"THE SEC AND THE MUTUAL FUND INDUSTRY: AN ENLIGHTENED PARTNERSHIP"

REMARKS BY

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Typically, it falls to the SEC Chairman to highlight problems in the securities and mutual fund industries and call for changes. But after almost two years at the Commission, my concerns about the fund industry are probably familiar to most of you -- and in the case of Jon Fossel and Matt Fink, they're probably too familiar...

I'll grant that, in some cases, we may appear to push too hard and move too fast. But the Commission has precisely the same goal as each person in this room: a strong and dynamic industry, ready to meet the challenges of the next century. And it's clear to us that a strong and dynamic industry is one that serves the interests of investors, above all else.

Today I want to balance the concerns I've articulated about mutual funds, by talking about some of the many positive aspects of the industry. I also want to address the relationship between the SEC and the mutual fund industry -- a partnership that has served American investors well for more than half a century.

I believe that, in the fullness of time, the mutual fund will come to be regarded among the greatest financial innovations of the modern era. Your industry is outstanding proof of Adam Smith's thesis that by pursuing private gain, one can promote the public good.

You've democratized our markets, enabling even Americans of modest means to own the greatest corporate giants.

You've made our markets safer, allowing investors to diversify their portfolios and hedge against risk.

You've contributed to market stability, tempering the short-range view of the speculator with the long-range view of the investor.

And you've strengthened our economy, providing an efficient way to channel vast amounts of capital to companies and communities that wish to grow and need funds.

That's not just rhetoric -- it's reality. Consider the figures for just one recent year, 1993: Stock mutual funds accounted for all of the new money flowing into exchange listed stocks; and, by some estimates, municipalities saved $290 million because they were able to place large amounts of debt with a small number of mutual fund purchasers.

By serving the interests of investors well, the industry has served itself well -- in fact, it's grown enormously. There were 125 funds in 1955; by 1980, there were about 500; today, there are more than 5,000. As Morningstar has put it, were that rate of growth to continue, "The number of funds would . . . soon threaten the number of stars in the sky."

As recently as 1980, only one in 16 American households invested in mutual funds; today, that number is almost one in three. That's more than 30 million households -- almost the same as the number that have personal computers. We've heard lots of fanfare about the computer revolution. It's time we recognized that there's another revolution going on in America right now -- the mutual fund revolution.

During that same time period, since 1980, investment company assets grew 905%; by comparison, life insurance company assets grew 224% and bank deposits grew 132% -- not even close.

That leads us to the most significant fact of all, in my eyes: For the first time in history, mutual fund assets -- at more than $2.2 trillion -- now rival the amount on deposit at commercial banks. A sea-change is taking place -- a nation of savers is becoming a nation of investors. Mutual funds won't put banks out of business, to be sure -- especially since banks now include mutual funds among their offerings -- but the supremacy of the FDIC-insured savings account is clearly challenged, and that's a monumental change.

You've grown so rapidly and dramatically because you've responded creatively to people's needs -- the need for diversified, professionally managed stock investments; the need to participate in the higher short-term interest rates of the money market; the need to accumulate retirement savings.

But as well as you've met those needs, your efforts would still amount to little if not for one other vital ingredient -- and that is the industry's record of integrity. You have earned the confidence of the American public -- and you've done so without the safety net of federal insurance to protect investors from mistakes or abuses.

As a matter of fact, the closest thing this industry has to a safety net is its independent oversight bodies, especially the SEC. No less an authority than your own Matt Fink recognized this when he testified to Congress that "the SEC's diligent and effective regulation of the mutual fund industry has contributed to a high level of investor confidence in the integrity of the industry."

I see our relationship as a partnership, with responsibilities on both sides. The fund industry has a practical **responsibility**, to see that it is innovative and competitive. But you also have a **public responsibility**, to safeguard the interests of the investors who rely on you -- in many cases, literally to manage their life savings.

The SEC has responsibilities, too. Key among them is to respect the awesome power of the free market, and, whenever possible, to use market solutions, such as disclosure, to solve market problems. When we identify an issue as fundamental to protecting the industry's valuable franchise, we work with you to resolve it. The process is not without its tensions -- but together, we've created a regulatory framework that has helped make the American fund industry the most innovative and successful in the world.

One of the most remarkable things about this process is how both parties have remained steadfastly non-partisan. There's a great deal of wisdom in this approach. In politics, just as in buying mutual funds, it pays to take the long view. If the past four years have shown anything, it is how quickly and unpredictably the political mood can swing. We've really no choice but to work together, in enlightened self-interest.

I've tried to build on the SEC's record of working <u>with</u> the industry to enhance investor protection. It's my belief that consensus works better than confrontation, and that many industry problems can be solved through education, not regulation. That's one reason we've been holding investor town meetings throughout America in recent months.

Among many other things, we've been explaining sales loads and other distribution expenses to investors -- pointing out that they buy you a broker's services and advice, but not necessarily superior performance. We're also stressing the importance of evaluating <u>all</u> charges and expenses over the investor's entire expected holding period. But there's a big difference between telling **investors** <u>how</u> expenses <u>work</u>, and telling **funds** <u>what</u> expenses should <u>be</u>.

We'll regulate where warranted -- but it's my strong belief that a call for legislation or rulemaking should be only a last resort to the kinds of consensus actions that have characterized our relationship during the past year and a half. Just think of some of the things we've been able to accomplish:

- The Commission expressed apprehension about personal investing by mutual fund managers; the ICI quickly developed recommendations to prevent abuses and your recent report -- which we're now reviewing -- shows that most fund groups are seeking to follow those recommendations.

- The Commission sought simpler, more understandable fund disclosure documents; industry leaders are working in earnest with us and with the states to develop "Profile Prospectuses" that investors can read and understand.

- The Commission expressed concern about the ability of mutual funds to report timely and accurate prices to the NASD for publication in the press; the ICI worked with the NASD and the press to improve the price reporting process.

The process works the other way as well, to address the issues <u>you</u> raise. You told us we could do better with our disclosure review process. We examined our procedures and invited you to share your suggestions.

Just this week, we responded specifically to those suggestions: We agreed, for example, that in some areas, notably junk bonds and foreign securities, we have been a party to "prospectus creep." We are taking tangible steps to reduce burdensome disclosure in those areas. We have appointed a "trouble-shooter," experienced in disclosure, to work closely with funds in registration to resolve issues and improve the quality of prospectuses. We have also expanded the circumstances under which you can amend or update registration statements without review.

This pattern of cooperation holds true for any number of goals we've identified: Controls for derivatives use. Internal compliance procedures. Greater and more effective involvement by fund boards -- especially independent directors, who are really the investors' first line of defense against abuses. In each case, we've looked to the industry for an answer; in no case has the industry failed to respond. Although not every answer has been precisely the one we envisioned, partnership involves both give and take -- and on balance, we've done very well.

We'll continue to favor market approaches and to work toward consensus solutions, pursuing legislation and regulation only where necessary. We will use the best tools at our disposal, such as our exemptive process. Commission exemptive orders fostered the creation of money market funds, by enabling them to use specialized pricing methods. The exemptive process has also permitted funds to establish multiple classes with different sales charges and expenses. I would like to see the Commission make even greater use of the process in the future, to nurture your innovations.

The Commission expects certain things from you -- most importantly, we expect your cooperation as we move forward to do a better job for you and for investors.

We've identified a need for improved risk disclosure. Over the last decade, U.S. households have become more significant risk takers, raising the proportion of assets invested in stocks and longer-term bonds from roughly one-third to one-half. Mutual funds have served as the principal vehicle for taking on these additional risks. But we're concerned that the risks are not presented well enough.

You can help us design approaches that work well for investors and for you. I was surprised by some of the initial reactions to our call for improved risk disclosure -- "It can't be done," "It's just too hard," "It's pie in the sky," "It's seeking the Holy Grail," and so on. I find it hard to believe that so creative an industry can be stymied by so basic a question. Investors who do not understand both the potential returns and risks of investments will be unhappy investors, more likely to leave mutual funds for other, potentially less rewarding investments. Even if you cannot yet agree on a numerical or graphic measure of risk, you should at least be able to find concise and understandable <u>words</u> to explain it. How would you explain risk to your parents, or siblings, for example?

Another issue of mutual interest is our new Office of Compliance Inspections and Examinations. We believe it will make the best of our limited resources and direct them to where they're needed more rapidly. I've heard concerns that the Office will be used to generate more enforcement cases, or that it will establish policy in the fund area different from the Division of Investment Management, or that it will not focus enough resources on fund examinations. Let me put your fears to rest. We established this Office because it makes sense for our inspections group to mirror the industry.

Increasingly, firms are providing multiple services -- a large fund complex, for example, will have registered advisers, sub-advisers, and funds, and may also be a registered broker-dealer and perform in-house transfer agent functions. We need to be able to coordinate our inspections so that our teams have the full range of expertise to examine all facets of a company's business. We think this will be good for the industry -- by reducing duplication and improving coordination on our side, we'll <u>decrease</u> the time you spend with our inspectors and <u>increase</u> the time you spend on your business. If anything, our examinations will be even <u>more</u> focused than before. Let me stress that I welcome any additional ideas on how we can make our inspections process even better.

The truth is, we have many interests in common. We ought to continue to work together closely to solve the problems we face today, as well as to build a solid foundation for tomorrow.

Many funds are doing just that, and I want to take this opportunity to cite a few positive practices that have caught my attention recently. I'm not a lawyer, but I do know when I need a disclaimer: the following is not an endorsement of any company or fund group on behalf of the Commission; it's merely a list of what seem to me to be positive practices. It's not complete; I welcome anyone not on it to share the practices you're proudest of -- I'd like to help you bring attention to them.

Let me begin by applauding the eight fund groups that stepped forward to pilot the new Profile Prospectus: Bank of America, Capital Research and Management, Dreyfus, Fidelity, American Express Financial Advisors, T. Rowe Price, Scudder, and Vanguard.

I also commend TIAA-CREF, ITT Hartford, and the other organizations that have been working through the National Association for Variable Annuities to develop Profiles for variable annuities.

A number of fund groups -- including Calvert, Dean Witter, Fidelity, Janus, and, in the area of unit investment trusts, Merrill Lynch -- have worked to simplify and reformat their prospectuses to meet investor needs for clear and understandable information.

Some companies are already experimenting with new ways to explain fund risks to investors -- for example, Gateway has included a broad spectrum of numerical risk measures in its prospectus; T. Rowe Price has published a brochure on risk-adjusted performance, explaining concepts of risk and the relevance of an investor's time horizon.

Several funds have gone on-line to meet investors on the information superhighway. Among the pioneers are Dreyfus and Twentieth Century Investors.

With the proliferation of 401(k) programs, more Americans are now responsible for planning their own retirement. For many, this is a bewildering new experience. Vanguard, among others, has shifted gears with a greater emphasis on retirement planning, and is offering kits with workbooks, strategies, and model portfolios.

As compelling as the practices I've mentioned are, I'm sure you'll agree that there's room for improvement. In the spirit of our continuing dialogue, let me close with some details about three broad areas of emphasis in the months ahead: investor education, investor protection, and regulatory reform.

<u>Investor Education</u>

We'll expand our efforts to educate investors and hear about their concerns -- through brochures, town hall meetings, investor hotlines, the rulemaking comment process, consumer research, and even through the Internet.

We'll set a higher standard of clarity for mutual fund prospectuses. We want to simplify money market fund prospectuses to try to eliminate information that investors don't want and can't use. And we want to find ways to get better information to employee benefit plan participants.

Investor Protection

We will continue to seek better ways to convey risk to investors. Prospectuses, fund advertisements, and even some fund names can leave investors with the wrong impression about safety. So can oral presentations -- thus we'll focus not just on what investors read, but what they hear from their brokers as well.

A recent *Money* magazine study found that brokers often do a poor job of explaining mutual fund fees, leaving investors to discover them later, when they tend to see them as "hidden costs." More than a fourth of the brokers surveyed explained sales charges poorly; one salesman left the tester believing that house-brand funds with 12b-1 fees of up to 1 percent were "no-load." And 42 percent of brokers studied by *Money* didn't discuss annual management fees at all.

That is going to change. Together, the Divisions of Investment Management and Market Regulation, and the Office of Compliance Inspections and Examinations, are working with the NASD to address the need for better and fairer sales practices. Your support in this is crucial. Earlier this week, I attended a board meeting of Capital Research Funds, at which a wholesaler made a presentation on how his group explains funds to brokers. I was impressed with the primacy of investor concerns in that dialogue. Our aim is to see that kind of concern become the norm in the business.

We'll be moving forward with rule amendments designed to tighten the risk standards for tax-exempt money market funds. But we'll also be taking seriously the concerns you've expressed about the rule's complexity and the difficulties funds might have faced under the proposed standards.

We will continue to emphasize the responsibilities of boards, to stress the need for independence, and to insist that the interests of investors are held paramount -- even if it means crossing swords with management. We'll ask directors to make sure they understand "soft dollar" policies, and to inquire about internal controls.

Regulatory Reform

We will be attentive to the ideas coming out of Congress regarding the mutual fund industry, and we will work hard to ensure that your needs, and investors' needs, are met.

In the international arena, the SEC will work to preserve the preeminence of our nation's capital markets, to expand the choices available to American investors, and to remove roadblocks to your operations in a world of globalized markets. We plan to propose rule amendments shortly that will liberalize conditions for the custody of foreign securities and reduce the burdens on fund directors when foreign custodians are used.

Those are some of the highlights of our investment company agenda for the coming months -- assuming that market events don't distract us.

These priorities focus on investor interests, which are really the interests of the industry. Anyone who advises differently, advises poorly. Mutual funds became as popular as personal computers not because they were anointed by some heavenly authority, but because they served investors above all other interests. That's why industry leaders say the Commission is the best protection they could have -- you, of all fiduciaries, cannot afford the slightest public doubt that you are comprehensively regulated.

By raising standards and fostering trust, the SEC has been a partner to your success -- an <u>unsung</u> partner, perhaps, but a partner nevertheless. That's an enlightened view -- but this is an enlightened industry. For the good of your firms -- for the good of the nation -- let us not only continue our partnership in the public interest -- let us make even <u>more</u> progress in the year ahead than in the productive year just past.

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