"Taking the Mystery Out of Mutual Funds"

Remarks by Chairman Arthur Levitt
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It's great to be back in Boston, the birthplace and the heart of the mutual fund industry. These Citizen Seminars exemplify the spirit of this city, whose pride, patriotism, and sense of public duty have so deeply influenced our nation.

Once upon a time, you led a revolution against English oppression; today I've come here to wage a revolution against oppressive English.

The British writer W.Somerset Maugham once remarked that "There are three rules for writing a novel. Unfortunately, no one knows what they are."

He could just as well have been talking about prospectuses.

On the day after tomorrow, the SEC will consider the most sweeping revision of mutual fund disclosure in many years. With all respect to Somerset Maugham, the number of rules involved is three. But I assure you that's just a coincidence. Both the SEC and the mutual fund industry have been seeking ways to improve prospectuses for half a century. These new rules may not represent the Holy Grail -- but they will make prospectuses simpler, clearer, more useful, and, we hope, more used.

Signs of the prospectus's disuse are evident everywhere. One survey by the Investment Company Institute last year found that only half of fund shareholders consulted a prospectus before making an investment. Another survey by the SEC and the Comptroller of the Currency revealed that, although investors consulted the prospectus more than any other source of information about a fund, they considered it the fifth-best source of information -- after employer-provided written materials, financial publications, family or friends, and brokers.

This take-or-leave attitude toward the prospectus has even seeped into popular culture -- like the cartoon that appeared in the Washington Post the other day. A man and a woman are researching mutual funds, at a table covered with papers. The man cracks open a prospectus and says, "You know, I met a guy once who actually read one of these."

There's no question that an overhaul of the prospectus is long overdue. The problem is not merely how we write prospectuses, but how we think about prospectuses. Investors today are bombarded with information from every quarter. The world has changed since the Securities Act was passed in 1933, but our rules about investor information haven't kept pace.

In 1933, only 31 percent of American households had telephones. Today, 94 percent have telephones -- and 30 percent have computers that can turn their telephone line into the world's greatest library of information, the Internet.

Back then, you had a limited number of financial instruments to choose from: stocks, bonds, and a handful of funds. Today, we have mutual funds investing in every conceivable instrument, including collateralized mortgage obligations, futures, options and other derivatives. I wouldn't be surprised if we soon saw funds holding the "Bowie Bond," a triple-A rated investment in the British rock star based on anticipated sales of his records.

In 1933, investors could choose from 32 mutual funds; today, they have a staggering 6,270 funds to sift through.

The radio was a primary source of information in 1933, but only 63 percent of US households had one -- and by the end of the decade, they had 847 stations to choose from. Compare that with 99 percent of households today, with more than 10,000 stations available.

And I haven't even mentioned television, which was in its infancy during the 1930s. Even a decade later, in 1946, only 8,000 US households owned a set, and they had access to 30 stations. Today, 95 million households can tune in to more than 1500 stations, many of which are devoted to conveying financial information.

No wonder people don't read prospectuses anymore -- if they ever did. We are the most wired, signaled, cabled, beeped, paged, plugged-in, on-line, and communicated-to society the world has ever seen. Years ago, the problem was a lack of information; today, it is a glut of information. Prospectuses have to work for investors, if they are to survive in the new world of information.

As funds, lawyers, and regulators have loaded up the prospectus with more and more information, the prospectus has strayed from its primary purpose of helping people decide whether to invest in a particular fund. Today, many prospectuses, by their very length and complexity, tend to obscure the essential information that would help people make investment decisions.

One of the more startling pieces of information to come my way in almost 4 years as Chairman was a summary of an SEC focus group. We asked participants what sources of information they used in deciding whether to invest in a fund. Their answer? Friends, family, brokers, financial advisers, magazines, newspapers, financial publications, the Internet, radio, and television. Only one investor mentioned using a prospectus.

This is not an easy message for people to hear. Many of us find it hard to accept that the prospectus is not fulfilling its intended purpose.

This disuse of the prospectus comes at an inauspicious time: During the 1990s, a long decline in interest rates, a continued bull market, and a shift from defined-benefit to defined-contribution pension plans have sparked a mass migration of investors away from bank accounts, CDS, and other insured products, and into our stock markets. Investors today have far more money in mutual funds -- $3 « trillion -- than in commercial bank deposits -- which total some $2 « trillion.

This huge influx into our securities markets has provided new opportunities for investors -- and new opportunities for America. But it's also increased risk -- and it's created confusion and a greater potential for disappointment among investors who don't understand their investments.

The fact is, investors are not as informed as they should be. This is especially troubling because most of these new investors have experienced only a bull market; I fear that in a downturn, those who don't understand risk may react precipitously and carelessly, at great cost to themselves and our markets.

This new generation of investors has provided the impetus for our improvements in disclosure.

Two and one-half years ago, I announced a major SEC initiative "aimed at the heart of prospectus-speak." I acknowledged that the SEC itself was part of the problem, and we committed to change our ways and support funds if they wrote their prospectuses in plain English and made them less encyclopedic.

Several funds responded -- they obviously realized that better communication to investors leads to better understanding by investors. Indeed, efforts to give new life to the prospectus struck a chord with investors and inspired some of the changes we will propose -- off the top of my head, I can think of several fund companies that have heeded the call to simplify, including John Hancock, Vanguard, and Gateway, among others.

In addition, eight fund families stepped forward at the SEC's request to participate in a pilot project for a prospectus summary we call the Fund Profile -- a description of eleven key attributes in a standard format, easy to read, and easy to compare with other funds.

We are now ready to take the best practices and products of our volunteers, together with the results of our own research into how we can best improve disclosure, and implement positive change throughout the mutual fund industry. The three rules to be considered this week aim to close the circle on this initiative. Underlying them all is the simple notion that it is not necessarily the quantity, but the quality of information that is most important to investors. In our view, prospectuses, whether long or short, should provide investors with useful, accurate, and relevant information in language that they can understand. Let me tell you about each proposal in turn.

Revised registration form

The first rule is the keystone of our entire effort -- it essentially dismantles the registration form and prospectus requirements for mutual funds, and rebuilds them in a more logical way. This initiative attempts to make prospectuses easier for investors to use and easier for funds to prepare.

The new prospectus would refocus content on what's important to people in the real world faced with investment decisions. We've concluded that prospectuses contain too much generic disclosure of technical, legal, and operational matters common to all funds.

Instead, we will ask for essential information people should know about that particular fund before investing. The focus will be on how funds differ, rather than how they are the same. Risk disclosure will emphasize the risk of the fund's portfolio as a whole. This is a shift away from the current approach of most funds, which give laundry lists of detailed, technical descriptions of the risks of individual securities or other tiny components of the funds' holdings. This tells an investor little about how risky the fund itself may be.

We recognize the importance of risk disclosure to investors, and so we will propose to include a new risk/return summary at the beginning of all fund prospectuses. It would highlight the fund's investment objectives and strategies and improve disclosure by including four items:

* first, a concise narrative description of a fund's overall risks;

* second, a bar chart reflecting a fund's ten-year returns, which would illustrate risks by showing how the fund's performance has changed from year to year;

* third, a table accompanying the bar chart that compares the fund's performance to that of a broad-based securities market index; and
* fourth, an improved fee table.

The risk/return summary would ensure that all investors have concise summaries of key information that they really could use at the kitchen table to evaluate and compare fund investments.

There's another problem with prospectuses: They are too thick. Our passion for full disclosure has resulted in fact-bloated reports, and prospectuses that are more redundant than revealing. It turns out that more disclosure does not always mean better disclosure and that -- especially in an environment that virtually inundates us with data -- too much information can be as much a curse as too little.

We propose to clear away the clutter by moving information that is the same for all funds -- such as legal, technical, and operational matters -- out of the prospectus. This information does not help a person decide whether to invest. Those investors who are interested could obtain this information upon request in a Statement of Additional Information. At the same time, we have addressed a longstanding concern that an investor who wants additional information should get it -- promptly. Our rules would require a three-day response from funds.

On a similar streamlining note, we intend to allow funds to tailor prospectuses to meet the needs of investors in retirement plans, by omitting information that is not relevant to plan participants, such as purchase and sale procedures.

Our proposals would also allow for "one-stop shopping" by requiring information about a fund's fees and expenses to appear together in one place in the prospectus. Currently, this disclosure may be scattered throughout the prospectus and hard to find.

Finally, we have tried to make it easier for funds to prepare and file their registration statements, by simplifying the instructions for preparing prospectuses. We are also eliminating or updating SEC disclosure positions now found in 35 Guides and numerous Comment Letters.

Fund names

These measures will change the information we require funds to give investors. Our second rule, however, will ask funds to live up to the information they themselves give investors.

We are concerned that certain fund names may inadvertently mislead investors about a fund's investment objectives and risks. It's been said that potato-chip makers are subject to stricter labeling requirements than mutual funds. I don't buy that argument -- in fact, I think it would be destructive to force each fund to carry a label, and thereby reduce its investment options. The fund industry has gotten along just fine for half a century without such pigeonholing.

But at the same time, it's only fair that if a fund represents itself as investing in Japanese bonds, it ought to live up to that label. Our new rule would require a fund with a name suggesting a focus on a particular type of investment to invest at least 80 percent of its assets accordingly. This will give investors greater assurance that the fund's investments will be consistent with its name. It will also help reduce confusion when an investor selects a fund for specific investment needs and asset allocation goals.

Fund Profiles

The third measure we will consider this week is the coming of age of Fund Profiles, after a successful two-year experiment. Profiles summarize key fund information, including investment strategies, risks, performance, and fees -- and they do so in a concise, standardized format. The profile also includes information about the fund's investment adviser and portfolio manager, purchase and redemption procedures, tax implications, and shareholder services.

The profile proposal will let funds offer investors the option of relying on a new, summary disclosure document when buying fund shares. Neither funds nor investors would be required to use a profile. Nor would the profile replace the prospectus.

If a fund does employ a profile, an investor could either purchase the fund's shares based on the profile alone, or could request and review the fund's prospectus and other information before making an investment decision. All investors would still receive a prospectus, upon confirmation of a purchase and no later.

We've made certain enhancements to the Profiles since our pilot program to improve their risk disclosure. Among them, the profile will compare a fund's past performance to that of a comparable broad-based securities market index.

Let me add that the proposal would not limit a fund's use of any particular medium for disseminating the profile. A fund could make a profile available on the Internet or by mail, in newspapers or in other media.

This initiative recognizes the diversity of investors that exists today and their equally diverse information needs. Our experience with pilot profiles has shown that investors want more choices about how they receive information about funds. For many investors, a profile can be as helpful to the decision making process as a full prospectus. Some investors may even prefer it. It makes sense to stress quality in all disclosure documents, whether long or short. It also makes sense to give investors more options.

Plain English

There is one other aspect of these rules I want to share with you before I close. They call for clear communication, and a vital ingredient of clarity is the use of plain English.

There's no escaping it -- especially with so many people now investing in the market. If you want to communicate with a broad segment of society, you must use the vernacular.

This is no new thing under the sun. In the 9th century, the Emperor Charlemagne ordered sermons to be delivered in the vernacular. In the 16th century, Martin Luther translated the Bible into the vernacular.

Our task is far more humble -- the subject we address is not faith, but finance; and the idiom we reject is not Latin, but legalese.

It is possible that no document on Earth has committed as many sins against clear language as the prospectus. The prose trips off the tongue like peanut butter. Poetry seems to be reserved for claims about performance, and conciseness for discussions about fees.

In fairness, much of the arcane language is aimed at legitimate legal concerns. But the fact remains that disclosure is NOT disclosure if it doesn't communicate.

The time has come to pierce the shroud of jargon and boilerplate surrounding the prospectus. It's my aim to have prospectuses begin to speak a new language -- the English language.

The SEC is not alone in recognizing this problem. I can't tell you how many times, in the town meetings we've held across America, investors have stood up and requested, argued, pleaded with me for documents that are useful and easy to read.

Making disclosure documents more readable is especially important today, with all the new investors in our markets, and with all the choices they face. For these people, plain English is not a novelty, but a necessity.

Plain English does not mean "dumbing down" -- it means presenting information clearly. The SEC recently compiled a handbook that features advice from people who have created plain English documents, with a foreword by Warren Buffett. We've posted it in draft form on our Web site, and we invite you to comment on and use it.

We recognize that all of us need to work together to do better at this. The SEC is hardly in a position to throw stones -- our own rules and communications are among the reasons why plain English has not taken root sooner. And if we succeed in improving investor understanding, the winner will not be any one of us -- it will be the 63 million Americans who invest in mutual funds -- that's 63 million and growing every day.

We have within our grasp a chance to help them -- a chance to change the way they buy funds, and to ensure their expectations are realistic -- a chance to make it easier for them to make comparisons, and easier to get right to the key issues they need to know before investing. For when all is said and done, that's what these initiatives are about -- hardworking people reaching for a better life -- buying that new home, sending the children to college, taking that much-needed vacation, or enjoying a decent retirement. People looking to our capital markets as never before, for financial growth and economic success.

This is the promise of America -- and few industries have brought that promise within the reach of more people than the mutual fund industry. Let's build on that trend -- let's strengthen our markets and strengthen our people -- through better regulation and clearer communication. Thank you.

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