MEMO# 5897

May 20, 1994

CHAIRMAN LEVITT'S REMARKS AT INSTITUTE'S GENERAL MEMBERSHIP MEETING

May 20, 1994 TO: BOARD OF GOVERNORS NO. 43-94 SEC RULES MEMBERS NO. 36-94 RE: CHAIRMAN LEVITT'S REMARKS AT INSTITUTE'S GENERAL MEMBERSHIP MEETING ____ SEC Chairman Arthur Levitt delivered a keynote speech this week at the Institute's General Membership Meeting. Chairman Levitt first addressed the issue of personal trading by portfolio managers and then discussed four issues that he believes deserve "increased vigilance" by the SEC and the industry: fund investment in derivative products; investor communications; portfolio liquidity; and compliance systems. His remarks, a copy of which is attached, are summarized below. Personal Investing Chairman Levitt stated that the SEC was pleased with the recommendations of the Institute's Advisory Group on Personal Investing and specifically remarked that "[t]hey go a long way toward responding to our concerns." He cautioned that in order to maintain investors' confidence and trust in the mutual fund industry it is necessary to take appropriate steps to avoid even the appearance of a conflict. In this regard, he noted that the Advisory Group's Report should provide fund managers with the appropriate guidance. Chairman Levitt stated that the results of the SEC's survey of portfolio managers' trading activities should be available in a few weeks. Derivatives In view of the proliferation of derivative financial instruments and their lack of a clear track record in times of market stress, Chairman Levitt stated that they are an important subject of inquiry. He noted that the recent uncertainty about interest rates has heightened the concerns about the use of derivatives by funds. Specifically, Chairman Levitt stated that funds should "satisfy themselves that portfolio managers have the expertise to handle them -- that their uses are in keeping with the fund's policies -- that appropriate limits are set and observed -- and that managers are not blinded to their risks." In addition, pricing issues, trading strategies, accounting questions, and internal controls need to be examined closely. Chairman Levitt warned that the use of derivatives by money market funds merits special attention. In this regard, funds should look closely at those financially engineered instruments that may be able to achieve their intended results only in a stable interest rate environment. He noted that the Commission staff has been questioning the appropriateness of these instruments for money market funds during the past two and a half years. Finally, he expressed concern about the adequacy of the disclosure relating to derivatives in mutual fund prospectuses. He recommended that funds go a step beyond meeting the technical requirements and "ask if the prospectus scrupulously describes investment risk, and in an understandable way." Investor Communications Chairman Levitt stressed the need to ensure that all communications with investors and potential investors meet consumer needs. He also stated that he has asked the SEC's new Consumer Affairs Advisory Committee to consider the summary prospectus proposal. Liquidity Briefly discussing the issue of liquidity, Chairman Levitt identified some questions that funds need to consider in making a liquidity determination and stressed that "a fund needs to satisfy not only today's liquidity requirements, but has to be prepared to meet redemptions under a variety of market conditions." Compliance Systems Chairman Levitt described several compliance initiatives that the SEC is considering, such as increasing the amount of information required to be reported to the SEC about fund portfolios and requiring that each fund designate an individual to be responsible for overseeing the fund's compliance activities. He stated, however, that "in the final analysis, compliance is the princial responsibility not of the Commission, but of each investment company." Matthew P. Fink President Attachment

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