REMARKS BY CHAIRMAN ARTHUR LEVITT
UNITED STATES SECURITIES AND EXCHANGE COMMISSION
INVESTMENT COMPANY DIRECTORS CONFERENCE
WASHINGTON, D.C.
SEPTEMBER 23, 1994

I'm very grateful for those kind words, Matt -- and that gratitude extends to all the people of the Investment Company Institute, who have really worked hard to address the important issues affecting the industry. Their diligence and professionalism cannot go unacknowledged.

I've been thinking a lot lately about the SEC's history and its mission. We're celebrating our 60th anniversary this month, and anniversaries have a way of bringing out the fundamental questions: What have we achieved in threescore years? Where are we headed?

One way to get some perspective on what we've achieved is to look back at Franklin D. Roosevelt's first inaugural address: "The rulers of the exchange of mankind's goods have failed, through their own stubbornness and their own incompetence, have admitted their failure, and abdicated. Practices of the unscrupulous money changers stand indicted in the court of public opinion, rejected by the hearts and minds of men..."

In 1933, those words echoed from the canyons of Wall Street to the clapboards of Main Street. They resonated because Americans <u>knew</u> that the financial industry had failed them and their nation.

Scholars often disagree about the causes of the Great Depression -- but they rarely disagree about the marketplace anarchy that accompanied it.

In the Roaring 20s, our stock markets were about as orderly as a demolition derby. There was more confidence than competence. Abuses were endemic.

Shareholders signed over proxies to management to vote on questions in which they had huge conflicts of interest -- unbeknownst to shareholders.

Corporations were created for the sole purpose of trading shares of other corporations' stock and driving prices up.

Cash was paid to reporters at the New York Times and the Wall Street Journal to plant false information on companies and false tips on stocks.

Investors were sold securities without benefit of a prospectus or offering circular; without ever seeing a balance sheet; without knowing the first thing about a company beyond its name and share price.

In the dark days of depression that followed, people cast about desperately for solutions. One United States Senator even proposed that all short sellers be imprisoned -- which may not be such a bad idea, when you come to think of it...

All kidding aside -- I think it's fair to say that nowadays, we tend to forget the magnitude of the disaster our nation faced in those difficult years. I take this as a positive sign -- our marketplace has come so far since then that it's hard to conceive just how terrible things were.

This is a tribute to the structure and order imposed on the market by the securities laws. The SEC is part of that structure -- but so is each and every one of <u>you</u>. We are <u>all</u> investor advocates in this room.

We share a responsibility to investors.

We share a responsibility to our markets.

We share a responsibility to the nation.

And lately, that responsibility has grown.

Mutual funds are now a cornerstone of American investment.

In 1980, one out of 16 American households owned mutual funds; today, it's one out of four.

For the first time in history, investment company assets, at more than $2.4 trillion, exceed the deposits of <u>the entire banking system</u>. Mutual funds account for $2.1 trillion of that figure.

More than 38 million Americans now depend on us -- they've entrusted their retirement savings, their children's education savings, and even their ready cash to the investment company industry.

Never before has there been such a massive show of faith in the mutual fund industry.

And rarely have so many questions been raised about it.

We've all seen the headlines:

"Questions of Conflict Sting Mutual Funds."

"Money Funds Face New Woes."

"Is the Fund Industry Toying With Its Integrity?"

"Controversies Threaten to Halt Fund Industry's Growth."

"Lax Controls" -- "Fragile Nest Egg" -- "A Trust Betrayed."

In my lifetime, I can't remember when I've seen so many negative stories about mutual funds. In part, this is due to the growth of the industry -- the more funds and investors, the more stories, bad and good, you can expect to hear.

But you and I know that that's not all there is to it. There are some very valid, hard questions being asked about the industry -- and it's our shared responsibility to address them.

At the SEC, we've been rethinking our entire approach to consumer protection. We're concerned that investors don't always understand the risks involved in our markets -- especially those investors who have migrated from bank CDs to mutual funds in recent years.

And so we've decided to change the SEC's emphasis in a subtle but crucial way: We'll of course continue our "top-down" approach to changing marketplace behavior -- proposing rules to compel mutual funds to make their fee tables clearer and more comparable to others, for example.

But from now on, we're also going to be taking our case right to the people most affected -- individual investors. We will work to influence market behavior from the grass roots. This will enable us to get maximum leverage from our minimal resources.

There is also much that you can do. Because of your continuing involvement with your funds and your oversight responsibilities, you're able to oversee fund operations in a way the SEC cannot. In many ways, directors are in the best position to monitor new developments and trouble-shoot problems as they arise.

There are four areas of board activism and involvement that I want to discuss with you today: compliance activities; derivatives; "soft dollars" and questions of disclosure; and conflicts of interest, real and perceived. I think it's useful to keep directors abreast of the SEC's agenda for the months ahead.

Compliance is the least concrete of these issues, but the most important. It underlies all the others. There's no lack of ways for directors to fulfill their obligation to oversee the compliance activities of the fund.

I'm familiar with one investment company board whose independent members are organized into two standing committees. One is concerned with policy, operations, and administrative matters; the other with accounting, auditing, internal controls, and investigative matters that all come under the rubric of "compliance."

Although this is a sensible arrangement, I recognize that in some ways, each fund is unique, and that not all boards can function like this. The important point is not the structure -- it's that these directors understand they have a role to play in compliance.

I don't expect directors to be involved with day-to-day matters, but I <u>do</u> expect you to ask the hard questions. What resources has the fund devoted to compliance activities? The mutual fund business can be a very profitable one. Isn't it incumbent upon funds to plow some of those profits into making the fund work better, as compliance surely does? Does the compliance staff receive the full support of management? To whom do they report? When the auditors report a problem, what is the reaction of management? When SEC examiners send a deficiency letter, how quickly does management respond?

Asking these questions makes good business sense. A fund's financial success depends on its reputation. Compliance problems are suicide -- they can take you off the road to prosperity and onto the vicious circle of bad publicity, shareholder redemptions, further compliance problems, fewer new shareholders and so on.

And speaking of bad publicity, let's move on to derivatives. When I said in Arizona last March that directors ought to review derivatives policies, some people were skeptical. "That's of concern to money managers, not Directors," they said.

Some asserted that I was expecting too much of directors, asking them to get involved with something as technical as derivatives. But like it or not, you're <u>already</u> involved with something the moment it appears in your portfolio.

I don't say that derivatives are inherently bad or good -- just volatile. Now, gasoline is volatile -- but it's used every day, to good effect. Handled appropriately within a portfolio, derivatives are a high-powered fuel; handled poorly, they can be more like a Molotov cocktail.

If directors don't take the time to understand how derivatives work, how the fund is using them, how clearly their effects are described in the prospectus, and what the exposure of investors is -- well, if the portfolio begins to explode, those directors are likely to get burned along with the fund and its investors.

I think recent events have made this case more clearly than any speech ever could. Better disclosure and more reporting would solve some of the problems. The SEC is considering asking mutual funds to reduce their exposure to illiquid securities, which would include some derivatives. We're also exploring the possibility of measuring and comparing the risk of various funds. But I hope you won't wait for the SEC before you consider and approve your own proposals to deal with derivatives.

"Soft dollars" are another issue directors would do well to stay on top of, one that also presents the potential for problems. In the typical soft-dollar arrangement, an advisor routes client brokerage orders to particular brokers and in exchange, gets research. More recently, brokers have agreed with some funds to pay for or provide certain services that funds normally would pay for directly, including custodian arrangements and transfer agent services.

These arrangements can be beneficial to investors, especially when a fund negotiates a very good deal. But they deserve to be monitored by the board, because they open the door to so many valid questions: Which broker is being used, and why not another? What is the value of services being provided? Will it affect the investor's ability to compare one fund with another? To address these concerns, the SEC recently proposed to require funds to disclose the implicit costs of acquiring services through brokerage.

Disclosure is an area in which directors clearly can make a difference --and not just about soft dollars. Your responsibility for the fund's disclosure obligations gives you an extraordinary tool with which to protect investors. Does the fund clearly describe its strategy? Are risks adequately conveyed?

Clarity is good for investors -- but let's not underestimate its value to management and to you. Someone reminded me the other day that disclosure requires articulation -- and it's always helpful to be forced to articulate one's policies and objectives. You have the power to compel that.

The Commission is also considering a requirement that investment advisors tell their clients more about brokerage practices, including soft dollar payments. But if directors start asking such questions <u>now</u>, fund managers will be compelled to provide the information without government fiat. That's better for you, better for me, better for your funds, and better for American investors.

Another potential problem that should always be on the board's radar has to do with inherent conflicts of interest in the way portfolio managers are paid. I'm concerned that performance-based pay may encourage them to assume excessive risks. That's why the Investment Advisers Act of 1940 prohibits most types of performance-based fees for registered investment advisers. That prohibition, however, does not apply to the compensation arrangements investment advisers have with their own employees.

Some have said the Advisors Act's prohibition should be extended to portfolio managers. I'm not convinced that this is necessary. Rather, I hope that directors will respond by asking more questions: Is there a lopsided emphasis on performance in compensation decisions? If so, what compliance systems are in place to ensure that conflicts of interest don't result in abusive activities?

The point is <u>not</u> that pay by performance is inherently evil; it's simply that directors ought to anticipate the potential for conflicts of interest within a particular compensation system, and they ought to take measures to mitigate those conflicts.

As some of you may know, I recently appointed a blue-ribbon panel to study how compensation arrangements may exaggerate conflicts of interest among brokers. Led by Dan Tully, the Chairman and CEO of Merrill Lynch, the Committee will soon be reaching out to the industry and the public to address industry compensation methods, identify actual and perceived conflicts of interest, and describe the "best practices" in the industry.

There's no reason why fund directors shouldn't consider similar questions about compensation within the industry -- including their own compensation, and the effects of high pay on directors. A willingness to engage in such self-examination can do more to inspire consumer confidence than any advertising campaign.

There's one other potential conflict of interest that deserves your attention: personal trading by portfolio managers. In May, the Investment Company Institute released the report of its Advisory Group on personal trading.

The Group concluded that fund personnel, including portfolio managers, should be permitted to trade for their personal accounts. But they went on to recommend that funds adopt new ethics provisions designed to minimize perceived and actual conflicts of interest with fund shareholders.

Next week, the SEC's Division of Investment Management will issue its own report on personal trading by portfolio managers. The Division reviewed codes of ethics for 30 fund groups and the actual trading by the portfolio managers in those groups. As I have suggested before, the Division did not uncover widespread abuse, but they did find ample room for improvement. And with the popularity and importance of mutual funds at historic levels, we're compelled to ensure that those improvements are made -- and by "we," I mean the SEC, the ICI, the industry, and all of you.

Our proposals won't supplant the ICI's; they'll complement them, and in some instances they'll amplify them. But if there's one thing I've tried to convey today, it is that, irrespective of what we do, and irrespective of what the ICI does, these are precisely the kinds of questions you ought to be considering and acting upon as directors -- for you are in essence the investors' representatives at the fund.

I hope that I've given you an idea of my views on the historic burden that we share in protecting investors. I recognize that not all of you may agree with what I've said. Some of you may think I've overstated the obligations of the board.

In reply, I ask you to remember your critical role as investor advocates.

I ask you to remember that you have a constituency, usually numbering in the thousands.

Every time you sit down at the table with your fellow directors, thousands of investors sit with you.

Every time you stand up for what's right, even if you think you may be alone, thousands of investors stand with you.

What's more, the SEC stands with you. For the actions you take, and the standards you set, have an impact far beyond any individual fund. The 38 million Americans who invest in mutual funds are counting on you and me to look after their interests.

That's a tremendous show of faith. We must keep that faith -- in the next 60 years just as well as in the last 60. I'm sure we will.

Thank you very much.

# # #