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News Release

REMARKS TO THE
1989 MUTUAL FUNDS AND INVESTMENT MANAGEMENT
CONFERENCE

By

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Good Morning. I'm delighted to be here today representing the new, improved, kinder and gentler SEC. And I want to thank Dave Silver for giving me such a warm welcome.

This is the sixth Mutual Funds Conference I've attended as Director of the SEC's Division of Investment Management. My, how time flies when you're having fun!

Fund sales seem to be perking up, and that's good news, but they weren't so great last year. I'm told that can make this audience down right surly. But, since the SEC is a "kinder, gentler" place these days, and I'm well-known to be so kind and gentle myself, I'm confident that you'll respond the same way.

This morning, I'm going to give you a report from the SEC-- an update on some of the important issues and projects we're working on, in my little corner of the SEC, the Division of Investment Management. Before I begin, I want to make plain that the views I express are my own, and not necessarily those of the Commission or other members of the staff.

When I refer to my "little" corner of the SEC, I want to stress the word "little". This year, we had to cut our staff 11%, because Congress did not give us enough money to pay the people we had. We achieved this by not replacing folks who left. We have, today, about the same number of people we had in 1980. The industry has grown, and our work load has grown in proportion. Our staff size is the same.

If you've encountered more delays in dealing with the Division during the past several months, this is why. Looking ahead at the Federal budget, I am saddened to predict that this situation will not improve in the near future. If anything, it will get worse.

Many of you may have heard, last year, that the Division of Investment Management was slated to get a big staff increase. That was true. Chairman Dave Ruder, Lord love him, really went to bat for us. And even the hard-hearted Hannahs over at the Office of Management and Budget looked at my Division's situation and felt we truly needed help. President Reagan recommended a 33% staff increase for us. Many in the Congress agreed. Unfortunately, in the end, and in the face of the Gramm-Rudman requirements, Congress not only turned down the recommended increase, they cut us back. Last week, Dave Ruder, told the House Appropriations Committee that my Division was the most understaffed of all units at the SEC. Chairman Ruder also told a Federal Bar group last spring that IM is "lean and mean". He said we were getting so lean that before long we would be mostly mean.

For those of you that have to deal with the SEC, and clear filings, exemptive applications or no action letters with us before you can go to market or change your business operations, this is not good news. I know, as does everyone on my staff, that receiving prompt service from us can be critical to your business, necessary to let you grow and change to meet investor needs and new market conditions. I also know that this industry pays fees to the SEC in amounts that greatly exceed what we spend regulating you. Your fees don't stay at the SEC. They go into the general revenues of the United States, and are spent on other government functions, as Congress sees fit.

What's the solution? Well, asking Congress for more money is one idea that industry people frequently suggest, but it doesn't seem to be an idea whose time has come. Try as we might, we never get the money. Congress is terribly strapped for cash, and has lots of deserving programs on which to spend the limited funds available.

The SEC is, of course, continuing its efforts to increase efficiency, streamline procedures, and cut back on activities that can be identified as not essential -- or at least not as essential as other things we do.

We have done a fair amount of this over the past six years, as many of you know. In addition, we have made a lot of management changes. We've gotten more computers for our lawyers, accountants and analysts, and we use them to produce written work much more quickly than in the past. We changed our compliance examination procedures, and increased staff productivity in that area. In reviewing disclosure documents, we have adopted selective review procedures to pare down what we look at. We have continued our efforts to codify exemptions granted by individual orders into rules of general applicability. We'd like to do more of that, and to do it more quickly, but again, we are severely limited by the lack of staff.

Our most recent major effort to speed things up has been in the exemptive applications office. First, we got our hands on as many computers as possible, both to manage and track the work and to produce the written documents we need. Second, following suggestions from the bar, we now put our comments in writing, and try to let applicants know, early on, what the Division's position is on a filing, and why. In the last six months, the number of exemptive requests we've been able to act on has gone steadily up. But so has the number of filings coming in. In fact, our productivity increases have consistently been beaten by the increase in productivity of the folks filing new applications. Each application must be treated on its own merits, and very few are just like the last one we handled. They reflect the problems faced by a growing industry, trying to work under a 50 year old law.

All of our difficulties are exacerbated by the low level of salaries that we can pay staff. This makes it tough to hire people, and causes most staffers to leave after just a few years. As a result, we spend far too much time interviewing and recruiting new staff, and are constantly having to use experienced staff to train the new ones. Constant turnover makes us inefficient, and less effective than we should be. It also means that you in the private sector are going to have slower service, and will have to take extra time to explain your business and proposals to us.

Now don't get me wrong. The people we have on staff today are truly excellent and very, very hardworking. There simply aren't enough of them to handle the work that you send us, and I dearly wish I could pay them even quasi-competitive wages so that they would stay a little longer. Even a year or two more would help.

Unfortunately, I have very little hope for improvements in our staffing or salary levels. So I encourage all of you to do whatever you can to help us out in this very difficult time.

What can you do? Well, in the past, we have received some very practical and helpful suggestions from the industry and the legal and accounting professions for ways in which we can improve our efficiency and eliminate unnecessary tasks and roadblocks. Please keep the constructive comments coming.

It also helps if you can plan for delays at the SEC in setting your business schedules. We very much want to accommodate your deadlines whenever we can, and as much advance notice and lead-time as possible helps us do that.

It also helps if the filings we get require very little comment or work on our part. We have put out releases suggesting procedures to follow in preparing and making filings, and it helps a great deal when these are followed to the letter, along with our other procedural rules.

I am particularly worried about the impact of our staff situation on the investment company and adviser compliance examination program. Despite the fact that our examiners now do more exams per person than in 1983, we haven't been able to keep up with industry growth. As a result, the frequency of our compliance exams, which wasn't much to brag on, is getting worse. Fortunately, we are dealing with an industry with a long tradition of good compliance. I know sales are down, and money is tight for you too. But I think it very important for each individual firm and complex in the industry, to redouble and bolster its own compliance efforts and resources, in order to preserve and maintain the industry's reputation for integrity, good service and safety and soundness. Investors must continue to be confident that mutual funds and unit trusts are a good place to put their savings. I don't want to see investors suffer, and I don't want to see investor confidence in this industry suffer, because there aren't enough SEC cops on the beat. You guys must take up the slack.

In this vein, I also urge you to take a second look at two proposals we have made to get ourselves more help with the compliance work. These proposals have been greeted with less than the usual enthusiasm by various industry groups. The first is our rule proposal to exempt from SEC registration small investment advisers that are registered as advisers in each state where they do business, and to expand the intrastate exemption, again for state registered advisers. The Board of Governors of the North American Securities Administrators Association advised the Commission, before we publicly unveiled this idea, that they supported it, and believed the states could handle the responsibility of being sole regulators for the smallest class of investment advisers. Industry comments, however, have been largely negative, expressing fear that if State regulators are given an area of exclusive jurisdiction over small advisers, they might do more to regulate all advisers, large and small, thus adding extra burdens for the big boys. The better approach, say the commenters, is for the SEC to get more staff and more money. Say, why didn't I think of that? A budget increase -- just the ticket.

A related idea is to seek legislation to require investment advisers to join self-regulatory organizations, which would share the standard-setting, inspection and enforcement burden with the SEC and the states, much like the NASD and the stock exchanges do today for broker-dealers. A self-regulatory organization would be funded out of members dues, not Federal tax dollars, and would increase regulatory coverage. I've been working on this for a number of years, and even got you a volunteer - the NASD. But, alas, once again, the industry reaction has been largely unfavorable, and the same solution --more money for the SEC-- is put forth as an alternative.

Since the suggested alternative to both these proposals is pie in the sky, I likely will recommend that the Commission pursue them both. Whether we'll succeed in getting an exemption for small, state-regulated advisers adopted, or legislation providing for an adviser SRO enacted, is uncertain. But under the circumstances, I have no choice but to try.

I hope that all of you will take a second look at these proposals, and, if you can't live with them, try to come up with constructive alternatives. The "more money" comments simply do not help.

Despite our money troubles, we have been busy. So I'd like to spend the balance of my time bringing you up to date on some of our rulemaking and other projects.

Next out of the box from the Disclosure rulemaking office will be recommendations for a proposed new registration form for closed-end investment companies.

We also hope to get a recommendation to the Commission for adoption of N-7, the proposed new form for unit investment trusts, with changes responding to the comments we got. This project has been on a very slow back-burner for most of the past year, because of the unexpected and very serious illness of our Chief and Only Accountant, Larry Friend. Larry's now back, and work on the N-7 has resumed.

We are also moving ahead, with the Division of Corporation Finance, on rule proposals to implement our EDGAR system. We have a contractor, and we are moving on a fast track to get EDGAR up and running. A number of investment companies have been active participants in the EDGAR pilot, and many more have gotten their toes wet by filing semi-annual reports and some 13-f reports, through EDGAR. The fund industry's participation in the

EDGAR pilot has been extremely helpful. We have gotten, and adopted, many good suggestions from investment company filers that will make EDGAR a much better system. The Investment Company Institute has taken the lead in coordinating the efforts of the EDGAR investment company pilot group, and I thank the ICI for this help.

Our disclosure rulemaking office is also very interested in pursuing a suggestion that we recently received from a member of the fund industry, that funds be required to provide shareholders with a "management discussion and analysis" of the year's investment results, perhaps in their annual reports to shareholders, or, in the case of open end funds, in the updated prospectus prepared each year for new investors, possibly in proximity to the per share table. This could be modeled after the management discussion and analysis now included in corporate annual reports. The fund's management would review the fund's goals and objectives, and report to shareholders on the fund's success, or lack thereof, in meeting its goals, and analyze the factors that led to its performance.

We are also looking forward to receiving the draft standardized yield formula now being developed by representatives of the unit trust industry, and once we get it (or even if we don't), we will develop rule proposals to standardize UIT yield and performance numbers in advertising and sales literature.

Our other rulemaking office is now analyzing the comments we got on one of the more popular Commission proposals, made last June, to amend Rule 12b-1. We hope to move that work forward promptly, although we may delay some because of the effort now underway at the NASD to develop rules governing 12b-1 fees. Comprehensive NASD rules in the area could address many of the concerns that prompted the Commission's proposal, and we will take whatever the NASD does into account. We asked the NASD to consider this, over two years ago. But they declined. I'm pleased that the NASD has reconsidered the matter. Wouldn't it be great if the NASD solved most of our problems! We might even be able to get rid of some paperwork and other burdens that the existing rule places on investment company directors. Of course, it depends on what the NASD does, and how quickly. Go NASD! Among other things, I hope the NASD will consider the need for breakpoints, so that the percentages charged as 12b-1 fees can be reduced as fund assets increase in size, and how this might work in light of the use of 12b-1 fees to make continuing payments to salesmen.

We're making good progress on proposed Rule 11a-3, which would permit exchange offers between funds and allow funds to impose fees of various types on investors switching from one fund to another. The comments on our most recent proposal were helpful, we've heard you, and we will recommend adoption with changes that address most of the problems that were pointed out to us.

We are well along in our effort to develop a rule proposal that would extend the exemption provided by Rule 12d3-1, one of my first projects as Division Director. The rule now allows investment companies to purchase limited amounts of securities issued by persons engaged in the brokerage and advisory business in the U.S. We plan to include securities issued by foreign brokers and advisers as well.

In the insurance products area, we have recommended that the Commission approve the offer of settlement submitted by TIAA/CREF in the pending administrative proceeding involving the CREF funds. This settlement was worked out with various parties that intervened in the proceeding, including a number of mutual funds and the ICI. If approved, it will significantly open the door for others to compete for the college retirement business, and, most importantly, the settlement will give many college and university teachers more flexibility and choice in picking investment vehicles for their retirement plans, and a greater voice in governing the operations of TIAA/CREF itself. Not surprisingly, this proceeding has consumed a lot of staff time, particularly in the Insurance Products Office. Our next major effort, I hope, will be to get the "T" removed from our temporary Rule 6e3-T, and make that a final rule. This rule is now operational, even if it is temporary, and was adopted to permit the insurance industry to market flexible premium variable life insurance, by granting a number of exemptions from provisions of the 1940 Act which didn't quite "fit" the new product. We will also try to fish or cut bait on a related insurance rule, 26a-3, codifying exemptions allowing the deduction of mortality and expense risk charges, sometimes also known as money spent for distribution, from annuity separate accounts.

In the inspections and enforcement area, we have some major efforts underway, most of which I can't discuss. We are going to be looking, as a matter of routine, at the steps firms have taken to adopt and enforce procedures to prevent insider trading, as required by the Insider Trading and Securities Fraud Enforcement Act of 1988. I was very pleased that the industry, under the auspices of the ICI, developed guidelines for firms to use as a starting point. We recognize that the new law did not give firms much lead time, and we will certainly take that into account in the early stages of our monitoring. We are also taking a closer look at foreign portfolio funds, since they have grown so much in recent years. Gene Gohlke, who heads our inspection program nationwide, has asked me to remind you that the law appears to require advisers to these funds to keep records and review the trading activities of subadviser personnel, both foreign and domestic, if they are "access persons". We will be asking whether the U.S. adviser is reviewing these records, and we will expect to see them covered in your policies and procedures. Gene and his staff also would like to see a little more vigorous enforcement by all investment companies of their codes of ethics. And we hope never to see a repeat of some of the massive failures in "blue sky" investment company shares that we have discovered in the past year.

On the disclosure front, we recently asked the ICI to help us educate the fund and advisory industry on the securities law requirements that apply to tender offers for shares of closed end funds. We are also exploring ways to better communicate new disclosure comments, that come up frequently in our review of new fund filings, to old funds that are in the automatic effectiveness mode.

In our Chief Counsel's office, we are grappling with a host of international issues, including the question of cross-border sales of investment company shares with Canada, the European Community and Japan. We are keeping your trade association, the Investment Company Institute, abreast of our government-to-government discussions, and the ICI, in turn, has recently agreed to our request that it keep the SEC staff posted on its discussions with foreign firms and groups in the private sector. We don't want to see the U.S. industry left out of new opportunities to do business abroad.

We've also recently been asked for our views on the question of an investment adviser's responsibility, as a fiduciary under common law and the two 1940 Acts, with respect to proxy voting and the exercise of other ownership attributes of securities held in managed accounts or investment company portfolios. As you know, last spring, the Department of Labor announced plans to monitor investment managers voting proxies of employee benefit plans, and published some specific guidelines on how voting should be handled for ERISA-covered accounts. The Labor Department's analysis concludes that routinely following the "Wall Street rule" of voting with management or selling out, is not appropriate for fiduciaries. Our preliminary conclusion is the same. Because of the significance of the issue, we plan to bring it to the Commission and to devise a procedure that will allow us to have the benefit of industry views and comments before our own ideas are cast in concrete, with the implication of retroactive effect.

We are also quite interested in the Financial Analysts Federation's proposed "performance presentation standards", released in December. The FAF hopes these standards will be used voluntarily by money managers in portraying their performance results to clients. The FAF developed these standards in response to what it called very uneven and, in some cases, dishonest methods of showing investment performance. The FAF effort, I think, reflects the frustration many analysts and pension consultants have experienced in evaluating money managers' performance and drawing comparisons. The basic idea is to eliminate sleaze and provide greater comparability. The SEC had the same objective in mind last year when we adopted rules spelling out, in detail, how mutual funds that choose to advertise yields and other performance numbers, must calculate and display those numbers.

The FAF's approach is much less specific, really just a set of general principles that should be applied. For example, the FAF recommends that

- all accounts be included, including terminated accounts;
- performance calculations be time weighted, to more fairly portray results; and
- figures be given for no less than 10 years and up to 20, if possible.

The FAF principles would not require that performance be shown net of advisory fees, but instead that the fee schedule be included with the presentation. As you may know, the SEC staff has opined that a registered investment adviser must deduct fees from performance figures, although we were later persuaded that this was not necessary in one-on-one presentations with clients, so long as the individual fees to be charged are clearly explained.

In regulating investment advisers, the SEC approach has been to rely on general antifraud prohibitions, and our ability to take enforcement action when needed. We have not adopted anything comparable to our mutual fund advertising rules, to mandate or suggest a particular form of presentation of performance data.

We will, however, be very interested in the industry's response to the FAF's standards. The FAF hopes that there will be voluntary compliance, but seems to suggest that if the industry doesn't volunteer, then perhaps the government should step in.

It would be nice to see the problem of accuracy, reliability and comparability of adviser performance numbers solved voluntarily by the regulated industry, before we regulators feel compelled to step in. We are not into heavy-handed regulation these days. We're a kinder, gentler SEC. But we still have a pair of hobnailed boots in the closet and are ready to put them on if the need arises.

We have many other major projects in the works that are important to constituents not represented in this audience, like making better sense out of the treatment under the 1940 Act of mortgage-backed securities as well as other asset-backed financings. All place enormous demands on staff time, and compete for our attention with some of the things you'd like us to do.

You'll be hearing more discussion in greater detail about some of these items from the Division's staff and other panelists later this week. So I'm going to stop now.

Thank you very much for your attention.