First, it recommended that off-board trading restrictions should be removed for after-hours trading. Second, the Division instructed the NYSE and AMEX to make it easier for issuers to delist from their respective exchanges. Some of the self-regulatory organizations apparently have not been as decisive as the NASD in embracing the recommendations flowing from the study. I find this disappointing. Both of these recommendations make sense to me.

The staff concluded its report with the identification of four trends that may drive the evolution of our equity markets in the future. First, institutional investors are expected to continue to account for the lion's share of the equity trading volume. Second, global trading is expected to continue to increase, and thus U.S. markets must continue to improve in the area of efficiency in order to remain the dominant marketplace. Third, continued growth in the derivatives market is anticipated. I remain concerned that these synthetic instruments can be structured so as to evade regulatory oversight. Fourth, technological advances should continue to make it easier for the investing public to deal directly with market players, without the benefit of a professional intermediary. While only time will tell, I suspect that the Division is right with respect to all four trends.

I am glad to see that the Market 2000 report was finally published. As I noted, only in the areas of payment for order flow and proprietary trading systems has the Commission actually issued proposals. However, I would expect that 1994 will see many more rule proposals concerning equity market structure issues which were addressed by Market 2000.

III. Wrap Fee Programs

Let me switch to the subject of wrap accounts. Wrap fee programs currently hold more than $50 billion in assets and are expected to continue to grow. Both the Commission and Congress have been concerned that clients participating in wrap fee programs have not been receiving adequate disclosure concerning the costs of these programs and the services provided.

Since discussing this topic last year, there have been some changes. In January, in conjunction with the state securities regulators, the Commission proposed amendments to Form ADV, the registration form for investment advisers that also serves as the basis for the disclosure brochure advisers are required to deliver to their

clients. The proposed amendments set out specific disclosure requirements for wrap fee programs that were intended to provide prospective wrap fee program clients with better information about the programs, including their cost and the services provided (and not provided) as part of the wrap fee.

As everyone here is probably aware, earlier this week the Commission adopted amendments to Form ADV, with some revisions to reflect the comments received on the proposal. Also earlier this week, the North American Securities Administrators Association voted to amend its Uniform Rules under the Uniform Securities Act to adopt the same wrap fee brochure amendments. The Commission amendments would require that a special "wrap fee brochure" be provided to prospective wrap fee clients in lieu of the brochure the sponsor would otherwise be required to deliver. The wrap fee brochure would be in narrative form and would provide prospective clients with important information about the sponsor and the wrap fee program, including the services provided and the fees charged. Mutual fund asset allocation programs are excluded from the new brochure requirement.

Since the amendments will require new materials to be developed, printed and distributed by most wrap fee sponsors, sponsors are given until October 1 to begin delivering the brochure to prospective wrap fee clients. In addition, sponsors are required to deliver the new wrap fee brochure to existing wrap fee clients on a one-time basis no later than October 1 as well.

The expected interpretive release to address other substantive issues surrounding wrap fee programs which I mentioned last year has yet to be considered by the Commission. I hope that it is soon. Of course, the primary issue confronting the Commission in the interpretive area is whether a wrap fee program is a de facto investment company that should be subject to the provisions of the Investment

Company Act of 1940, including registration. Secondary issues involve conflicts of interest 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 more customer assets are bundled together by the investment adviser, the more likely the finding that there is an investment company. The inverse is true for the level of individual customer control over the account. The less ability provided to customers to control the universe of investment choices, the more likely the wrap program is an investment company.

Apart from the issue of whether wrap accounts are de facto investment companies, there are other concerns that wrap accounts present heightened conflict of interest situations, involving best execution requirements and affiliated transaction prohibitions. 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 are related questions about principal transactions and the possibility of "double-dipping" when a manager places money with in-house mutual funds.

Another concern is suitability. The members of this audience should be aware that the Commission has recently proposed an express suitability provision for investment advisers. I will come back to this point in a few minutes. However, I do have two specific suitability concerns in the wrap fee area. First, wrap accounts are not suitable necessarily for all clients. Second, the manager should have a reasonable basis for believing that the sponsor is sending suitable clients to the manager.

The bottom line in the wrap fee area 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 guidance will be forthcoming in the near future.

IV. Investment Adviser Legislation

Another item still on the plate from 1993 is investment adviser legislation. The legislation introduced to date on this subject reflects that the adviser industry has grown exponentially, while the Commission's resources available to oversee the industry have not enjoyed the same growth.

Investment adviser legislation has passed both the House and the Senate. The legislative version approved by the House contains far more sweeping provisions than does the Senate approved version. Unfortunately, the legislation has stalled in conference. The one issue that both branches of Congress apparently do agree upon is the need for increased funding for the Commission's oversight of the investment adviser community.

Recently, the Commission has taken action to help break the conference logjam obstructing this legislation's enactment by beginning to implement by rule some of the provisions favored by the House, thereby eliminating the need for conference committee action on these matters. For example, last month, the Commission proposed two new rules. The first rule, which I mentioned earlier, would make explicit an adviser's suitability obligations. While an implied suitability obligation has always existed, an express requirement should heighten the awareness of the investment adviser community of this obligation. Some advisers apparently forget that a suitability obligation exists, albeit somewhat differently, even with an institutional client.

The second rule proposed would have the effect of assuring that customers receive a quarterly statement from the adviser's custodian. This rule is intended to obviate the Wymer situation. Both of these rule proposals make sense to me as a regulatory matter independent from the desire to enact the investment adviser legislation, and I was pleased to support both proposals. The comment period for the proposals ends May 23rd. I would anticipate additional Commission action on these

proposals later in the summer. In the event that the investment adviser legislation does not become enacted this year, I would expect the Commission to unearth some old suggestions to improve investment adviser oversight, such as the creation of an investment adviser self-regulatory organization.

V. Enforcement

Let me close with an overview of some of the Commission's enforcement priorities for the future which may be of interest to you. Of course, enforcement actions are often driven by external, unforeseen events, and it is very 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. Last year, I mentioned the Salomon Brothers Section 21(a) Report, which had just been issued, and the importance of that report in the failure to supervise area. That discussion is just as relevant today. I also anticipate that the Commission will continue to focus on sales practice cases. The recent $330 million Prudential Securities settlement that grabbed the headlines should have made that clear. The Commission, particularly under Chairman Levitt, will not tolerate the abuse of investors in our securities markets. If such abuses are discovered, severe sanctions will follow.

In addition to the usual array of insider trading cases and misappropriation of client fund cases, I expect that the Commission will continue to expend enforcement resources on financial accounting fraud cases, like the Towers Financial Corporation case, and, to a lesser extent, on management discussion and analysis disclosure cases, such as the Shared Medical Systems, Software Toolworks, and Del-Val cases. Moreover, I anticipate that the Commission will continue to focus enforcement attention in the penny stock area. Further, given the vast amount of media attention involving alleged corrupt practices in the municipal bond area, I expect the Commission to focus increased enforcement attention on that area. In light of recent

reports alleging abuses of Regulation S, I would not be surprised to see some enforcement activity in that area as well.

Of course, the Commission has also stepped-up its enforcement activity with respect to investment advisers and investment companies. During the past year, for example, the Commission instituted '40 Act cases against Kemper Financial Services, Aetna Capital Management, Bank of California, and Merrill Lynch, among others. I expect this activity will continue, particularly if the investment adviser legislation alluded to earlier is enacted, as the Commission will then add a significant number of investment adviser examiners to the staff. In particular, I anticipate that the Commission will continue to concentrate on trade allocation cases. Further, I would not be surprised to see Commission enforcement cases develop in the area of personal securities trading by mutual fund portfolio managers.

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 always strives to "do the right thing" in its enforcement program.

VII. Conclusion

Let me conclude by saying that the Commission has made progress with respect to many of the items that were on last year's "plate." I hope such progress continues. In the interest of time, I did not mention the Commission's activities either in the derivatives area or in the foreign listing area; but I do anticipate continuing Commission interest in both of these areas. The plate for 1994 looks to be even more full than that for 1993, especially as Congress and the media focus greater attention on certain aspects of the securities marketplace, such as mutual funds and derivatives activities. For example, I anticipate that the Division of Investment Management will

even more closely scrutinize mutual fund disclosures to ensure that the derivatives activities of funds are being accurately and adequately disclosed. I also suspect that the Division will take the steps necessary to ensure that the proper internal controls are in place to prevent a fund from being bamboozled by one of its investment advisers in the derivatives area.

I intend to work with Chairman Levitt and my other colleagues on the Commission, as well as with the NRS, among others, to continue the Commission's active presence in an appropriate manner in our securities markets. While there may be differences in the approach taken from time to time, I know that everyone is committed to the goals of ensuring that our securities markets operate fairly and efficiently and that our securities market professionals conduct themselves with integrity. I look forward to working with each of you in the future toward accomplishing these objectives.