



Speech by SEC Chairman:  
**Mutual Fund Directors Education Council  
Conference**

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*Remarks by*

**Chairman Arthur Levitt**

*U.S. Securities & Exchange Commission*

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Two weeks ago marked the longest period of economic expansion in our nation's history. A new, heightened optimism is fueling an almost unbridled culture of entrepreneurship, innovation, and investing. And more and more Americans are investing in our stock markets.

In increasing numbers, investors are looking to mutual funds to diversify their portfolios and manage their risk. Today, nearly 77 million investors have put their hard earned dollars into mutual funds. Never before have the roles and responsibilities of mutual fund directors been more crucial to protecting so many Americans' financial security.

The Commission has dedicated itself to providing independent directors with a regulatory framework that gives them the power and the tools to fulfill their obligation to investors. But ultimately, good fund governance depends on how prepared individual directors are to discharge their duties.

I want to applaud the Mutual Fund Directors Education Council and David Ruder for your efforts and your commitment to preparing independent directors for their service to investors. By hosting conferences like today's and promoting other educational opportunities -- possibly even a fund directors' college -- you are taking a leading role in improving the quality of corporate governance.

It has been almost thirty years since significant improvements have been made to the fund governance regulatory framework. As we embark upon a new millennium, we must rethink and strengthen that framework to give independent directors the power and flexibility to confront the increasingly complex issues before them. More than ever, investors depend on your integrity and your commitment to the public interest.

## **A Partnership for Better Fund Governance**

Throughout this past year, the Commission and the mutual fund industry have worked hand in hand to give fund directors the tools and the authority to act as "independent watchdogs" for millions of shareholders.

One year ago, the SEC sponsored a comprehensive roundtable on the role of independent directors. At that time, I also asked our Investment Management Division, led by Paul Roye, to join the industry in devising proposals to increase the effectiveness of fund directors.

The mutual fund industry, through the ICI, responded to that challenge. They established "best practices" for fund directors. I know many of you in this room have already adopted and implemented these recommendations. Tonight, I want to acknowledge the industry's commitment to these practices and to strengthening the role of independent directors.

### **The Commission's Proposal**

The SEC has also responded to the imperative for stronger fund governance. Last October, the Commission proposed a corporate governance package that yields fund boards greater power to act independently and in the best interest of shareholders.

Under this plan, independent directors would represent a simple majority or two-thirds super-majority of fund boards. They would be self-nominated by other independent directors, and have legal counsel unaffiliated with the fund's adviser, underwriter or administrator. In addition, the proposal requires greater public disclosure about the fund's board -- including potential conflicts of interest.

We have received a number of constructive suggestions from fund directors regarding alternative ways to accomplish the goals of our fund governance package. I welcome these suggestions. Your input is an integral part of the rule-making process. The SEC is committed to working in partnership with you and the broader industry to forge the best possible framework for directors and the investors they protect.

In our efforts to bolster the effectiveness of independent directors, we are also looking for ways to reduce unnecessary burdens. Directors must always remain proactive and hands-on in certain areas, such as assuring best execution practices for their funds. But, it is not our goal to require that independent directors micro-manage funds.

In many instances, various functions and responsibilities can be delegated to fund advisors. Recently, we have taken actions related to fair value pricing, repurchase agreements and foreign custody arrangements which

allow for greater delegation and a reduced burden on fund directors.

### **Special Review of Fund Advertising**

Fund directors today must also pay more attention to the types of advertisements and commercials that are being used to market their funds. In far too many instances, these advertisements are offering quick returns or instant wealth -- but in reality, have performances that are not sustainable.

Today, it seems you can't open a newspaper or read a magazine without seeing ads promoting the stellar performance of "hot" mutual funds. And how many funds have we all seen claiming to be the "number one performing fund" -- some boasting returns of over 100 percent.

A few weeks ago, the Commission issued an investor alert about the folly of chasing only performance. This is only part of our broader effort to focus investors on the information they need to act in their best, long-term financial interests. Today, I would like to announce another initiative aimed at protecting investors from misleading or fraudulent information.

I have asked the Investment Management Division and our Office of Compliance Inspections and Examinations to conduct a special review of fund marketing -- including fund web-sites, sales literature and advertisements. This specialized group will determine whether a fund's *actual* portfolio performance and investment strategies are consistent with its web-site statements, its advertisements, and its disclosure in prospectuses. We want to be sure that funds today are telling the whole story in their marketing efforts to attract new customers.

In addition, we will be reviewing the current rules governing fund advertising to promote, more generally, balance and responsibility. We realize that some advertisements, when viewed through this lens, will no doubt lurk in the grey area beyond the bright line of right and wrong. We will be working closely with the NASD to assist us in bringing clarity to what's meaningful and appropriate to tell investors.

We will also be asking fund directors to review critically their own funds' advertisements and to challenge "accurate" but perhaps overly aggressive ads. It is neither in funds' nor shareholders' interests for fund advertisements to encourage unreasonable expectations and unwise investment decisions. And there is no better place for directors to keep a watchful eye on fund advertisements than their own backyards.

### **Remembering the Fundamentals**

In the war against confusion and legal jargon, we've also adopted amendments to Form N-1A that bring to light the most useful information to investors as they compare funds. In this vein, the Commission will

propose that funds show the effects of taxes on performance.

Let's look at the tax implications of investing in mutual funds. Estimates show that over two and a half percentage points of a fund's total return is lost each year to taxes. What's more, shareholders of diversified U.S. stock funds surrendered on average *15 percent* of their annual gains to taxes.

In 1997, shareholders of stock and bond funds paid an estimated \$34 billion in taxes on distributions by their funds. And the next year, mutual funds distributed approximately \$166 billion in capital gains and \$134 billion in taxable dividends.

The truth is, many investors lack a clear understanding of the impact taxes have on their mutual fund returns. To this point, you can expect to see a proposal soon that will assist investors in understanding the impact of taxes on their funds' returns. But there are a number of other fundamentals as well that, all too often, are being lost on investors.

All of us need to work harder to communicate to investors the things they should be thinking about before investing in mutual funds. Investors need to ask themselves: What is my time frame for investing? What happens to my overall portfolio if a certain investment doesn't do well? What is my tolerance for risk? And, just as importantly, investors need to think about what a fund's performance really means.

Maybe a fund invested early in a few successful IPOs giving the fund unusually high returns. If it's a small fund, this would boost the overall performance even more as each stock accounts for a larger part of the total fund. Or maybe a fund had an extraordinary year or two, but over the longer term, has not done as well as recent returns suggest.

Investors need to scrutinize a fund's fees and expenses. Over time, expenses and fees can really make a difference. On an investment held for 20 years, a 1 percent annual fee will reduce the ending account balance by 18 percent.

Fund directors must encourage their fund groups to join us in educating investors regarding fundamental investment principles and in managing investors' expectations. Investors must remain focused on the financial facts that form the bedrock of a sound, long-term investment strategy.

## Conclusion

The developments I've touched upon today are just a few of the many increasingly complex issues created by the accelerating evolution of markets and fund practices. No matter what challenges the markets, funds and shareholders face, they need the assistance of vigilant, well-informed and dedicated directors to meet those challenges.

It is all of our responsibility to be continually thinking of new ways to promote even more effective fund governance. We hope and expect fund directors will work with the Commission in a combined effort to improve fund governance, the quality of mutual fund disclosure, and to help investors make better-informed decisions for their families, for themselves, and for a more financially stable future.

Thank you very much.

#### **Additional Materials Available on This Topic**

- [Fact sheet on Special Review of Fund Advertising](#)