Remarks Of

Richard Y. Roberts
Commissioner*
U.S. Securities and Exchange Commission
Washington, D.C.

Pension Plans, Off-the-Page Sales, and Chinese Walls

Bank Securities Association
1992 National Mutual Fund Conference
San Francisco, CA
November 9, 1992

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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.

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

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I. Introduction

I appreciate the opportunity to address the Bank Securities Association's 1992 National Mutual Fund Conference. It is my intention today to comment briefly on the need for participants in participant directed defined contribution plans to have more information concerning their investment choices. I also wish to offer support for the proposal to allow off-the-page mutual fund sales. Finally, I wish to share with you some of my concerns in the conflict of interest area pertinent to the banking community involved in the mutual fund industry and how the use of Chinese Walls can mitigate some of these concerns.

II. Mutual Fund Developments

Over the last decade, there has been tremendous growth not only in the size of investment companies, as measured by assets under management, but also in the number and type of funds available to investors.

Investment company assets, now at approximately $1.5 trillion, rose over 450% during the last ten years. As a result, investment companies have become the nation's third largest type of financial intermediary in terms of assets. Only commercial banks and insurance companies have more assets than investment companies.

Among the factors contributing to the growth of investment companies is the relatively few barriers to entry for new funds. This is a point that the Commission should bear in mind when acting upon the recommendations deriving from the Investment Company Act Study (the "Study").

Obviously mutual funds have rapidly become America's investment vehicle of choice. However, the growth and prosperity that this industry currently enjoys is of course inextricably linked to investor comfort and acceptance. For this success to continue, it is incumbent for everyone here to maintain an atmosphere that is conducive to a high degree of investor confidence. It is clear that investors now have the confidence in the mutual fund industry to trust you with their money. In my opinion the level of prosperity that you will enjoy in the future will be directly proportional to the level of investor confidence in your products and services. When investor confidence begins to diminish, I assure you that bad times are soon to follow. Thus, you are partially responsible for pointing out bad apples in the industry and questionable practices that may be occurring in the industry. Certainly one of your foremost challenges in the future will be to maintain investor confidence in your products and in your services.

III. Future Trends

Looking ahead, the investment company industry is likely to benefit in the coming years from, among other things, increased retirement savings as baby boomers start planning for retirement. Mutual funds appear especially compatible with the long-term objectives of investing for retirement, and the industry has already seen its share of the rapidly growing individual retirement account ("IRA") market expand from roughly 10% to about 25% the last decade.

In addition to the IRA market, mutual funds are apt to continue to profit from the growth of defined contribution plans, especially participant directed plans that provide multiple investment choices. Over the last several years, the growth in defined contribution plans has been approximately 50% higher than the growth in defined benefit plans. Some predict that defined contribution plans will account for at least 70% of the growth of pension assets over the next five years. Defined contribution plans are undeniably the wave of the future for corporate pension funds. In particular, Section 401(k) plans have become enormously popular over the past decade.

Unlike more traditional defined benefit plans, where the employer generally handles the investments and bears the investment risk, the employee often makes the investment decision and bears the

investment risk for defined contribution plans, including the 401(k) plan. Typically, companies offer their employees a broad array of investment options for their 401(k) plans, and these options generally include some type of mutual fund, most often an equity fund and/or a money market fund -- although a variety of bond funds are also offered in connection with 401(k) plans.

It appears to me that in the situation where the employee makes the investment decision and bears the investment risk (i.e., a participant directed defined contribution plan), the employee, like any other investor, should have adequate information about his or her investment options in order to be able to make an informed investment decision. However, it is my understanding that the disclosure regulations under ERISA in the past focused only on disclosure about the plan itself. Thus, many plan participants who direct the investment of assets in their defined contribution plan accounts may not currently receive adequate information about the investments that underlie their plans.

I have grown increasingly concerned about this lack of information. The opinion exists that individuals who direct the investment of their defined contribution plans should be provided with the protection of our federal securities laws. For this reason, the Study recommended legislation to amend Section 3(a) (2) of the

Securities Act to remove the exception for interests in collective trust funds and separate accounts in which participant directed defined contribution plans invest. Such legislation would include a provision to require the delivery of funding vehicle prospectuses to plan participants that direct their investments. For many pension plan participants, choosing where to invest their retirement plan assets will be the most important decision that they will ever make. They should be furnished more complete information with respect to their investment options.

While I continue to advocate the need for such legislation and fully support the recommendations of the Study in this area, I recognize that such legislation would be controversial and strongly opposed in some quarters. Happily, I can report that the Department of Labor has issued new regulations under ERISA which may solve some of the investment information shortcomings in this area that currently exist.

The detailed rules, published in the Federal Register on October 14 of this year, specify how an employer can be deemed as exercising proper fiduciary responsibility while allowing employees to make their own investment choices. While employers are not compelled to subject themselves to the new rules, which take effect for most plans in January 1994, they must do so in order to obtain

the relative immunity from lawsuits by employees disappointed with the return on their investment.

The new rules are a positive step toward providing participants in these pension plans with enough information to make sound investment decisions. Among other things, the new rules allow such participants to choose from a broad range of investments, and to modify their choices regularly. Specifically, to meet the guidelines, plan sponsors will have to provide employees with those core investment choices, detailed information on each option offered, and the chance to change investment funds quarterly. The Department of Labor has also recently allowed some plan administrators to provide investment advise to employees covered by participant directed defined contribution plans in an additional step to help such employees make appropriate decisions about their retirement money.

I am encouraged by the Department of Labor's actions. Again, while the legislative recommendation of the Study has not been rendered unnecessary by the new ERISA rules and the new ERISA exemptions, the new regulations and exemptions represent a significant effort to partially close the information gap that I believe currently exists in the participant directed defined contribution plan area. Unfortunately, even with the new rules and exemptions in place, an information gap will continue to exist. Also, the new rules

are voluntary. Further, ERISA does not apply to all pension plans. Thus, legislation remains necessary to ensure full and fair disclosure to every pension plan participant responsible for investing his or her own retirement funds. However, I am confident that the Department of Labor will continue to follow this issue closely in an attempt to ensure that these investors will receive sufficient information to make such an important decision.

IV. Off-the-Page Sales

At this point, I wish to change gears and say something in favor of the off-the-page sales recommendation contained in the Study.

The Study concluded that Securities Act Rule 482 currently creates an unwarranted competitive disadvantage for direct-marketed funds. Direct-marketed funds must attract investor interest by complying with the requirements of a safe harbor rule such as Rule 482. Investors who now clip a Rule 482 advertisement must complete a form requesting the statutory prospectus which is received days, or perhaps even weeks (depending on when the investor has time to complete the form), after the investor first becomes interested. Finally, either the customer or the fund must initiate further contact to close the sale. This process is expensive and time-consuming.

In contrast, investors that desire to purchase investment company shares from brokers based on oral communications need not request, or wait for, a statutory prospectus before buying; they only need to receive the statutory prospectus prior to, or with, the earlier of the confirmation of the sale or the delivery of the securities, both of which occur after the investor has made an investment decision. For example, Investor A may discuss various investment options at his broker's office or over the telephone and may actually purchase securities based on those discussions without receiving a prospectus until the confirmation of the sale. Investor B, who also may know what he wants to buy based on his own reading and research, but whose interest runs to a fund that is not sold by commissioned sales personnel, cannot make that purchase until he requests and receives the prospectus. Obviously Investor B is unable to invest his money as quickly as Investor A.

The Study recommends amending Rule 482, or adopting a new rule, to give investors the option of purchasing mutual fund shares directly from advertisements ("off-the page"). According to the Study's recommendation, off-the-page advertisements would be prospectuses with prospectus liability and would be required to contain standardized, core information about the fund. Under an off-the-page system, an investor would be able to purchase securities by

completing an application form included with the advertisement and sending a check with the completed form. The statutory prospectus would be delivered with the confirmation of the sale, parallelling the current requirements that apply to sales entered into on the basis of oral, rather than written, communications. Of course, investors also would have the option of requesting the statutory prospectus before investing; every off-the-page advertisement would be required to contain a prospectus request box, just as the Rule 482 advertisements do today.

Selling off-the-page would provide significant savings for direct-marketed funds, would increase competition, and would provide investors with a new source of important information about their investment alternatives. The Study concluded that an amendment to Rule 482 (or adopting a new rule) providing specific requirements for selling off-the-page could be accomplished for the most part without the need for legislation.

In general, I support the Study's recommendation to allow off-the-page sales and hope that the Commission either proposes a new rule, or an amendment to Rule 482, to implement this recommendation in the near future. I suppose that I would prefer amending Rule 482 rather than promulgating a new rule in order to avoid duplication and possible confusion. I believe that if this

recommendation is implemented properly, the investor protection concerns with off-the-page sales can be handled appropriately.

V. Bank Mutual Fund Growth

Moving on to the subject of bank mutual funds, there has been tremendous growth in the bank proprietary mutual fund area. In 1987, banks managed just over 200 investment companies with assets of $35 billion, less than 5% of the investment company industry's total assets. Banks now manage over 700 investment companies with total assets of about $170 billion, a four-fold increase in assets at a time when the assets of the industry as a whole did not even double. Bank-managed investment companies now contain almost 15% of the investment company industry's total assets. It has been reported recently that the biggest selling alternatives to certificates of deposit at banks are investment companies. Further, banks now manage over 340 money market funds containing over $112 billion in assets, 79% of total bank investment company assets.

The popularity of investment companies among bank customers is demonstrated by the fact that banks are increasingly registering common trust funds and collective trust funds as investment companies. This year's vetoed tax bill, the Economic Growth Act of 1992, proposed permitting tax-free conversions of common trust funds into investment companies. Last year's banking bill also would

have permitted these tax-free conversions. More bank mutual funds will undoubtedly spring up when they are allowed, as I believe they should be, to convert their common trust funds to registered investment companies on a tax-free basis.

I anticipate that the recent growth in the bank proprietary mutual fund area will continue. For example, I noticed that Dean Witter and NationsBank have recently entered into a joint venture to sell mutual funds and other investments. As Charles King, the president of NationsBanc Securities stated with respect to this new joint venture, "low interest rates have driven a lot of people to look for alternative investments, but I really believe the growth of the bank's mutual fund business reflects a change in . . . the investment patterns of our customers who are looking for better opportunities."[1] Likewise, Jim Higgins, the president of Dean Witter said, "I think there is a whole segment of customers out there looking to their banks . . . for answers to questions . . . relative to savings products, and now investment products."[2] There is speculation that other banks and securities firms will engage in similar joint ventures. In any event, I anticipate that bank involvement in the mutual fund area will continue to increase.

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1 Hinden, "NationsBank - Dean Witter Plan Is a Pairing of Opposites," The Washington Post (Nov. 4, 1992), at F3.

2 Id.

VI. Conflict of Interest Problems

The entry and increased presence of banks in the investment company business, does, however, pose certain potential problems, and these potential problems, whether real or imagined, are worth including in my presentation today. All kinds of potential conflicts of interest appear when a bank becomes involved in the provision of investment company and investment advisory services.

For example, a bank that makes commercial loans and provides trust or investment advisory services faces conflicting duties to its clients.[3] The bank's commercial loan department has a duty to its customers not to disclose any material, nonpublic information it has about its customers, as well as a duty not to purchase or sell, or recommend the purchase or sale of, securities on the basis of that information. In contrast, the bank's trust or investment advisory department has a duty to its customers to make investment decisions in light of all relevant information in the bank's possession or that the bank could reasonably obtain.

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[3] The case of Connell v. Chase Manhattan Bank, N.A., N.Y.L.J. (Jan. 15, 1981), p.7, illustrates this conflict. The trustees of a pension fund brought suit against its bank investment adviser, charging that the bank had breached its common law fiduciary duty to the pension fund by advising it to purchase the common stock of a bank customer-borrower while the bank knew that the client was having financial difficulties. The court held that since the bank had used information blocking procedures (i.e., Chinese Walls), knowledge of the client's financial condition could not be imputed to the employees providing securities advice.

Banks face similar conflicts of interest when advising investment companies, including the following:

(1.) whether a bank should permit its commercial loan department to transmit material, nonpublic information about its borrowers' creditworthiness to its advisory employees, who may then use that information in deciding whether to purchase securities issued by that company on behalf of the investment company; and

(2.) whether a bank should allow an affiliated investment company to invest in an initial public offering by a borrower that will use proceeds to reduce or retire its debts to the bank. Section 462(b) of last year's banking bill would have addressed this conflict of interest by amending Section 10(f) of the Investment Company Act to prohibit an investment company from acquiring, during the existence of an underwriting or selling syndicate, securities of an issuer that would use the proceeds of the offering to retire any part of an indebtedness owed to a bank or insured depository institution where the bank, insured depository institution, or an affiliated person thereof is an affiliated person of the investment company. That legislative provision appears to me to be a sound proposal

that should be resurrected if financial services industry legislative reform begins anew next Congress.

VII. Chinese Walls

The use of Chinese Walls is one method to limit some of these conflict of interest problems. The term "Chinese Wall" generally refers to policies, as well as physical barriers, designed to prevent the improper or unintended dissemination of material, nonpublic information from one division of a multi-service financial firm to another, for example, by keeping the trust department of a bank separate from its commercial loan department, or the broker-dealer department of an investment bank separate from its mergers and acquisitions department. A Chinese Wall is a method employed to segregate inside information in the functional area of the firm that has a reason to know the information. Firms complement Chinese Walls with trading procedures and reviews designed to prevent and detect insider trading.

Of course, the need for Chinese Walls arises because of the potential for dissemination of material nonpublic information that will serve as the basis for a decision to purchase or to sell a security when a bank makes loans to companies and also advises an investment company, other investment vehicle, or other advisory client that may invest in those borrowers. The bank's commercial

loan department often will possess material, nonpublic information about its borrowers. Chinese Walls are thus one method used to prevent the bank's investment management or trust department from learning and using this information in making investment decisions for its registered investment companies, other pooled investment vehicles, or individual advisory clients.

There are several provisions of both current securities law and banking law which, in effect, require a bank to establish Chinese Walls in its investment company operations. For example, the antifraud provisions of the federal securities laws impose a duty on banks that have access to material, nonpublic information about a client not to purchase or sell securities, or recommend that others do so, on the basis of that information.[4]

While banking law does not specifically prohibit trading on inside information, since 1977 national banks have been required to establish Chinese Wall procedures.[5] Further, the Federal Reserve Board has issued a policy statement recommending the adoption of

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[4] See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). See also Chiarella v. United States, 445 U.S. 222 (1980).

[5] In 1977, the Comptroller adopted a rule requiring national banks that exercise fiduciary powers to establish written policies and procedures to ensure that their trust departments do not use material inside information in connection with any decision or recommendation to buy or to sell any security for the bank or its trust customers in violation of the federal securities laws. 12 C.F.R. 9.7(d).

Chinese Wall procedures by state member banks to help avoid insider trading liability.[6] Interestingly enough, last year's banking bill would have added a new subsection to Section 17 of the Investment Company Act that would have restricted the access to certain nonpublic information in the possession of a bank to any employee providing investment advisory services to an investment company.[7]

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[6] Policy Statement of the Board of Governors of the Federal Reserve System: Misuse of Inside Information, 64, Fed. Res. Bul. 339 (1978). The policy statement sets forth guidelines to avoid the misuse of material inside information, including: denial of access to pertinent files; prohibitions against attendance by trust department personnel at meetings with bank lending or underwriting personnel; reporting to management by trust departments of the receipt of inside information and, if necessary, halting trading on such information, publishing the information, and obtaining legal advice.

[7] Section 473 of last year's banking bill would have added a new subsection (n) to Section 17 of the Investment Company Act as follows:

"(n) Access to Nonpublic Information.--

(1) Access Restriction.--It shall be unlawful for any financial services holding company, bank, insured depository institution (as that term is defined in section 3(c)(2) of the Federal Deposit Insurance Act), or affiliated person thereof, that acts as investment adviser to a registered investment company to provide any employee or agent providing investment advisory services to such investment company with access to any nonpublic information concerning

(A) the identity of any customer of such financial services holding company, bank, or insured depository institution; or

(B) any relationship arising from material extensions of credit or other material borrowings between any customer and such financial services holding company, bank, or insured depository institution.

(continued...)

This legislative proposal also strikes me as a sound proposal worth resurrecting.

There are additional legal restrictions to be aware of pertaining to the subject of Chinese Walls. The Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA") was designed primarily to prevent, deter, and prosecute insider trading. Among other things, the Act added Section 204A to the Investment Advisers Act.

Section 204A of the Advisers Act was enacted to institute a new affirmative statutory requirement for investment advisers to establish, maintain, and enforce written supervisory procedures to prevent the misuse of material, nonpublic information by investment advisers or their associated persons. The legislation does not set forth specific policies and procedures required of an investment adviser, but the legislative history provides that it is expected that institutions will adopt policies and procedures appropriate to restrict communication of nonpublic information and to monitor its

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[7](...continued)

(2) Rulemaking Required.--The Commission, as it deems necessary or appropriate in the public interest or for the protection of investors, shall adopt rules or regulations to require specific policies or procedures reasonably designed to ensure compliance with this subsection."

dissemination. There exist other such legal restrictions which I will not specifically mention today.[8]

While the Commission's Division of Investment Management has not articulated specific Chinese Wall standards for investment advisers, I understand that the Investment Company Institute has developed guidelines for investment advisers to use in formulating their own Chinese Wall procedures.

Until last year, while the Commission's staff would determine whether an entity had in fact adopted the procedures required by Section 204A of the Advisers Act, the staff did not conduct a comprehensive review of those procedures unless problems manifested themselves during other aspects of the examination. In

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[8] For another example, Rule 17j-1 under the Investment Company Act of 1940 requires that any registered investment company and its investment advisers and principal underwriters adopt a written code of ethics designed to prevent insider fraud and to use reasonable diligence and institute procedures to prevent violations of that code. Codes of ethics often incorporate Chinese Wall procedures to prevent the misuse of nonpublic information. The rule also requires that certain insiders provide to the investment company, investment adviser, or principal underwriter, as appropriate, information regarding their personal securities transactions.

Finally, Section 203(e)(5) of the Investment Advisers Act provides that the Commission shall penalize any investment adviser for violations of the federal securities and other laws or for failing to supervise persons who commit such violations. An adviser does not fail to supervise if it has in place Chinese Wall procedures that would reasonably be expected to prevent and detect such violations and it carries out its duties under those procedures without reason to believe that those procedures were not being complied with.

light of the development of, and of the growth in, the number of funds, particularly vulture funds and prime rate funds, the staff now more intensively reviews firms' internal control procedures for controlling the use of nonpublic information and for preventing inherent conflicts of interest from harming the interests of clients.

It is my understanding that the staff is now examining and evaluating funds' written policies and procedures with respect to the control of information, as well as several other matters such as:

1. its organizational structure and its investment practices and businesses (to identify potential sources of nonpublic information),
2. its procedures for controlling the flow of information among departments, such as its use of information blocking devices, such as Chinese Walls,
3. its use of restricted lists, watch lists, black-out periods on employees' trading, reporting of employees' personal securities transactions, prohibitions on personal trading in securities held by clients, and other methods used to control conflicts of interest,
4. its education of employees about insider trading,
5. its enforcement of policies, and

6. data with respect to its securities transactions and its employees' securities transactions, including comparing the timing of a fund's or adviser's transactions with news reports and press releases (in a case involving an investment company that acquired large blocks of stock, for example, it is my understanding that the staff compared the timing of the fund's Section 13D filings with press releases).

VIII. Conclusion

In conclusion, I challenge everyone here today to take the steps necessary in your operations to maintain and even enhance investor confidence in your products and in your services. I also challenge everyone here specifically to examine the Chinese Walls utilized in your operations. Compliance with appropriate Chinese Wall provisions can save the operational nightmare posed by the conflict of interest appearance problems encountered in your business everyday. Such compliance, in my judgment, would operate for the benefit of both your bank and the bank mutual fund industry.