Remarks Of

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Strengthening Investor Confidence In U.S. Securities Markets

Eleventh Annual Northwest Securities Institute
Seattle, Washington

February 22, 1991

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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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I. Introduction

During my confirmation process, I stressed the importance of strengthening investor confidence in our securities markets. I did not realize at that time what a daunting challenge that task would be. In the wake of 1) what has finally been acknowledged as a recession; 2) record bank failures; and 3) the war in the Persian Gulf - Congress, regulators, members of the bar and industry professionals must devote more attention to creating an atmosphere in which investors believe that the U.S. securities markets are safe and efficient. We also must remind investors that their participation, through investment in the U.S. securities markets, both individually and through institutions, is important and valued.

Individual investors have been leaving our securities markets for about 20 years, a trend that accelerated after the market crash in 1987. In the last five years, individual investors have decreased their direct holdings in securities by more than a third.[1] According

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[1] Michael C. Jenson, "Eclipse of the Public Corporation," Harvard Business Review, September-October 1989, p. 61.

to the Securities Industry Association, individual investors were net sellers of stock at a rate of an average 3.5 million shares per day in early 1989. Even though individuals or households still own about 50 percent of American equity securities, fewer than one in five trades are executed for individual investors.[2] This "retreat" of the individual investor from direct equity investments has been accompanied by an increase in equity holdings by pension funds and other institutional investors. Institutional investors -- such as pension funds, mutual funds and insurance companies -- have increased their U.S. equity holdings by more than 300 percent over the last 25 years.[3]

We may boast to our foreign competitors that the United States securities markets have the highest level of individual participation in the world. The long-term trend, however, has been that individuals are leaving those markets as direct investors. The

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2 U.S. Congress, Office of Technology Assessment, Electronic Bulls and Bears: U.S. Securities Markets and Information Technology, OTA-CIT-469 (Washington, D.C.: U.S. Government Printing Office, September 1990).

3 "Setting the Record Straight," Testimony by Wendy L. Gramm, Chairman, Commodity Futures Trading Commission, before the Committee on Banking, Housing and Urban Affairs, United States Senate (February 15, 1990).

"small investor" will increasingly be found "under the umbrella" of large investment funds with professional investment managers and pension plans. This shift, while it has created its own problems, has broadened, to some extent, the base of participation and given more Americans a stake in the liquidity, efficiency and fairness of securities markets. Accordingly, one goal of the SEC should be to devote our regulatory resources to that portion of the market where small investors place their funds - particularly in the area of mutual funds and money and investment managers.

However, I believe that there still exists a place in our securities investment structure for individual share ownership. While individual stockholders have become concerned about their ability to compete effectively on a short-term basis with professional investors and have fled to institutional participation, there are those who proclaim that the individual pursuit of a long-term securities investment strategy can continue to be successful. 1990 was hardly a banner year for domestic brokerage firms; yet I noticed that a recent article stated that one particular prominent brokerage firm posted $22.5 million in pre-tax income on revenue of $320

million, giving it a return on equity of 30%. This article indicated that this firm made its money the boring way: by telling customers to buy and hold.

"We find no evidence that the vast majority of investors can systematically make money trading securities" says John Bachmann, the managing principal of this particular firm. "We believe you should buy good securities and keep them for the long pull."[4]

There are indications that the trading atmosphere is changing and that a return to direct investment participation by individuals may be on the horizon. While my predictive abilities are not particularly acute, I have noticed that since the first of the year, in spite of the lull in market activity this week, the Dow Jones Industrial Average has risen approximately 300 points and that during this month, the New York Stock Exchange per day trading volume has increased by 50 million shares over the average for the prior six months.

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[4] "Keeping Up With Down-Home Joneses," The Wall Street Journal, p. C1 (February 12, 1991).

Other, far wiser, individuals are also sensing a trend. Joseph Hardiman, the President of the NASD, has recently remarked that a fundamental change in investment trends may be under way. He stated as follows: "The stocks of small to medium-sized companies in the post-war period traditionally out performed the big companies. Then they did not between 1983 and 1990. Now, perhaps, that tradition is returning."[5] Bill Donaldson, the new Chairman of the New York Stock Exchange, has stated to me personally that he is urging his member firms to exercise extra effort to win back the loyalty of individual investors and to refocus attention on the individual investor.

Thus, another goal of the SEC should be to adopt a regulatory scheme that will nurture individual participation in securities investment to continue the vital capital raising function of our securities markets.

Today I wish to point out some recent examples of what I consider to be the Commission's incremental progress toward

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5 "The New Year Greets NASD," The Financial Times, p. 21 (February 13, 1991).

strengthening investor confidence in U.S. securities markets both in terms of institutional and individual participation.

II. Section 16 Revision

The Commission recently adopted amendments to the rules promulgated under Section 16 of the Exchange Act which represent the first comprehensive revision of those rules. By retaining the shareholder approval requirement of employee benefit plans, in my judgment, the Commission reaffirmed the message that investors are important.

III. Amendments to Rule 2a-7

Last week, on February 13, dubbed "Wednesday the Thirteenth" by commercial paper issuers, the Commission approved amendments to Rule 2a-7 under the Investment Company Act. Originally adopted in 1983, Rule 2a-7 is an exemptive rule that permits money market funds to value portfolio securities by reference to amortized cost rather than market value as otherwise required by the Act.

In late 1989 and early 1990, several money market funds held second tier commercial paper of issuers that defaulted. The

investors in these money market funds did not suffer any loss, only because the advisers to the funds purchased the paper from the funds at amortized cost or principal amount.

Today, over 20 million investors own shares in taxable money market accounts, holding assets of over $455 billion.[6] Money market funds are viewed by investors as the psychological equal of savings and checking accounts, even though they are not federally insured. In fact, some say that money market mutual funds are showing signs of replacing banks as safe havens for consumer funds.[7] This movement would be reversed if a run on money market funds occurred, and such a run would further weaken investor confidence in our capital markets.

In view of the recent problems with commercial paper that was rated second tier paper before the issuers defaulted, the Commission concluded that amendments to Rule 2a-7 were necessary in order to tighten the rule's risk-limiting conditions and

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[6] Opening statement of Richard C. Breeden, Chairman, Securities and Exchange Commission, Proposed Rule 2a-7 (February 13, 1991).

[7] "Jittery Consumer Turning to Money Funds, Not Banks," American Banker, p. 1 (January 22, 1991).

to require any registered investment company that holds itself out as a money market fund to meet these conditions.

Among other things, the amendments to the rule would:

1. Limit money market funds to investing no more than 5% of their assets in any one issuer;
2. Limit money market funds to investing no more than 5% of their assets in securities not having the highest rating from the required rating organizations, with investment in any one issuer being limited to the greater of $1 million or 1%, but broaden the definition of required rating organizations so that more split rated securities are considered "First Tier Securities;"
3. Reduce the maximum allowable average weighted maturity of money market portfolios from 120 to 90 days; and
4. Require the cover page of money market fund prospectuses to disclose prominently that an investment in the

fund is not guaranteed or insured by the U.S. Government.

These amendments should decrease the likelihood of one or more money market funds "breaking a dollar" and should enhance investor confidence in the money market fund industry.

In my judgment, the focus of the Commission in adopting amendments to Rule 2a-7 properly was on the protection of money market mutual fund investors rather than on the market for second tier commercial paper. The Commission had an opportunity to bolster investor confidence in an appropriate fashion and did so.

I noticed with interest that the Chairman of the Federal Reserve Board is reportedly still considering a proposal whereby the Fed would purchase commercial loans from banks.[8] Some may argue that the focus of such a proposal is not on the protection of depositors but on the protection of certain banks.

IV. Amendments to the Net Capital Rule

The Commission also acted recently to further make sure that

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[8] "Fed Weighed Buying Commercial Loans From Banks to Help Ease Credit Crunch," The Wall Street Journal, p. A2 (February 22, 1991).

investors confidently can invest through broker-dealers without fear of losing their investment due to the broker-dealer's financial difficulties. The bankruptcy of Drexel, the parent company of one of the largest investment banking firms in the United States, and of its registered broker-dealer, prompted questions about the SEC's capital requirements for broker-dealers. As Michael Macchiaroli, the Assistant Director of Compliance and Financial Responsibility for the Division of Market Regulation, has stated in a recent article: "[t]he primary mechanism the SEC uses to determine the financial integrity of broker-dealers is its net capital rule. Essentially, the net capital rule is a requirement that broker-dealers maintain enough liquid assets, net of liabilities, to pay all their obligations in the event they must liquidate."[9]

The Commission's net capital rule requires that every registered broker-dealer maintain certain specified minimum levels of net capital. The purpose of the rule, and related rules, is not to protect particular brokerage firms from failure. The rule's primary

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[9] Michael A. Macchiaroli, "Who's Watching Wall Street?", Secondary Mortgage Markets, p. 8 (Fall 1990).

purpose, and the Commission's role in such cases, is to protect customers of a failing or failed brokerage firm. The net capital rule has several features that serve this purpose:

First, the rule not only requires that each broker-dealer maintain liquid assets in excess of liabilities; it requires specific, realistic adjustments to asset values to reflect market and credit risk.

Second, the rule requires broker-dealers to mark their securities positions to market value daily. This provides meaningful, up-to-date information with which to assess the real economic values and risk exposures of broker-dealers.

Third, when a broker-dealer's net capital drops below certain levels, the net capital rule requires it to notify the Commission and refrain from paying dividends or withdrawing equity capital in any way for its shareholders or partners. This provides the Commission with an early warning of capital difficulties and prevents a broker-dealer in difficulty from depleting its capital through dividends. However, as I will mention in a minute, the Commission did conclude that this warning is required not quite early enough.

Fourth, if a broker-dealer fails to meet its minimum net capital requirement, it must cease conducting its brokerage business immediately. There is simply no such thing as "regulatory forbearance" in the securities industry. There is simply no such thing as a "too big to fail" doctrine in the securities industry.

Because of these features, the net capital rule has both protected investors from loss in broker-dealer failure and minimized the costs of such failures to the Securities Investor Protection Corporation ("SIPC"). Indeed, in many cases, because the Commission has current, realistic information about a broker-dealer's capital problems, the Commission can wind the firm down without SIPC liquidation. The most recent and most vivid example of this was the Drexel bankruptcy situation. The Commission worked with the Drexel broker-dealer and other regulators to limit Drexel's securities operations and to transfer the remaining customer accounts and securities positions to other broker-dealers. This entire program was completed without any cost to the SIPC fund or, more importantly, to the U.S. taxpayer.

Even when a SIPC liquidation is required, the net capital rule generally ensures that the costs of liquidation are slight. The largest payout in the twenty-year history of SIPC has been $32.5 million. That contrasts rather favorably with the estimated cost, for example, of the liquidation of the Bank of New England; over $2.3 billion.

While the net capital rule has worked well, the Drexel situation pointed out the flaw that the rule applies only to registered broker-dealers and not to the holding company or to its other subsidiaries. Drexel, like other large investment banking concerns, developed an organizational structure in which the registered broker-dealer DBL was one member of a number of subsidiaries and affiliates of Drexel conducting financial and securities activities, some of which were regulated by the Commission, while others were regulated by other agencies or were unregulated. When the Drexel parent encountered financial difficulties, it began to withdraw huge amounts of capital from its broker-dealer subsidiary. Other than in certain limited circumstances, current Commission rules did not contain any provisions that would either require prior notice of or

prevent the withdrawal of excess net capital from a registered broker-dealer. Also, the early warning standard that did exist had too low of a threshold. Thus, the Commission has taken several steps to improve its financial responsibility standards.

First, the Market Reform Act of 1990 gave the Commission new authority to monitor, on a consolidated, world-wide basis, the activities of a broker-dealer's parent and affiliates. The Commission expects to soon publish for public comment its proposed rules to implement these "risk assessment" provisions of the Market Reform Act.

Second, two days ago, on Wednesday, the Commission adopted amendments to its net capital rule that would require a broker-dealer to give prior written notice to the Commission of its intention to disburse more than a specified percentage of its capital to its parent, shareholders, or related entities. The amendments would also permit the Commission to block withdrawals of capital that would expose the broker-dealer to an unacceptable level of financial risk. In addition, the amendments would prohibit capital withdrawals when the effect of the withdrawal is to reduce the

registered broker-dealer's net capital below a certain percentage of the broker-dealer's haircuts on its securities positions. This additional early warning standard is necessary in the Commission's view to reflect the shift of many large firms toward an increased focus on proprietary activities.

In my judgment, the Commission once again had the opportunity to bolster the confidence of a broker-dealer's customers and did so in an appropriate fashion. The focus of the Commission was properly on updating its financial responsibility rules in recognition of the fact that brokerage firms increasingly are owned by holding companies that have numerous subsidiaries and affiliates operating with little or no regulatory oversight.

V. Proxy Voting Reform

The Commission will have an opportunity in the future to bolster investor confidence in our securities markets when it considers revisions to the proxy voting rules. I noticed that in a recent speech, Commissioner Lochner has proposed, as both an interim solution and as a mechanism to obtain more information, that companies be required to prominently disclose their voting

procedures, and whether or not such procedures are confidential, and their voter tabulation procedures, and whether or not such procedures are conducted in an independent manner.[10] I would be inclined to support such a proposal.

I also wish to recommend that companies engage in increased communication with their shareholders whether they be individuals or institutions. Companies that seek relief from the inevitable tension that exists between corporate management and large institutional shareholders could discover solace in the individual investor. Individual shareholders often have a long-term investment strategy and may identify more closely with the stated objectives of management rather than those of institutional shareholders. Thus, companies should exercise effort to attract more direct individual investor participation as a means to balance the often conflicting interests of institutional investors.

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10 "The Proxy Rules: Reflections on Some Proposals for Change," Remarks of Commissioner Philip R. Lochner, Jr., before the ALI/ABA, New York, New York, pp.15-19 (November 29, 1990).

VI. Conclusion

In conclusion, I wish to mention that public policy has traditionally focused on encouraging investors to invest by protecting them against market fraud and manipulation. Traditional public policies and regulatory procedures that were designed to protect the "small investor" must be restructured to recognize the changing patterns of market participation. Today, I have mentioned only a few recent examples of an effort by the Commission, in light of current market practices, to make incremental progress toward increasing both institutional and individual investor confidence in our securities markets. I look forward to continuing that progress throughout my term on the Commission.