U. S. Securities and Exchange Commission
Washington, D.C. 20549 (202) 272-2650

News Release

GOOD COMPLIANCE IS GOOD BUSINESS

Keynote Address to the
1985 ICI/SEC Procedures Conference

The Hyatt Regency Hotel
Washington, D.C.

October 31, 1985

Kathryn B. McGrath
Director
Division of Investment Management
Securities and Exchange Commission

Good Morning.

On behalf of all the SEC staff members who will be speaking at the 1985 SEC/ICI Procedures Conference, I want to join Matt Fink in saying Welcome to Washington, and Welcome to our Conference. A key purpose of this Conference is to give people in the investment company industry a chance to hear industry experts and SEC staff members -- who are experts in their own right -- discuss current regulatory issues and new developments facing the industry. I hope that you will find the panel discussions during the next day and a half informative, and helpful. All of the speakers have worked long and hard to put together an excellent set of written materials and to prepare their oral presentations. I think their time has been very well spent, and I want to compliment -- and thank -- the panelists for their fine work.

The SEC staff members on these panels are some of the people that many of you deal with on a day-to-day basis, most often by telephone. Through this conference, we want to let you see and hear the people who are on the other end of the phone. Many of the SEC speakers will be here during the breaks, and other staff members will be here attending parts of the program that relate to their work. Please take advantage of this opportunity to meet them, and please feel free to raise with them or with me any problems or concerns you may have about our procedures or substantive aspects of our work. The more we can learn from you, the better job we will be able to do administering the statutes and rules under which you do business.

The investment company business today is a growth industry. More and more investors are turning to pooled investment vehicles, like mutual funds or unit investment trusts, as a way to save for the future and for their retirement. The services this industry offers are very popular, and they're very valuable. The products investment companies sell have historically been pretty safe and sound investments. This industry operates under a fairly strict regulatory scheme, and has a very good record of compliance with those regulations. Ethical and legal standards are among the highest in the financial services field. Investment company failures are rare, not something you read about every day in the newspaper. Luck and good market conditions probably have a lot to do with it. But I think there's a more fundamental reason: this industry has proved that compliance with the law and compliance with high standards <u>is good business</u>. Compliance keeps customers happy, and they keep coming back. Compliance helps maintain investor confidence, a particularly important factor for an industry which can't rely on the back stop of government deposit insurance. And compliance keeps us regulators <u>very</u> happy too, and that lets you avoid the adverse publicity that invariably comes when we are forced to sue to redress violations of the law and our rules.

With so much growth in the industry, and the entry of so many new participants, I think it vitally important to maintain this strong compliance ethic throughout the industry. This means that your firms must continue to stress good compliance as a very important aspect of your business. Compliance procedures must be kept up-to-date, and up to speed with the much higher volume of business, products and customers that you are handling. And resources spent on new products development and marketing must be matched with more resources spent on compliance. New entrants to the business need to be taught the high standards and ways of doing business that have been traditional. The ICI does an excellent job coordinating much of this effort, and the ICI staff, under the very able leadership of Dave Silver and Matt Fink, particularly deserves to be commended for their role in this. Those two guys are terrific advocates for the industry, as any good trade association leaders should be. But somewhere under Dave's pinstriped suit lurks at least part of the heart of a regulator, and it is the same with Matt. I'm convinced that their strong sense of ethics and genuine concern for investor protection has been very, very beneficial to the industry over the years. It also helps give the ICI enormous credibility in Washington, and makes the Institute a <u>very</u> tough adversary, as well as an effective ally, as I've learned from personal experience in the past two years. I don't mind -- you can't enjoy a good fight without a worthy opponent on the other side.

The SEC also has an important role to play in ensuring compliance with the law, to maintain the investor confidence that the industry must have to thrive and grow. As an agency, we historically have enjoyed a good reputation. The public believes that we're effective cops and counts on us to make sure investors get full and fair disclosure, and that our many other rules and regulations are enforced, through regular routine compliance examinations, or inspections, and prompt law enforcement action in those rare instances where it is needed. We also are expected to update our rules and requirements to keep pace with business changes, and fill regulatory gaps where they occur. At the same time, we can't over regulate and hamstring the industry we're regulating in the name of investor protection. We recognize full well that the Investment Company Act is a very stringent statute, as are some of our rules, and we need to make adjustments from time to time to accomodate new ideas and new ways of doing business. Contrary to what some people may believe, we <u>don't</u> think investors should be protected by being prevented from having new investment opportunities. We're not always as quick to change as one might like, but we do want, and we do try, to keep up with market developments, and our minds are generally open, even if the opening is sometimes only a small crack.

These days, it is not so easy to do everything we ought to be doing. For while investment companies are a booming growth industry today, I can assure you that Government regulation is not. Your industry has increased enormously over the past several years, in terms of assets under management, the number of investors served, the number of firms in the business and the number and types of new products being brought to market. Meanwhile, our staff resources have remained the same, or, in some cases, have been slightly reduced. Given the huge deficits the Federal Government faces today, and the overriding national importance to our economy of reducing those deficits, we at the SEC, and in the Division of Investment Management, can not reasonably expect to grow, and I don't think we should, at least not until we have done everything in our power to use our existing resources as efficiently and as wisely as is humanly possible.

Much of our effort these days is directed to achieving that goal, and we are constantly striving to do a better job, and to do it more quickly. We've had some spectacular successes. Our Chief Counsel's office has made a truly outstanding effort, and we are now responding to "no action" and interpretative letter requests in a fraction of the time it used to take us -- well under the goal we set for ourselves of a 30 day average response time. In fact, for the four weeks ending October 25, our average time for providing written answers to "no action" letters was 17 days, and we had none that had been hanging around for more than 30 days.

Our two rulemaking offices also have achieved much faster turnaround time between the proposal and final adoption of new rules. We focus on better management of our time and resources. We've also tried to cut down on the amount of time we spend debating issues and get decisions made promptly, for better or worse, and I don't think the quality of our work product has suffered as a result.

We have also been able to speed up somewhat our processing of registration statements and the other disclosure documents that are filed with us. Our new Assistant Director, Carolyn Lewis, isn't satisfied, however, with the status quo, and she and her staff are working very hard to come up with ways to make our review and comment process faster, more useful, faster, more efficient and faster.

In the applications area, we are continuing to experience difficulties. Our staff there is simply terrific, and they're all working harder than ever. The problem seems to be that we've adopted exemptive rules which have eliminated most of the routine applications we used to get, and yet the volume of exemptive applications each year keeps going up, up, up. Each one seems to raise more difficult and complex legal and policy issues than the last, to say nothing of the intricacies of the new financial products or arrangements involved. Our applications workload continues to defy all our efforts to wrestle it under control, and to devise a method for promptly granting or denying exemptive requests.

This always seems to come as a great shock to lawyers and businessmen. They seem to think we ought to be capable of instantly analyzing and immediately appreciating the true merits of their highly sophisticated new ideas. Applicants seem to forget how long it took them to figure it all out in the first place! Also, we no longer seem to have the benefit of the work and persuasion that used to be done by experienced '40 Act counsel, before filings were presented to us, to pare down the broad scope of requested exemptions to something closer to what we bureaucrats could be expected to accept, given the statutory strictures under which we must operate. Section 6(c) of the Investment Company Act, which is the general provision that allows us to grant exemptions from the Act, is not viewed by the Commission or the staff as a blanket license to rewrite the statute. So while we want to accommodate new ideas and new business proposals, and we do understand the need for speed in the business world, we are finding this more and more difficult, given the far-reaching requests we get. Mary Joan Hoene, our new Associate Director, recently listened to the Division's senior staff discuss the applications problem, and she heard me and others express our very great frustration about how long it takes and how hard it is for us to deal with so many complicated applications. She advised me that the best thing I could do was to quit getting so upset about it. In her view, exemptive applications of the type filed in 1985 are by their very nature going to be tedious and time-consuming to deal with. I'm trying to take her good advice to heart. I'm still concerned, and still unhappy, but I think I might better spend my time on problems I can reasonably expect to solve. However, if any of you have any bright suggestions, please let me know. If all else fails, be a little patient with us.

I don't think anyone here would believe me if I claimed that under my pin-striped suit beats the heart of a businessman, but I have been on the other side of the fence, I do understand how important it is to get issues resolved promptly, and I am trying, along with the entire Division staff. Our record shows that we are succeeding in many areas. And I promise we'll keep at it.

We've also made dramatic changes in our inspection procedures, and as a result have increased the number of investment company compliance exams completed in fiscal 1985 by 140% over what we did in 1981. Over the same four year period, investment adviser exams are also up 103%. In the investment company area, this has allowed us to keep up with growth in the industry and at the same time increase the frequency of our inspections, without additional staff resources. On the adviser side, we have a more difficult problem. The number of investment advisers registered with us has more than doubled since 1981, up from about 4,000 to 11,200 today. New adviser registrations continue to pour in at the rate of about 340 a month. We are starting to work more closely with the states to share the inspection burden - and results of inspections - with one another, and to do a better job of targeting where we spend our resources. We are also studying a proposal that has been made by the Atlanta-based International Association For Financial Planning, for the establishment of a self-regulatory organization, under SEC oversight, to regulate financial planners. Financial planners are the largest and fastest growing segment of our investment adviser population. Last month, the NASD Board of Governors set up a task group to study, among other things, whether the NASD should take on the task of acting as an SRO for financial planners and for other types of advisers as well. I think these proposals deserve our careful study, and they will get it from us, as well as the North American Securities Administrators. Self-regulation has worked well in the broker-dealer area, and it could provide a way to increase investor protection, and supplement the Federal and state resources available for adviser regulation, at minimal cost to the taxpayers. At least one major investment company complex, IDS, has expressed support for the IAFP effort, and I would urge others in this industry to look at the idea with open minds as well. There, of course, are a number of legal, policy, business and competitive issues involved, and they must be addressed.

The outcome of any action on the IAFP proposal, or other similar proposals, undoubtedly will affect some aspect of your business. I hope that more of you will focus attention on this issue. Rightly or wrongly, I think there is a strong perception among regulators, particularly at the state level, that more should be done to regulate financial planners. As the financial planning industry grows, as the press publicizes the problems caused by the few bad apples that have unfortunately, but predictably, popped up in this business, I have to believe that more regulation will in fact occur. Isn't it better to get involved, to use your talents and resources to help make sure that the end result makes sense; that it is tailored to correct only real abuses, and will only hamper the efforts of a few unscrupulous persons instead of impairing the ability of honest financial services businesses to continue to offer their services for the public? Your trade association, the ICI, is widely viewed as one of the most knowledgeable and capable such organizations in this town. I urge the ICI and its members to bring their very great talents to bear on this issue, and to play a constructive role in the process.

While I'm on the subject of compliance and high ethical standards, let me mention one area where we have continuing and growing feelings of concern and unease, and then make a suggestion as to how the problem we see might be handled. The problem is your advertisements. Not all of them, but enough to make us wonder and worry, and conclude, like true regulators, that it is high time we tightened up on our rules. First, I'd like to outline for you what's bothering us, then I'll scare the daylights out of you by describing what we might do to cure the problem, and then I want to suggest that a better approach might be for the industry to develop reasonable standards on its own and present them to us as a rulemaking petition. We are convinced that something does need to be done, and soon. We're not interested in getting back in the business of reviewing all your ads, or prohibiting advertising altogether, and we don't want to needlessly restrict industry flexibility. 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.

One of our main concerns is the way in which funds advertise their performance. So far, and only on the staff level, we have reached the following general conclusions:

First, we shouldn't prohibit advertisement of a fund's performance figures. Such advertising can be informative to investors.

Second, given differences in accounting practices and the fact that investment techniques are constantly changing, we would prefer not to try to limit fund advertising to rigorously defined indicators of performance. But if you can come up with something in this area that is fair and that you can live with, God bless you all!

Third, some existing fund advertising practices are horrid and must be stopped.

In general, we don't have much complaint about the way money market funds advertise their yields. We think investors generally understand that money market fund yields vary and that the yield advertised is based on a prior week's result and is <u>not</u> an indicator of what the investor will receive over a year's period.

Money market fund investors appear to use advertised yield figures mainly to compare a fund with other similar funds or deposit arrangements. In addition, an annualized yield based on a recent week's results is relevant to short term future yields, so long as the recent results have not been manipulated by an adviser absorbing fund expenses from time to time. Also, investors in these funds tend to have short term horizons.

Because money market funds continuously reinvest their undistributed income, and because money market fund investors seem to understand what advertised yields signify, the advertising of annualized yields based on compounded seven day results also appears acceptable. Banks advertise their money market accounts on a compound basis, and money market funds should be permitted to advertise on the same basis.

Unit investment trusts that have fixed portfolios of debt instruments have been permitted to advertise estimated current returns. The rationale for this is that the incomes of such funds are unlikely to change and their expenses are fairly constant. UITs do not reinvest earnings, and, thus, they do not estimate earnings on a compounded basis. But there are some problems.

First, stale estimated current returns. Advertising an estimated current return that is based on a non-current offering price can be misleading. We think that an estimated current return should be advertised <u>only</u> if it is calculated as of no more than one day preceeding the ad. Of course, most UIT offerings are sold out as initial offerings and, therefore, do not give rise to these problems.

A second problem arises when a unit investment trust invests in debt securities on a when issued basis. Variations of from 3 to 15 basis points can occur between the UIT's first year's income and its subsequent year's annual income. An ad based on first year income isn't necessarily indicative of what is to follow, or vice versa.

A third problem is when advertisements for unit investment trusts holding long-term debt instruments do not make clear that the value of interests in the trusts <u>are</u> subject to market risk, such as the risk of changing interest rates, and credit risks, that is, the risk that an issuer of a security in the trust portfolio will default. Even trusts that invest in only U.S. Government securities bear a market risk.

As to other types of funds, we think that managed funds whose assets are invested mainly in long-term debt should be required to base advertisements of their current return (including their realized and unrealized capital gains and losses) on the immediately preceeding year, if they advertise a yield (not including capital gains and losses). Current returns should not be computed on any basis other than actual one year periods. We're still debating whether such funds should be permitted to advertise annualized yields based on a recent seven day period's results or whether a longer base period should be required.

We also think that long-term bond funds should not be permitted to advertise annualized yields on a compounded basis, even though they do reinvest their earnings. This is because annualizing a short period's results, such as the earnings for a seven day period, on a compounded basis, requires the making of two assumptions: first, that earnings will remain the same from period to period, and second, that net asset value will remain unchanged from period to period, both of which assumptions are false with respect to such funds. Also, the advertisement of a current return based on a recent full year's performance would reflect not only reinvestment of earnings, but also losses and gains of capital and, thus, provide a better basis for comparing funds than compounded annualized yields.

If managed funds investing substantially in equities advertise any yield, we think it should be only their current returns for the last year and that they should be prohibited from advertising annualized yields that are based on short periods, such as seven days, because of the significant variations from period to period in the earnings of such funds.

There are two other points I want to mention. Although I've just praised the industry to the skies for generally good compliance, the advertising area is a weak spot. Many funds are <u>not</u> complying with the filing requirements of rule 424, which apply to rule 482 advertisements. Please shape up.

In addition, don't forget that the minimum type size requirement contained in rule 420 applies to rule 482 printed prospectuses, including the footnotes.

Now, as to how to solve these problems: we at the SEC can and will try to develop our own solutions. But I think a better result might be attained, and much more quickly, if the industry, through the ICI, or otherwise, were to use an industry task force to develop a workable solution and present it to us as a rulemaking petition. Greater uniformity and consistency among funds in advertising yields and other measures of performance is needed. I understand that some steps may have already been taken to do this. I encourage you to move ahead. If you don't, we will.

In closing, I'd like to thank all of you for coming today, and invite you all to come by the SEC and see our EDGAR pilot operation. We're very proud of it, and grateful for the enthusiastic support we've gotten from those industry members who are participating in our pilot.

Enjoy the conference!