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SOME FURTHER CHALLENGES TO MUTUAL FUNDS

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In the two years since I last addressed the Institute's General Membership Meeting, the mutual funds industry has been transformed from an industry suffering from net redemptions to one which has experienced the most explosive period of growth in its history. In aggregated assets, mutual funds have doubled during this period -- picking up over $50 billion. A remarkable accomplishment.

Yet, the obvious satisfaction of this achievement should not be allowed to obscure the important lessons of the industry's longer-term experiences of the last two decades -- a period marked by a cycle of unprecedented growth, followed by severe net redemptions, and then even greater growth. For, as any prudent investor in mutual funds knows, it is best to judge performance over a longer time period encompassing a variety of economic conditions. And, applying such a perspective to the mutual funds industry as a whole reveals its apparently extreme sensitivity to governmental policies, i.e., the industry's historic dependence on, and vulnerability to, governmental actions in determining its economic success.

This sensitivity has been most pronounced in three particularily critical areas of concern to the industry. First, governmental policies -- including fiscal, monetary and tax policies -- to a large extent determine whether the public is receptive to investing at all, and, if it is receptive, the media in which it will make investments. In the second area, governmental policies determine if a heavily-regulated industry -- such as mutual funds -- can operate in an efficient and innovative manner, or whether the opportunities of entrepreneurism will be frustrated. Finally, governmental policies have largely established the parameters in which mutual funds compete -- or are insulated from competition -- with other financial institutions.

Recognizing the impact of government on its operations, the industry has strongly reacted to governmental policies which it has perceived as harmful to its interests. For example, its battles with federal agencies over the application of the Glass-Steagall Act are well documented by numerous judicial decisions. While I begrudge no industry the right to defend its interests, I am concerned that an undue reliance on <u>reacting</u> to governmental policies may result in the industry's shortsightedly ignoring those actions, within its own initiative, that could more productively insulate its fortunes from government. These actions most notably include: first, developing innovative, alternative investment vehicles so that, regardless of then-current economic conditions, the mutual funds industry will remain attractive to investors; and, second, establishing an effective and efficient self-regulatory system to maintain the industry's high levels of integrity with a minimum of burden to its operations. This afternoon, I wish to amplify on these thoughts.

Governmental Economic Policies

Initially, let's look at the importance of governmental fiscal, monetary and tax policies to the mutual funds industry. Some unquestionably benefit mutual funds. For example, the nontaxable pass-through treatment of dividends under Subchapter M of the Internal Revenue Code represents a tax policy which impliedly recognizes the current societal benefits of mutual funds -- although the industry itself has no property right in Subchapter M's continuing existence. On the other hand, some governmental policies contribute uncertainty to the industry. For example, changing governmental macroeconomic policies have been associated with the boom-and-bust cycles experienced by the mutual funds industry in recent years. In the early 1970s, governmental policies contributed to a major downturn in the equities markets -- which, to a large extent, precipitated a period of net redemptions among the traditional equity mutual funds upon which the industry was then inordinately dependent. Subsequently, other governmental policies -- especially, the convergence of a very tight money supply and

Federal Reserve System Regulation Q -- facilitated the remarkable growth of money market mutual funds, during which unprecedented numbers of investors have been attracted to the industry. And, as you know, governmental policies recently resulted in the imposition of reserve requirements on many of these funds which -- in addition to the apparent peaking of short-term rates -- may, over time, have an effect on the industry's growth.

Nevertheless, it should be remembered that a significant period of time elapsed between when equity funds went into disfavor and the industry geared-up money market funds. The interim period of net redemptions -- a situation which contributed to the industry pattern of boom-and-bust -- could be seen as the result of the mutual funds industry's continued heavy reliance on a particular product without the immediate availability of an alternative more appropriate to the changed economic conditions. In my opinion, this experience underscores that the future of the mutual funds industry and its ability to retain its consuming public -- similar to that of any other successful industry -- is dependent on the existence of a farsighted program of new product development.

The import of this lesson should be obvious today when half of the mutual funds industry's assets, and most of its new sales, are represented by money market funds. While I am not aware of any impending governmental action in this area, the industry cannot assume that future governmental policies will continue not to have the effect of causing these funds to eventually decline in favor among investors. Therefore, to avoid the possibility of again suffering the net redemptions and loss of clientele that it experienced in the last decade, the industry must be prepared to hold on to its newly-attracted clientele by satisfying their changing investor needs with timely, alternative investment media, i.e., it must stand ready to provide investors with a full range of investment opportunities in order to immediately provide services appropriate for any economic conditions. It would be ironic indeed if the fortunes of an industry whose existence, in large part, is justified by the principle of diversification, again suffers because that industry became too dependent on a limited number of product lines.

The industry's prosperity, over time, cannot depend on its ability to exert pressures or to enter into protracted litigation against governmental policies which might have an adverse impact on its then-successful product lines. Neither does it do the industry credit when it disparages adverse governmental policies as politically motivated. This is particularly true when a negative impact is merely incidental to an effort to address rationally a national problem of critical importance. In an economic democracy, the parochial concerns of any particular indusry will be -- and should be -- invariably subsumed by more compelling national priorities. Thus, the mutual funds industry will remain only as viable as its continuing sensitivity to the investment needs of the public -- and its innovation and creativity in meeting these needs.

Governmental Regulatory Policies

A. Rebalancing Investment Company Regulation

However, the characteristics of innovation and creativity historically have not often flourished in a heavily regulated environment. I described to you two years ago that, as an industry becomes increasingly regulated, the result is an excessive dependency on the regulator to pass on a wide variety of day-to-day activities. This situation often culminates in the regulated industry's abdicating its corporate responsibilities in favor of the regulator's judgment -- and, in that process, the competence and managerial skills from which the beneficial qualities of entrepreneurship arise seem to invariably atrophy.

The Commission began its efforts to redress these problems when, in 1978, it embarked on a study intended to enhance the industry's decisionmaking authority and responsibility.

This goal, in turn, required that the Commission take steps to develop a system of consistent rules designed to give reasonably clear guidance to prudent fiduciaries, and to set standards of conduct and duty which will be enforceable in court, both by the Commission and by private litigants.

To date, the Commission has adopted or proposed more than 25 rules as part of this program. Many of these rules remove the Commission from the posture of prior approval of business transactions, and instead state standards of conduct for fiduciaries and leave it to each investment company's directors to determine the appropriate process for their company to meet these standards.

The goal of diminishing the Commission's presence in routine investment company decisions also is reflected in the Commission's withdrawal of its "Statement of Policy" on investment company advertising, coupled with its adoption of Rule 434d to permit investment companies much more flexibility in mass media advertising. The effect of these actions is to place on investment companies, rather than on arbitrary rules and staff clearances, the decisionmaking authority for the fair presentation of investment company advertising.

Moreover, other rules are intended to eliminate the undue delays and costs which seem to inevitably infect a regulatory system over the years. For example, the proposed rule for post effective amendments of investment company registration statements would permit most to go effective automatically upon the fund and its counsel making certain representations. The time and expense savings of such an expedited process should be significant.

Notwithstanding these achievements, possibly the most important consequence of this rebalancing process is not explicitly memorialized by any single rule or any regulatory promulgation. Rather, it is a new attitude, shared by the Commission and by the staff, which recognizes the need for the innovation and creativity which, as I stated a few minutes ago, will be, over time, determinative of the industry's success -- that means, both in terms of serving the needs of public investors and entrepreneurial profitability. This does not imply that we are compromising on our responsibility to protect public investors. Rather, it evidences a view that our responsibilities are not always best satisfied by an inflexible adherence to a 40-year old regulatory model.

I do not wish, however, to leave you with the impression that the search for a new regulatory balance will be an effortless venture. To the contrary, as in any experimental or transitional endeavor, there is a certain learning process among all involved -- including on both the Commission's and the industry's parts -- which may require subsequently revisiting and rethinking actions taken in light of actual experience with this program. To the extent that these experiences are positive, the Commission may determine that this rethinking means removing further conditions and guidelines in deference to disinterested directors' decisionmaking.

B. Enhanced Role of Disinterested Directors

Indeed, the logic of this entire rebalancing process is dependent on an enhanced role for disinterested directors in overseeing investment company affairs. However, the necessary obverse of such enhanced private sector authority in decisionmaking is its acceptance of responsibility for the consequences of these decisions. And, in fact, over the last two years, the Commission has brought a number of enforcement actions against directors of public companies -- including both interested and disinterested directors of investment companies -- who failed to satisfy their obligations to their shareholders. While I appreciate that being an independent director to any publicly-held corporation is a difficult task, I am not sympathetic to the argument that to assist directors in resolving the burdens of their office, the Commission should relieve them of the obligations of their stewardship.

Nonetheless, I understand that even experienced directors of corporations other than investment companies may have second thoughts when faced with the responsibilities of compliance with the Investment Company Act, which is reputed to encompass arcane procedures and unspecified fiduciary obligations. However, many of these trepidations are less founded in reality than they are a reflection of the fact that disinterested directors -- while generally having a satisfactory comprehension of financial matters -- rarely come to the mutual funds industry with a comfortable understanding of the industry's regulatory system. And, there are few sources available to fill this void -- other than seemingly high-risk, on-the-job-training. Particularly as increased reliance is put on disinterested director decision-making by the Commission and the courts, a better system should be devised for providing both initial training and continuing education.

The Investment Company Institute can play a uniquely constructive role in this area. I personally would encourage the ICI to give serious thought to the support it can provide disinterested directors in meeting their already significant, but increasing responsibilities. This support could involve providing current literature -- particularly to the relatively inexperienced disinterested director -- as well as seminars and clearing houses to resolve developing issues and to disseminate new ideas. And, given the unique perspective of disinterested directors over investment company affairs, I would anticipate that, in an organized manner, they could provide a uniquely valuable service to the Commission by their input into our rulemaking and legislative processes.

Thus, while I am confident that disinterested directors are welcome to participate in the Institute incidental to their funds' membership, there would be benefits in their having a special status in the Institute commensurate with their special responsibilities in the industry. I believe there would be value in having, within the overall structure of the ICI, a suborganization -- such as a division or specialized committee -- administered solely with the particular concerns of disinterested directors in mind.

C. The Self-Regulatory Model

However, as important as disinterested directors are in allowing the Commission to remove itself from the day-to-day administration of mutual fund affairs, there exists a model for a system to provide even greater private sector discretion over the industry. That system would involve establishing the effective self-regulation of mutual funds, a process which would allow the Commission to generally limit its operations to an oversight mode. While I recognize that any such model possibly may necessitate enabling legislation, I think that it is not premature for the Commission and the industry to explore its feasibility.

As many of you know, I am a strong advocate of the self-regulatory process. First of all, I am convinced that a legitimate and mature industry -- such as the mutual funds industry -- can, and should be, committed to the success of a self-regulatory system. As valuable a service as they provide, mutual funds are successful only because the public perceives the industry as honest, credible and professional. But, any public perception that the industry -- or even a significant portion of the industry -- maintains a lesser standard of integrity could seriously harm the standing of the entire industry. Therefore, it is the mutual funds industry, itself, which has the greatest stake in maintaining its traditionally high standards of integrity.

Moreover, I would expect that a self-regulatory organization for mutual funds would be an appropriate forum for standard setting. In my experience, members of self-regulatory organizations enjoy a familiarity with their industry to a degree not always shared by governmental decisionmakers. In contrast to comments frequently received by governmental agencies -- including, at times, the Commission -- that a particular rule is fatally flawed by standards that have arisen through a misunderstanding of industry operations, self-regulatory organizations tend to be more precise standard setters. Rarely does an industry impose unreasonable burdens on itself.

Finally, there is another practical reason for my urging the industry's consideration of self-regulation. As I have testified before Congress, the Commission's inspection program cycle for examining investment companies and investment advisers is -- because of budgetary constraints -- woefully infrequent. This, of course, creates an increased risk that potential compliance concerns may grow into major problems. Such problems would not only raise the possibility of adverse consequences to particular public investors, but would threaten also to undermine the reputation of the entire industry.

To speak frankly, I do not expect the resources necessary to adequately administer the Commission's inspection program to be forthcoming in the near term. Mutual funds -- unlike banks -- do not pay for the privilege of being examined, and it would be unrealistic to anticipate increased Congressional funding of the Commission's inspection program in the foreseeable future. Therefore, as a practical matter, because of the mutual funds industry's own overriding interest in maintaining its standards, the industry should begin to take steps to establish its own effective inspection program through a self-regulatory medium. For, absent such high standards of integrity -- and a means to effectively determine and enforce compliance with these standards -- the mutual funds industry will not remain, in the public's mind, a viable alternative to other financial services.

Competition Among Financial Institutions

Needless to say, this reference to the industry's competition means, for all practical purposes, the banking industry -- which, in turn, focuses our attention on the Glass-Steagall Act. Governmental actions in this area may have a major impact in competitively restructuring the entire securities industry, including mutual funds, as well as the commercial banking industry.

There is a certain irony in this situation. The Glass-Steagall Act was not, in fact, intended to strike a competitive balance among these types of financial institutions. Indeed, Glass-Steagall was a somewhat punitive measure which divided a previously generally consolidated financial industry into two segments -- securities and commercial banking -- to prevent certain previous abuses from recurring. It is unlikely that, in taking this action, Congress consciously intended to balance the competitive interests of either segment against the other.

However, regardless of the original intent, over the last half-century two very complex financial systems have evolved -- and the viability of both the securities and commercial banking industries became independently critical to our national economic welfare. In recent years, the competitive interrelationship between these systems has become more pronounced as each offered services increasingly similar to those traditionally provided by the other. Thus, because these industries are subject to differing regulatory policies, it becomes increasingly necessary to distinguish whether the competitive posture of securities and commercial banking firms reflects performance in serving the public's needs, or whether it is more determined by the artificial advantages of one or the other regulatory system.

Yet, it is a rather challenging task for the government and the regulated to identify the inequalities that arise from differing regulatory policies and attempt to measure their current or prospective effects. Each analysis must make a judgment as to whether equal, though not necessarily identical, regulation can be applied across types of financial services firms without compromising such basic policy goals as the protection of investors and the maintenance of the integrity of our financial system. While these kinds of questions are exceedingly difficult to answer with much confidence, I am fairly sure that the frequency and urgency with which they are asked are unlikely to abate.

More and more, these questions raise issues which go beyond the comparatively narrow and familiar scope of a single industry and precipitate more expansive public policy debates. A recent example of this phenomenon -- and the Commission's analytical approach to the issues raised -- involved Congressional hearings on several proposed amendments to the Glass-Steagall Act. The proposals included one to permit commercial banks to underwrite most forms of municipal revenue bonds. Our involvement in that process was intended to point out the possible inequalities in the respective regulatory schemes for securities firms and commercial banks. But, in addition, we felt compelled to bring to Congress' attention the impact of bank participation in municipal revenue bond underwriting on the revenues of securities firms, and more particularly, those of the smaller broker-dealers who additionally provide services critical to the financing of smaller, private sector ventures. I believe our contribution was useful in assisting the Congress to appreciate that there may be many subtle ramifications in attempting to adjust complex financial systems.

This type of analysis illustrates that it is virtually impossible to understand the implications of specific issues without an appreciation for the overall relationship between banks, securities firms, and their respective regulatory and economic settings. In my judgment, both securities firms and commercial banks are too essential to the successful interplay of our financial and capital markets for any proposed changes in their relationship to be considered, other than in the context of a comprehensive, searching reappraisal of the Glass-Steagall Act and the other laws, regulations and policies which mark the boundaries between commercial banking and the securities industry. Any piece-by-piece approach, which considers merely the possibility of competition in specific services without due regard for the entities and the financial environment as a whole, risks the severe and irreversible consequences inherent in disturbing a complex system without understanding the consequences of our actions.

Nevertheless, within the constraints provided by such a conceptual framework, it is not philosophically unpalatable that the securities industry, including mutual funds, and the commercial banking industry each be subject to the fair competition of the other. In the final analysis, if mutual funds provide investors with superior and innovative services they will prosper -- even in the presence of such fair competition by other financial institutions. Or, alternatively, if the industry is not sensitive to investors' needs, it will not prosper -- even if insulated from such competition. It is this marketplace discipline that is the best and final regulator of the industry's success or failure.

Conclusion

In conclusion, my talk this afternoon has recognized the mutual funds industry's historical sensitivity and reactive posture to governmental policies. But, it is my thesis that the industry has a more affirmative role to play in insulating its fortunes from governmental activities. In large part, that means; first, providing a full range of innovative services so that, regardless of then-current economic conditions, the industry will offer products which are attractive to investors; and, second, taking responsibility for articulating, maintaining and enforcing its standards of integrity. In my judgment, it will be the industry's own initiatives in these areas -- or lack of them -- that, over time, will be determinative of its future.

Thank you.