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News Release

INVESTMENT COMPANY SERVICING:

GROWTH, INNOVATION AND COMPETITION

Remarks to

National Investment Company Service Association
Fourth Annual Conference

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After agreeing to deliver the keynote remarks at this gathering, I noted with interest that the theme of this Fourth NICSA Annual Conference was "Servicing Success." It seems to me that this success is self-evident when, in the midst of the longest and most enormous explosion of activity in the history of the mutual fund industry, you as custodians, transfer agents and general overseers of these funds can take this time away from your clients' frantic pace for a few days' relaxation and education.

I also noted that the theme "Servicing Success" is a subtle and perhaps unintentional play on words. It could refer to the success that investment company service organizations have had in meeting the needs of their clients -- that is, they have been successful in providing services. On the other hand, the phrase "Servicing Success" could mean that your organizations have had the benefit of servicing successful clients -- you have been servicing the success of others. This double meaning is important because we need to consider the impact of the success of both groups: you as well as the clients you serve.

"Servicing Success" may also be a little misleading, for it could also imply that the current state of affairs is permanent. It would be as easy for you to bask in the results of 1985 as in the warm Florida sunshine. But I believe that continued success requires you to anticipate changes in the investment company service industry. In the near future, those changes will involve growth, innovation, and competition.

A Closer Look at the "Mutual Fund Explosion"

Consider the "Mutual Fund Explosion" which took place in 1985. If you look at all open-end funds, including short-term bond and money market funds, the results for the past year are stunning. Net assets of all funds have reached almost 500 billion dollars, a one-third increase over 1984. 1/ That's one-half the proposed 1987 budget for the federal government, and over one-quarter of its deficit. 2/ It's a rare figure that can hold a candle to the federal government's deficit! The number of funds at the end of 1985 stood at about fifteen-hundred, or about a twenty-percent increase from the end of 1984. In addition, sales of all open-end fund securities totalled almost

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1/ All figures on funds are taken from the Investment Company Institute's monthly statistical summary Trends in Mutual Funds Activity for December 1985.

2/ Total proposed outlays for fiscal 1987 are $994 billion, with the total debt outstanding and held by the public projected at $1.86 trillion. Executive Office of the President, Office of Management and Budget, The United States Budget in Brief 77 (1986).

88 billion dollars, about a one-quarter increase over 1984. Another surprising number, and one that would be especially significant to investment company service groups, was the dollar value of open-end fund portfolio transactions. Even excluding short-term bond and money-market funds, there were transactions totalling almost 34 billion dollars in 1985, which is two-and-one-half times the amount in 1984. Although most of the increase was in trading in securities other than common stocks, it seems to me that this is a development which by itself almost revolutionizes the fund service industry. A recent Wall Street Journal article referred to mutual funds as "the professionally managed 'fast food' of investments." 3/ I trust that this was a reference to the speed with which service agents have been able to dish them out to the waiting public, and not necessarily a reflection on the nutritional value or intrinsic quality of the funds themselves.

A year that so completely pulverizes previous records the way 1985 did in the mutual fund industry requires that we hazard some guesses about the cause and the future course of this activity. In this area, there's been no shortage of opinions.

Some analysts attribute the surge in mutual fund investment in part to the performance of the stock market in 1984 and 1985, combined with lower inflation and interest rates. A. Michael Lipper of Lipper Analytical Services believes this is one of the main reasons for the funds' success. He notes that:

> [W]hen [investors'] certificates of deposit matured, they were used to, say, an 11 percent yield. So they went back to the bank or S&L and said "Well, roll it over." The institution said, "We'd be happy to do it at 7.5 percent." People said "No, I want double digits." So they found their way to mutual funds. 4/

In addition to the strong returns in the market relative to those from financial institutions, some experts have suggested mutual fund growth is due to the large variety of new funds offered to investors. This is important because a change in the funds' "marketing mix" may bring new permanent customers and add long-term strength to investments in the fund. An investment that is made only because the fund's relative return increases will be as quickly backed out in a decline; but an investor in new products is more likely to stay in a fund or group of funds.

Others suggest that funds grew in 1985 because investors are approaching this market with more money than before, as

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3/ "Many Small Investors Quit Picking Stock, Shift to Mutual Funds," Wall Street Journal, Feb. 7, 1986, p. 1.

4/ "Lipper Says Mutual Fund Industry Is Growing Rapidly," Washington Post, Feb. 9, 1986, p. F-3.

individual retirement accounts established some years back now begin to accumulate principal amounts worthy of attention. You may recall that last December the New York Stock Exchange released a survey of individual investment in the stock market. One of the most widely-publicized findings of this survey was that the increase in the number of shareholders from 1983 to 1985 was attributable almost exclusively to increased participation in mutual funds. Without these amounts, share ownership in the United States would have shown a decline. As interesting as this result, however, was the profile of new shareholders, because there was a major change in the survey's composite sketch of the new investor. In 1983, 46 percent of new equity investors had an IRA or Keogh account, while in 1985 that increased to 62 percent. 5/ This proliferation of IRA capital, seeking long-term secure investments, has no doubt contributed greatly to the growth of stock funds.

It has also been suggested that many funds are "sold and not bought," and that advertisements under Rule 482 and sales commissions and maintenance fees paid to brokers under Rule 12b-1 have contributed to the funds' successes. I don't believe that there's anything inherently wrong with "pushing your product," but I will have more to say about Rule 12b-1.

Although I hesitate to be too judgmental about investor motives, I would suggest that those I have just listed are some of the better motives for investing in mutual funds. And, like I said, I don't want to be too judgmental, so I will list the following as some "other" motives.

Some have suggested that the recent spate of tender offer activity is responsible for the demise of the individual shareholder and his or her reappearance as a mutual fund shareholder. The market swings that have recently accompanied takeovers or even takeover rumors may leave the individual feeling as a midget playing in a land of stampeding giants -- looking for higher ground in order to avoid getting trampled by the thundering crowd. A Wall Street Journal/NBC News poll found that 56 percent of those surveyed "believe the stock market is controlled by large institutions and that small investors don't stand a chance." 6/

Although this may be disturbing reasoning, other reasons for the increased investment in mutual funds cause greater concern to those of us at the Securities and Exchange Commission. Many experts have suggested that investors consider mutual funds safer and more conservative than other investments. This is an image that the industry has certainly taken advantage of, and perhaps

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5/ New York Stock Exchange, Inc., "New York Stock Exchange Survey Shows Record Number of Americans Own Stock," Press Release Dec. 4, 1985, at 2.

6/ *See supra* note 3.

has done less than it ought to see that this image, where it exists, is projected by truthful and complete information. For example, individuals may view mutual funds which invest in Ginnie-Maes as "risk free," although the mortgage pools are guaranteed only with respect to timely payment of interest and principal. The value of the fund -- and the individual's investment -- is still subject to prepayment, interest rate, and other risks. I'm concerned that the funds aren't doing enough to dispel investors' erroneous conclusions, especially since Ginnie-Mae funds have been some of the fastest-growing in 1985. According to Mr. Lipper, "[p]eople see 'government' and 'guaranteed' and conclude that these securities are conservative investments." 7/ The Commission staff, in a recent and unprecedented "mass mailing" to 56 Ginnie-Mae funds whose prospectuses and advertisements had been reviewed, squarely presented the issue, stating in the letter that "prospectus disclosure and related advertisements which do not give equal weight to benefits and risks are misleading."

Individuals may also be investing in mutual funds because of the advertised high yield that accompanies this perceived safety and conservatism. Again, this is entirely appropriate if the fund's image is based in fact. However, I believe that further disclosure may be needed in certain areas of fund performance measurement. Long-term bond funds are currently subject to few rules about how they calculate or advertise their yields. Funds with "back-end loads" or contingent deferred sales charges currently are permitted in some cases to treat these amounts differently when computing net investment income, which may result in non-uniform disclosure.

Another major factor in the growth of mutual funds is the so-called "internationalization" of the industry. Funds denoted by the Investment Company Institute as "international" funds were a small but very fast-growing group in 1985. Many of the new funds registered at the Commission are "mirror funds," composed of securities of a particular foreign country or foreign fund. Today we have a Japan fund, a Mexico fund, and an Australia fund, and registration statements pending for an Italy fund and a France fund. This is significant not only within the regulatory scheme of the Investment Company Act, but also in the more general internationalization of the securities trading markets.

Growing Pains

These are only a few of the explanations offered for the growth in mutual funds which has left pre-1985 years as historical curiosities. Of the reasons which I've just discussed, however, I'd like to look at some of them with you in a little more detail.

7/ *Id.*

In short, I see two developments which exhibit the "growing pains" of the mutual fund industry. First, funds are subject to a certain allure of safety and performance that may need some closer examination. Second, the new fascination of investors with overseas securities may require regulatory innovation. As service organizations, I believe you would be unduly basking in success if you believe that some of the competitive changes in the industry will not have an impact on your business. As funds strive to bring high, safe returns to their investors, they will demand inexpensive and perfect service from their custodians, transfer agents, and underwriters. And as funds seek to expand overseas, service involving foreign custodians and even foreign funds may prove more challenging. In both of these areas, both you and your clients will be subjected to the future challenges of past success. I'd like to examine each of these areas in detail, with an eye toward continuing the success on which you pride yourselves.

Fund Safety and Performance

In the area of fund safety and performance, there have been significant developments in the area of fund advertising. The problem is that we have seen some rather misleading statements of funds' compounded yield, or return based on short past periods, with the implication that this represents or accurately predicts future returns from the fund. This is no doubt an effort by these funds to project an image of stability and safety. Although this effort is certainly well-meaning, it may become misguided. Kathryn McGrath, the Commission's Director of Investment Management, recently put it more bluntly when she said that the Commission doesn't "want to needlessly restrict industry flexibility," but warned "at the same time, you can hardly expect us to sit back and ignore some of the dousies the marketing people have come up with and sneaked by the NASD." In that same speech, she warned that the Commission may consider action on substantive yield computations if the industry doesn't draw up its own guidelines. 8/

In response, the Investment Company Institute's Board of Governors passed a resolution including some disclosure recommendations. In essence, the ICI directed income funds which advertise other than total return to provide additional information about the returns they advertise. I think it's important to note that this resolution did not require funds to advertise the total return, but only to add disclaimers about the yields that were not based on total return. 9/ I believe that this missed the

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8/ McGrath, "Good Compliance is Good Business," Keynote Address to the 1985 SEC/ICI Procedures Conference Oct. 31, 1985, at 11.

9/ Resolution of the Board of Governors at the Investment Company Institute Regarding Advertisements by Income Funds, Jan. 15, 1986.

spirit of Mrs. McGrath's remarks. Let me note a few of her recommendations:

- Long-term debt funds should be required to base estimates of their current return on actual one-year periods, including unrealized gains and losses.

- Equity funds likewise should advertise only their current returns for the last full year.

- Funds should not be permitted to advertise annualized yields on a compounded basis, because there are significant variations from period to period. 10/

I think when you compare these suggestions with the ICI's response, some cross-purposes appear, although I'm not suggesting that these can't be resolved. The Commission staff has encouraged the industry to come forward with its own proposals as a precursor to Commission action, not as a substitute. Again, as Mrs. McGrath succinctly put it, "I encourage you to move ahead. If you don't, we will." 11/

Another area in which the Commission has already moved ahead concerns accounting for certain deferred sales charges in Rule 12b-1 plans adopted by funds. The Commission's proposed rule would provide that these charges be accounted for as current expenses, and not passed directly through to the fund's capital accounts. 12/ Investor perception of marketing costs suggests that there are not only accounting and computation questions but also disclosure questions that need to be addressed. Mr. Lipper commented that these fees may mislead investors, speculating about an investor who "doesn't realize [the deferred charges] are there and doesn't realize how funds are most appropriately used, and starts to trade them and winds up with an unexpected sales charge." In response to the question "Is the industry doing enough to tell consumers about these fees?," Mr. Lipper notes rather dryly, "I think they're doing all that the SEC requires." 13/

Disclosure of complex compensation plans, adopted under the letter but not the spirit of Rule 12b-1, is becoming very technical, and as a result these charges can be effectively hidden from the

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10/ McGrath, *supra* note 8, at 14-15.

11/ *Id*. at 15.

12/ *See* Securities Act Release No. 6598, 50 Fed. Reg. 28,953 (1985).

13/ *See supra* note 4.

investor. A recent financial magazine article on Rule 12b-1 plans carried a photo of a fund manager with the quote: "We wanted a mutual fund that looked like a no-load and smelled like a no-load, but was still a load fund."

These are issues that crop up as funds strive for safety and performance. Although you may view these as the funds' problems, it is not unlikely that the sins of the fund will be visited unto the service companies. Mr. Lipper notes that mutual fund fees are increasing because management fees are increasing, and the proliferation of funds has also increased marketing costs. 14/ As more funds strive to produce high yields, they may put pressure on servicing costs, or turn to in-house servicing. Furthermore, any significant disinvestment from the funds which contracts the mutual fund industry would have a similar impact on the fund service industry.

It's also important to note that the funds rely heavily on flawless servicing for their "safety and soundness" image, although this may be a point less appreciated by investors than the fund managers. Efficient and error-free transfer of consumer funds and accounts and portfolio securities is vital to the fund's success. A thorough and professional job by custodians and transfer agents is vital in an industry which depends on depositors but is not backed by government account insurance.

It's difficult to say how this mixture of business pressures, consumer and investor preferences, regulation and economic trends will affect the service industry. However, good business is not built on complacency in success -- neither you nor your clients can afford it.

Internationalization

The other major area which I want to explore today is internationalization. The Commission is "big" on internationalization, for we have recently promulgated major concept releases seeking comment on disclosure in multinational prospectuses, the linking of international trading markets, and problems in enforcement of the United States securities laws abroad. 15/ These are the

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14/ Id.

15/ See Securities Exchange Act Release No. 21958, 50 Fed. Reg. 16,302 (1985) (Internationalization of the World Securities Markets); Securities Act Release No. 6568, 50 Fed. Reg. 9281 (1985) (Facilitation of Multinational Securities Offerings); Securities Exchange Act Release No. 21186, 31 SEC Docket 20 (Jul. 30, 1984) (Improving the Commission's Ability to Investigate and Prosecute Persons Who Purchase or Sell Securities in the U.S. Markets From Other Countries).

Commission's concerns primarily because we see these as issues to be examined before the need for action is apparent. We must anticipate changes in these areas rather than play "catch-up" with a runaway international market.

However, I believe the task of addressing internationalization may be more difficult in the mutual fund area than in any of these others. For nowhere in the federal securities laws does one find a more provincial statute than the Investment Company Act. It is up to both the Commission and the mutual fund industry to adapt the law to the reality of international business and capital markets. I would like to use as examples the areas of foreign custodians and foreign funds.

Section 17(f) of the Investment Company Act 16/ provides a very short and extremely limited list of places funds may keep their portfolio securities. It could hardly be argued that Congress contemplated that funds would invest their portfolios overseas. On the contrary, Congress demanded that the securities be placed in certain basically domestic institutions. The reality of this requirement is that the only place for a United States fund to leave a security overseas is in a foreign branch of a United States bank. This is hardly a boon to the development of international markets. However, in fashioning the exemptions of Rule 17f-5, the Commission faced great difficulty in measuring the soundness of many of the other foreign institutions which funds want to use as depositaries for their securities. 17/

Although Rule 17f-5 as adopted in September of last year and the subsequent staff no-action positions may dispose of the issue for the moment, there are many unanswered questions. Do foreign custodians present an obstacle to effective service of mutual funds? And most importantly, who bears the ultimate responsibility for the foreign custodian, if that custodian is not directly subject to United States jurisdiction? This question has generated a lot of finger-pointing by funds, their domestic custodians, and their foreign custodians, but unfortunately none of them have volunteered to unconditionally accept the risks that accompany the convenience of using a foreign custodian not contemplated in the Investment Company Act. I believe this is clearly an area in which the investment company service industry can be an integral part of an effective solution.

The problem of foreign custodians, however difficult, pales in comparison to the issue of foreign funds themselves. For few provisions have been as unyielding as Section 7(d) of the Investment Company Act, which prohibits foreign funds from making public offerings in the United States unless the Commission finds that

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16/ 15 U.S.C. § 80a-17(f).

17/ See Investment Company Act Release No. 14711, 50 Fed. Reg. 37,654 (1985).

it is both "legally and practically feasible" to enforce the Act with respect to the foreign fund. 18/ With the exception of Canadian funds which qualify under Rule 7d-1, 19/ this is a finding the Commission has been unable to make. Indeed, the Commission sort of "threw up its hands" in late 1983 by suggesting that foreign funds wishing to trade in the United States would be better advised to incorporate a United States subsidiary rather than run the gauntlet of attempting to meet the standards of Section 7(d). 20/ The Commission noted then, and still believes now, that Section 7(d) should be modified by Congress, and has proposed a legislative solution to this problem. In addition, the Commission is pursuing a recent Investment Company Institute suggestion that the United States seek a bilateral agreement with the EEC, allowing reciprocal sales of fund shares, similar to the arrangement now made among EEC members themselves. 21/

If Section 7(d) were to be modified to allow certain trading by foreign funds, it could change the servicing industry dramatically. If the popularity of international funds in 1985 is any indication, a direct public offering by a foreign fund in this country would likely generate much investor interest. Assuming that Congressional or diplomatic modification of this restrictive law becomes a realistic possibility, it would only be good business for the funds and their service companies to be an integral part of forming the new environment for foreign funds in the United States.

Conclusion

In reviewing these few areas of current concern to you and your clients, I hope that I've gotten across the message that you can and should be proud of the "Servicing Success" which 1985 has brought. However, it is equally important to stress that complacency would be dangerous. A growth trend of the breadth and depth which we have witnessed in the mutual fund industry cannot be left to its own devices. It brings new challenges in competition, both foreign and domestic, in disclosure, and in regulation. In each of these areas, the Commission stands willing to work with you to fashion mutually acceptable solutions in the public interest. Ultimately, of course, it is this public interest to which you must extend your new-found "servicing success."

18/ *See* 15 U.S.C. § 80a-7(d).

19/ *See* 17 C.F.R. § 270.7d-1.

20/ *See* Investment Company Act Release No. 13691, 49 Fed. Reg. 55 (1984).

21/ Letter dated Jan. 2, 1986 to John S.R. Shad, Chairman, Securities and Exchange Commission, from David Silver, President, Investment Company Institute.