



**Remarks Of**

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**INVESTMENT COMPANY INDUSTRY DEVELOPMENTS,  
TRENDS AND CHALLENGES**

**FBA/CCH Mutual Funds & Investment Management Conference  
Tucson, Arizona  
March 23, 1992**

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**\*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.**

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# **INVESTMENT COMPANY INDUSTRY DEVELOPMENTS, TRENDS AND CHALLENGES**

## **I. Introduction**

**I appreciate the opportunity to address this annual conference of the investment company and investment adviser industry, which I will collectively refer to as the investment company industry. It is my intention this morning to share with you some of my thoughts concerning recent developments and future trends in the industry. I also wish to mention some of the challenges for both the industry and the Commission that accompany these developments and trends, along with a few specific editorial comments.**

## **II. Recent Developments**

### **A. Industry Growth**

**Over the last decade, there has been tremendous growth not only in the size of the investment company industry, as measured by assets under management, but also in the number and type of funds available to investors. Total assets of investment companies, both open and closed-end, have increased from approximately \$246 million in 1981 to over \$1.4 trillion today. These figures represent an astounding increase of 470%. This figure**

**is especially impressive when you consider that the asset base of commercial banks grew only 95% during the same period.**

**Mutual fund assets alone rose over 450% during the last ten years to well over \$1.3 trillion at the end of 1991. As a result, mutual funds have become the nation's third largest type of financial intermediary in terms of assets. Only commercial banks and insurance companies have more assets than mutual funds. In terms of ownership of municipal bonds, however, mutual funds have now surpassed both commercial banks and insurance companies. Certainly so far as short-term munis are concerned, mutual funds are presently by far the largest purchasers.**

**Among the factors contributing to this growth of the industry is the relatively few barriers to entry for new investment companies. This is a point that the Commission should bear in mind when acting upon the recommendations deriving from the Investment Company Act study.**

**Obviously investment companies have rapidly become America's investment vehicle of choice. However, the growth and prosperity that your industry currently enjoys is of course inextricably linked to investor comfort and acceptance. For this success to continue, it is incumbent for everyone**

here to maintain an atmosphere that is conducive to a high degree of investor confidence. It is clear that investors now have that warm and fuzzy relationship with your industry to trust you with their money. In my opinion the level of prosperity that you will enjoy in the future will be directly proportional to the level of investor confidence in your services. When investor confidence begins to diminish, I assure you that bad times are sure to follow. Thus, you are partially responsible for pointing out bad apples and questionable practices that may be occurring in the industry. Certainly one of the industry's foremost challenges in the future will be to maintain investor confidence.

#### **B. Distribution of Assets**

It is interesting to note that, during this period of rapid industry growth, there has also been a marked change in the distribution of assets among the various types of mutual funds. In 1981, money market funds represented approximately 75% of all mutual fund assets. However, by the end of 1991, that figure had fallen to approximately 33%. In contrast, bond and income funds comprise a segment of the mutual fund industry which has grown rapidly during the past 10 years, from only 7% of all mutual fund

assets in 1981 to approximately 33% in 1991. The percentage of mutual fund assets invested in equity funds also grew during this period, although somewhat more slowly. They rose from approximately 16% of mutual fund assets in 1981 to 27% in 1991.

### **C. Proliferation of Investment Companies**

Not only have assets increased dramatically over the past ten years, but so have the number and type of investment choices offered by investment companies. In response to investor demands and a changing economic environment, new types of investment companies have proliferated. Between 1981 and 1991, the number of open-end investment companies increased by some 415%. By the end of 1991, there were some 3,431 mutual funds. During this same period, the number of closed-end investment companies soared from 38 to 290.

The investment company industry has proven to be innovative and efficient, constantly tinkering to fill investor needs. One of the challenges confronting the Commission is to continue a regulatory environment that provides investors with fundamental protections without stifling the entrepreneurial spirit that has been the hallmark of the investment company

industry's success. At least at the present, it is my opinion that the Commission is applying that optimal regulatory balance. The industry's success in the future will to some extent depend upon its ability to continue to satisfy investor demands. If handled appropriately, there should be no reason why the presence of an active Commission should unnecessarily hinder the industry's ability to shift its services in accordance with capital market changes.

#### **D. Investing in Foreign Securities**

Funds investing in foreign securities comprise one of the largest areas of mutual fund growth over the past ten years; and, with the increasing internationalization of the world's securities markets, this trend is certain to continue. In 1991 there were 284 funds investing primarily in foreign securities, as compared with only 14 at the end of 1981. As of the end of 1991, these funds had total assets of almost \$65 billion, up from only \$2.4 billion at the end of 1981.

As the appetite for United States purchases and sales of foreign securities continues to grow, it will be incumbent upon the Commission to reevaluate its position on concepts such as that advocated by the New York

**Stock Exchange to list foreign issuers. To become rigid and inflexible on ideas that may have merit but are originally premature could result in the erosion of the United States as the world's premier capital formation system, which would act only to the detriment of the investment company industry.**

**Also, on the international front, it has been communicated to me by many in the industry that there exist in some foreign jurisdictions, various barriers to access in that foreign jurisdiction for United States investment companies. Apparently differing legal standards, onerous regulatory requirements, and cultural market distribution impediments continue to make foreign registration and operation problematic, if not impossible, for many domestic investment companies. Another challenge for the Commission is to embark upon a course of action designed to encourage foreign regulators to provide meaningful market access to United States funds. An integral part of any such course of action should be to facilitate access to United States markets by foreign funds from those jurisdictions that facilitate access by United States funds to their market.**

### **III. Future Trends**

#### **A. Growth from Retirement Savings**

Looking ahead, the investment company industry is likely to benefit in the coming years from, among other things, increased retirement savings as baby boomers start planning for retirement. Mutual funds appear especially compatible with the long-term objectives of investing for retirement, and the industry has already seen its share of the rapidly growing individual retirement account ("IRA") market expand from 9.9% in 1981 to over 24% in 1990.

#### **B. Defined Contribution Plans**

In addition to the IRA market, mutual funds are apt to continue to profit from the growth of defined contribution plans, especially participant directed plans that provide multiple investment choices. Over the last several years, the growth in defined contribution plans has been approximately 50% higher than the growth in defined benefit plans. Some predict that defined contribution plans will account for at least 70% of the growth of pension assets over the next five years. Defined contribution plans are undeniably the wave of the future for corporate pension funds. In 1988,



fully 86% of all new pension plans were defined contribution plans. In particular, Section 401(k) plans have become enormously popular over the past decade.

Unlike more traditional defined benefit plans, where the employer generally handles the investments and bears the investment risk, the employee often makes the investment decision and bears the investment risk for defined contribution plans, including the 401(k) plan. Typically, companies offer their employees a broad array of investment options for their 401(k) plans, and these options generally include some type of mutual fund, most often an equity fund and/or a money market fund -- although a variety of bond funds are also offered in connection with 401(k) plans.

It appears to me that in the situation where the employee makes the investment decision and bears the investment risk (i.e., a participant directed defined contribution plan), the employee, like any other investor, should have adequate information about his or her investment options in order to be able to make an informed investment decision. However, it is my understanding that the disclosure regulations under ERISA focus only on disclosure about the plan itself. Thus, many plan participants who direct the investment of

**assets in their defined contribution plan accounts may not currently receive adequate information about the investments that underlie their plans.**

**I have grown increasingly concerned about this lack of information. It is my recommendation that individuals who direct the investment of their defined contribution plans be provided with the protection of our federal securities laws. For this reason, I believe that legislation is needed to amend Section 3(a)(2) of the Securities Act to remove the exception for collective trust funds and separate accounts in which participant-directed defined contribution plans invest. This legislation should grant the Commission rulemaking authority, where necessary, to enable it to require the delivery of funding vehicle prospectuses to plan participants that direct their investments. For many pension plan participants, choosing where to invest their retirement plan assets will be the most important decision that they will ever make. They should be furnished more complete information with respect to their investment options.**

### **C. Bank Proprietary Mutual Funds**

**Another trend worth watching in the coming years is the growth of bank proprietary mutual funds. While bank proprietary mutual funds**

currently represent less than 10% of all mutual fund assets, these funds have recently posted some respectable gains. In fact, it has been reported that bank funds amassed one-third of all new assets placed in mutual funds during the quarter which ended June 30, 1991. More bank funds will undoubtedly spring up, particularly if banks are ever allowed, as I believe they should be, to convert their common trust funds to registered investment companies on a tax-free basis.

#### **D. Derivative Instruments**

The financial markets also have been transformed over the last decade by a broad array of new financial products that include various types of swaps, options, forward contracts and other so-called derivative instruments.

The use of derivatives in the marketplace has exploded in recent years, although the exact size of the market is not known. The exchange-traded derivatives market is estimated to be five trillion dollars in underlying contract value. The smaller domestic OTC market, estimated to range between ten and fifty billion dollars, appears to be growing. The combined domestic-international OTC market is estimated to be between sixty and seventy-five billion dollars.

**Investment companies use derivative products, such as options on individual stocks or stock indexes, financial futures contracts and options on futures contracts, in a variety of ways to help counter the effects of market volatility. Portfolio managers may employ derivatives to, among other things, protect against market and currency losses, hedge the risk of a general decline in prices, enhance yields, rebalance assets without effecting transactions in the underlying assets, diversify a portfolio, and produce income by writing covered calls.**

**Some experts have suggested that the rise of derivatives could redefine the mutual fund industry by the end of the decade. They assert that it is both theoretically and technically possible to use derivatives to cheaply replicate the performance of existing funds by, for example, creating a blend of options and futures to mimic the equity holdings of an existing fund. They add that the cost of managing such a "synthetic" fund should be less than the cost of managing the real thing. Others are more skeptical about the potential impact of derivatives and synthetic funds and are bothered by the unforeseen off-balance-sheet risks presented.**

**Although many investment companies have the authority to engage in derivatives transactions, it is difficult to determine the extent to which they are actually using derivatives because certain of these instruments are not reflected on a company's balance sheet. Derivative instruments with contingent liabilities, such as interest rate swaps, may not ever be separately disclosed as an item on an investment company's balance sheet -- although additional disclosures in the company's financial statements may be required to reflect such instruments because of so-called "off-balance-sheet risk."<sup>1</sup>**

**Presently financial reporting requirements make it difficult to monitor investment company activity in the derivatives market and to evaluate the potential risks to investors from various derivative strategies.**

**Substantial leverage resulting from the use of derivatives can affect dramatically the volatility of an investment company's net asset value. The risks inherent in derivatives transactions vary greatly depending on the type of derivative, the type of investment company portfolio, and the cumulative effect of derivative transactions on a portfolio. What might be an appropriate derivative transaction in one investment company portfolio might**

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<sup>1</sup> **See FASB Statement No. 105.**

be inappropriate in another. For example, there has been some concern over the use of certain derivative instruments by money market funds, often in an attempt to get higher yields, particularly in the tax-exempt area. I challenge the industry to continue to monitor practices in this area.

**E. Tax-Exempt Money Market Funds**

Speaking of tax-exempt money market funds, I am disappointed that the investment company industry is not more active in the municipal securities market area in general. More pointedly, I am somewhat mystified by the Commission's seeming lack of interest in amendments to Rule 2a-7 for tax-exempt money market mutual funds.

It appears to me that one of the more pressing problems affecting municipal money market funds involves variable rate demand notes ("VRDNs"), which apparently make up the majority of securities held by such funds. For the vast majority of credit-enhanced issues, letter of credit ("LOC") providers can be substituted without notice to the bondholders. Although with VRDNs, the critical credit question centers on the creditworthiness of the current LOC provider, it is my understanding that portfolio managers frequently encounter uncooperative bond trustees and

issuers who are unresponsive because they do not consider themselves to be obligated to disclose the identity of the current LOC provider.

While LOC provider substitutions apparently do not occur frequently, it is possible that even one substitution of a high credit quality provider could cause a municipal money market fund to "break the buck." This result would not only economically adversely effect the fund's shareholders but would do irreparable harm to the credibility of money market funds in general. I again refer to that relationship which I alluded to earlier that exists between industry prosperity and investor confidence.

Money market mutual funds are a major force in the municipal bond market, and it appears that this trend will continue. If these funds were to refuse to purchase issues which do not provide adequate secondary market disclosure, it would not be long before issuers would be more eager to disclose essential credit information about VRDNs. I have in the past suggested as a part of any proposed amendments to Rule 2a-7 for tax-exempt money market funds, that the Commission should propose that such funds be prohibited from purchasing short-term securities of issuers that do not pledge to provide secondary market disclosure. To my dismay, the

**industry to date has not expressed its support for such a proposal. I challenge the industry today to consider supporting such a proposal. I also challenge the industry, given its increasing presence in the municipal securities market, to become more active as a general proposition in municipal securities public policy issues. Such activity would, in my judgment, inure to the benefit of the investment company industry.**

#### **F. Fees**

**The last trend that I wish to discuss is in the area of fees. I have to tell you that while the investment company industry is currently enjoying a great deal of growth and prosperity, I continue to hear nagging complaints from potential mutual fund investors about the bewildering, complex array of fee structures that they confront when attempting to choose from the multiplicity of funds available. To state that many potential investors appear confused and "loaded" down, whether hidden, from the front, on the side, or in the back, is an understatement. For example, why does "no load" really mean some "load." It would be my suggestion that the industry give some thought to developing fee structures that do not require a Ph.D. in finance to understand. Unfortunately, I am less than certain that modifications to**



**the fee table that must appear in the front of every mutual fund prospectus would satisfy all the complaints in this area. A simple, consistent fee schedule that would allow potential customers to easily and accurately compare costs and benefits, which in turn would allow market forces to work, should be of benefit to all the industry. I challenge the industry to work on that.**

#### **IV. Conclusion**

**In conclusion, it appears to me that the investment company industry has enjoyed a great year in 1991 and a great beginning in 1992. The securities markets will eventually experience a downside, although hopefully not like in 1987 or even in 1989. Further, interest rates will, sooner or later, rise to more traditional levels. Your ability to imbed in the investor community, confidence during these good times, will assist you in maintaining business when the investment atmosphere is not so positive. I look forward to working with you during my tenure on the Commission to ensure that the integrity and efficiency of the investment company industry remains on the rise.**