REMARKS OF

COMMISSIONER J. CARTER BEESE, JR.*
U.S. SECURITIES AND EXCHANGE COMMISSION

HONEY BEES, MOHAIR AND INVESTOR PROTECTION

BEFORE THE

MUTUAL FUND CONFERENCE

CHICAGO, ILLINOIS
SEPTEMBER 24, 1993

* The views expressed herein are those of Commissioner Beese 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

HONEY BEES, MOHAIR AND INVESTOR PROTECTION

Now that the Berlin Wall has come down, the Gulf War has been won, and peace has been brought to the Middle East, it's time to tackle some really tough issues. Mutual Funds have become the investment vehicle of the 90's, and neither Main Street nor Wall Street quite know what to make of this phenomenon. Unlike S&Ls, which had a government safety net to fall back on when they needed it, mutual funds operate on the high-wire of investor confidence.

One of the keys to maintaining investor confidence in a dynamic and growing market is sound regulatory oversight. Well, as Washington goes about reinventing government, it has to decide whether to continue being penny wise and pound foolish regarding investor protection, or to make a smart investment in protecting the integrity of U.S. capital markets.

Up until now, the mutual fund industry has been treated like a cow to be milked. In 1992, investment companies paid filing fees to the SEC totaling $81 million, while the SEC was only allocated $18 million of these funds to oversee the investment company industry. If anyone in this room had a return on assets like that, you would soon be selling peanuts at Soldier Field. You will be happy to know, however, that the 73% of your investment that does not go toward meeting the regulatory needs of your industry does make it possible for the federal government to provide subsidies to honey bee and mohair farmers.

INVESTOR CONFIDENCE: THE KEY TO THE '40 ACT

How did we get to where we are today? Fifty years ago the leaders of the investment company industry came to Congress with a plan to regulate their industry. Battered by the collapse of investor confidence following the Great Depression, the investment company industry recognized the need for meaningful regulatory oversight in order to restore investor trust and confidence in the marketplace. By any standard of measurement, the resulting regulatory structure -- the Investment Company Act of 1940, has been a success.

Once again, however, the leaders of the investment company industry have turned to Congress in an effort to maintain investor confidence -- this time by increasing the SEC's inspection capabilities. The explosive growth in mutual funds, coupled with a change in the demographics of mutual fund investors, has prompted a reassessment of the regulatory scheme that helped the industry weather the storm in the 70's and prosper in the 80's.

I'd like to briefly provide an overview of the changing landscape of the mutual fund industry, highlighting the challenges that these changes present, and then discuss current SEC initiatives designed to meet these challenges. Our goal in undertaking this reassessment is not only to administer preventive medicine to the maturing goose that lays the golden egg -- but to protect the investor that has placed many of his eggs in the mutual fund basket.

INDUSTRY AND INVESTOR PROFILE

By far the most popular form of investment company is the mutual fund. The investment company industry has approximately $2.1 trillion in total assets -- 84% of which are held in mutual funds. In August 1993, there were close to 4,300 separate mutual fund portfolios, an increase of over 600% from just a decade earlier. There are now twice as many mutual funds in existence as there are stocks listed on the NYSE.

During the last 10 years, total mutual fund assets have soared from $135 billion to $1.8 trillion, an increase of over 1,100%. In recent months, investors have poured money into mutual funds at the rate of nearly $1 billion per day.

Who are these investors, and why are they choosing mutual funds? As of year end 1992, 27% of all U.S. households owned mutual funds. That's up from just 11% of households a decade ago. Individual mutual fund shareholders now total over 38 million people.

Unbundling these demographics highlights an even more interesting trend. The median age of new shareholders purchasing a mutual fund last year was 37, while 9% of investors coming into this market for the first time were retired. A recent article in Barron's quoted a source at Fidelity as stating that "90% of the customers opening accounts with Fidelity in the past 12 months fall into one of two groups, baby-boomers now in their 30s and older bank customers between 45 and 65 venturing into the market for the first time."

EXPLAINING MUTUAL FUND GROWTH

What explains the meteoric rise in mutual fund assets? What about this market attracts both baby-boomers and retirees? First of all, let's put it in perspective, not all the growth is due to new money. A large measure of the surge can be attributed to the capital appreciation of portfolio securities owned by mutual funds. Since January of 1984, 43% of fund growth has been due to capital appreciation, while 57% can be attributed to an increase in the net sales of fund shares.

Also fueling the growth of mutual funds has been the disintermediation of money out of the banking sector. Savers, unwilling to live with the anemic 2-3% return available on bank certificates of deposit, have increasingly turned to Wall Street and become first-time investors. By some accounts, as much as 40% of mutual fund net cash inflow can be attributed to outflows from bank deposits.

Finally, and I believe most profoundly, mutual fund growth has been fueled by changes in the way individuals invest for retirement. At year end 1992, retirement assets accounted for 21% of total mutual fund assets. These retirement assets are generally held in two types of account, the Individual Retirement Account and the defined contribution pension plan. At year end 1992, mutual funds held $211 billion, or 29%, of the IRA market.

The growth in defined contribution retirement plans, such as 401(k) plans, has been even more dramatic. In 1975, approximately 11 million participants were covered by defined contribution plans. Under current projections, by the year 2000, defined contribution plans will have 52 million participants. In other words, in the period from 1975 to 2000, defined contribution plans will see growth of nearly 500%.

NEW CHALLENGES FOR THE INDUSTRY AND THE SEC

What does this dramatic growth in mutual fund assets, coupled with the changing demographics of mutual fund investors, portend for the future? First and foremost, new investors have moved into this market in record numbers. From baby-boomers to retirees, many of these investors are unfamiliar with the risks involved with their marketable securities. Formerly the holders of government-insured instruments, these investors now find themselves chasing yields in a market with no federal safety net. Barron's recently editorialized that mutual fund marketing should resist the urge to capitalize on the "illusion that all investors can get at their money, just as in a bank." Future confidence in this market dictates that investors not learn the distinction that their principle is at risk the hard way.

The growth in retirement investors also presents new challenges for the mutual fund industry. As more and more companies convert to defined contribution plans, millions of employees are now finding themselves responsible for making the investment decisions that will determine their standard of living in retirement. For many employees, this is a responsibility that they are simply ill-prepared to undertake. Determining realistic retirement goals, selecting an investment portfolio designed to achieve those goals, and continuously assessing the portfolio's performance in a dynamic investment environment is beyond the expertise of most employees.

An analysis in Pension & Investments magazine highlighted this employee investment problem by comparing the asset allocation strategies used by professionals in the 1000 largest defined benefit plans versus those used by employee participants in the 1000 largest defined contribution plans. On average, over the three year period from 1989-1991, the professionals maintained 45% of their assets in equities, 35% in fixed income securities, and 3% in guaranteed investment contracts, better known as GICs. Employees, on the other hand, placed 35% of their funds in GICs, 24% in the stock of their employer (usually through some matching program), 18% in other equities, and 11% in fixed income securities.

While investing in equities is not the best avenue for every investor, outweighing professionals by a multiple of 10 in asset allocation for GICs suggests that many employees may be making ill-informed investment decisions. Having made their initial investment decision, employees, unlike market professionals, usually do not undertake periodic reviews of their asset allocation. As you can imagine, employees have certainly left plenty of money on the table in the last three years. The consequences of these decisions will potentially affect not only the employee, but future taxpayers.

The sheer size of the mutual fund industry certainly has a broad impact on the market. Being the new 800 pound gorilla on Wall Street, mutual fund buying is pushing the market to new heights. On days when mutual funds account for upwards of 40% of all trades on the New York Stock Exchange, its not hard to see how strategies such as momentum investing pushes some small cap stocks to dizzying heights.

THE MUTUAL FUND INDUSTRY IN THE NEXT DECADE

Aware of the new challenges success present, how does the mutual fund industry prepare for the next decade? While new product development will undoubtedly continue to present investors with a wide array of investment options, a primary concern of the mutual fund industry going forward must be investor education. The industry needs to explain to the public the nature of investing in mutual funds, the risks involved, how certain fund investments are likely to perform in various market environments, and instill a better understanding of risk-adjusted returns.

In conjunction with educating the public, the industry has an obligation to properly educate industry employees. The huge growth in funds has contributed to a corresponding influx of new personnel, some with little background in the mutual fund industry. Properly trained and supervised employees are imperative to maintaining investor confidence. More violations will invariably occur if internal compliance and procedures fail to keep pace with the growth of assets under management.

SEC PERSPECTIVE

From the SEC's perspective, three issues are of growing concern. The first is ensuring that investors in the retirement market receive meaningful and consumer friendly disclosure about their investments. Today, more and more employees are being asked to make investment decisions regarding their retirement assets without the benefit of the same mandated disclosure that every other investor making purchases in the open-market is entitled to.

The SEC's Division of Investment Management has recommended remedying this void by requiring the delivery of prospectuses for the underlying investment vehicles directly to plan participants. While this certainly would address the disclosure problem, this may not be the most cost effective means of achieving the desired result. Rather than inundating employees with paper, and increasing printing costs for everyone, the industry should continue to seize the day and provide a marketplace solution.

Some mutual funds have taken the initiative of providing short-form versions of their retail prospectuses directly to plan participants. This type of user-friendly disclosure, if it were to become the industry standard, may convince regulators that no further action is necessary.

Prospectus simplification can do much to improve investor education and the SEC is pursuing this goal on a number of fronts. As you are all aware, investors began receiving "new and improved" prospectuses on July 1st because of amendments to Form N-1A. These "new and improved" prospectuses will let investors see comparative information on fund performance in graph or chart form. Funds are also now required to disclose factors, strategies and techniques that materially affected its performance during its most recently completed fiscal year. Once again, the goal in this effort is to provide investors the information they need in a format that the average investor can understand.

The "one-page" or "off-the-page" prospectus proposal, currently out for comment, also seeks to satisfy investor's information needs in a format that is less intimidating to the average investor. Under this proposal, investors would have the option of purchasing mutual fund shares directly from advertisements containing an order form. The form would contain key information presented in chart format and would give investors the choice of whether to wait for the longer prospectus or to invest directly. I am particularly interested in the applicability of these short, comparable prospectuses to the defined-contribution market.

Another area that requires increased education, both among investors and market professionals, is the use of derivatives. Individuals evaluating mutual fund opportunities need to be aware of the use of these instruments and how they might impact fund performance. Even more importantly, market participants need to understand the risks associated with these complex instruments. Proper risk management, with oversight at the board level, is mandatory so that systemic risk remains in check.

Establishing an adequate understanding of risk was behind the Commission's efforts in 1991 to tighten Rule 2a-7, the rule that establishes how money market funds value their funds. The objective in tightening this Rule was to reduce the likelihood that a fund would have to "break a dollar" or mark down the per share price to less than a $1.00 due to changes in the underlying market instruments in the portfolio. Most of these valuation provisions, however, were not made applicable to tax exempt money market funds pending further study. I strongly support including tax exempt money market mutual funds in Rule 2a-7 coverage.

BOLSTERING SEC INSPECTIONS

Let me finish by discussing one area where SEC action is desperately needed, beefing-up resources allocated to the regulation of investment companies. Even though the mutual fund industry has experienced spectacular growth, SEC resources to supervise the industry have lagged far behind.

In 1982, the SEC had 123 staff to oversee 5,000 investment company portfolios with aggregate assets of approximately $335 billion. This worked out to a staff per portfolio ratio of 41 portfolios and $2.7 billion of assets under management per staff member. In 1992, the SEC had 214 investment management staff with a ratio of 87 portfolios and $8.9 billion in assets per staff member -- an increase of over 100% in terms of portfolios and 300% in terms of assets under management.

All aspects of Commission oversight have been affected by this staffing shortfall -- not only the inspection of funds, but also the reviewing of prospectuses, and the handling of exemptive, interpretative and no-action requests. The most serious deficiency, however, exists in the scope and focus of fund examinations. The 100 largest investment company complexes, which manage 83% of the industry's assets, will receive inspections once every 2 years, while some small complexes may receive an inspection only for cause. Even when inspections are conducted, these inspections are not necessarily comprehensive in nature. Often, limited resources dictates that an inspection focus only on portfolio management, rarely having the time to scrutinize fund marketing and shareholder services.

Broader and more frequent inspections are particularly important with regard to new entrants into the investment company business. New entrants generally have less developed internal compliance systems and procedures. Unfortunately, while these new entrants may control a small portion of assets under management, abuses in this sector could have a chilling effect on the entire industry.

The proliferation of international funds, as well as sophisticated products and strategies such as hub and spoke fund structures, derivatives and other synthetic instruments, also increases the possibility that the missteps of a relatively small fund could put a "chill" on the entire industry in the minds of investors.

The Commission's resources devoted to inspecting investment advisers are also woefully inadequate. The Commission has 48 examiners to conduct inspections of approximately 19,100 advisers with assets that exceed $8 trillion. The average adviser can now anticipate an inspection once every 32 years.

Congressman Markey and Senator Dodd, among many others, have worked hard to get increased funding through Congress. The House has already acted on legislation that would provide the resources for an additional 185 investment adviser inspectors, and Senate action should follow this Fall.

SEC SELF-FUNDING

While everyone in Washington seems to agree on the scope of the staffing problem, the resources needed to correct this imbalance are extremely scarce. One proposal, which has the strong support of the SEC, is to make the SEC a self-funding agency.

Instead of having the Commission forward revenues collected from the industry to the Treasury, and then seek an annual operating budget appropriated back from Treasury resources -- the self-funding proposal would allow the SEC to allocate its operating budget from a distinct fund containing industry resources collected by the SEC. In other words, in the true spirit of reinventing government, the regulated would be responsible for funding the regulators.

And finally, one last issue that doesn't need to be reinvented is the idea that some in Washington have mentioned recently of mandating that investment companies comply with the Community Reinvestment Act or CRA. While we all share the goal of increased investment in under served communities, CRA does not fit the mutual fund model. Mutual funds are fundamentally different creatures from government insured banks and the geographic dispersion of fund investors makes the concept of an isolated "community" inapplicable in the mutual fund context.

CONCLUSION

Some of you may be familiar with the old Texas adage that "only a fool rolls up his pants before he gets to the creek." That's true, and there is certainly no reason to be alarmist about the future of the mutual fund industry -- it has truly been an American success story. But let's not wait until the water starts rising before we take action either.

Our success in together meeting the new demands of the mutual fund industry will determine whether main street American investors stay with Wall Street in the years ahead. Sound marketplace solutions to the challenges presented by the changing nature of the mutual fund industry is in everyone's interest.

Many Americans are making long-term investments in mutual funds. Washington must also invest. The country simply cannot afford another misstep like what we experienced with the S&L industry. By now we've all learned the lesson that -- be it personal health or financial health -- preventive care is the most cost effective. Let's not "snatch defeat from the jaws of victory."

Thank you very much.