STATEMENT OF THE HONORABLE JOHN R. EVANS, COMMISSIONER OF THE SECURITIES AND EXCHANGE COMMISSION, BEFORE THE HOUSE OF REPRESENTATIVES SUBCOMMITTEE ON DOMESTIC MONETARY POLICY OF THE HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS, CONCERNING THE REGULATION OF MONEY MARKET FUNDS, APRIL 8, 1981.

Mr. Chairman and members of the Subcommittee:

I am pleased to represent the Securities and Exchange Commission before you today in response to your request that we give our views on proposed legislation which would require additional regulation of money market mutual funds. I am accompanied by Joel H. Goldberg, Director of our Division of Investment Management. We appreciate this opportunity to express our views and hope that our comments will be helpful to the Subcommittee. In addition, we will be providing the Subcommittee a report prepared by the staff of the Commission, which contains a comprehensive review of the federal regulation of money market funds.

I want the members of this Subcommittee to know that we are not here today to testify on behalf of the interests of institutions which we regulate or to suggest that they be protected from competition with other financial intermediaries. On the other hand, we are very concerned with the proposition that legislation be enacted which would require the Federal Reserve Board to impose reserve requirements on certain mutual funds, require the establishment of a maximum rate of return on an equity security, prohibit money market funds from offering their shares on terms that some investors may find more desirable than are offered by depository institutions, require a special liquidity account, and require dual regulation and examination of institutions which are already subject to a

pervasive regulatory framework. The Commission is very sensitive to the general criticism that the innovativeness and productivity of private institutions are being stifled by unnecessary government regulation, and we are attempting prudently to reduce regulation of those under our jurisdiction. We believe that a clear public interest must be served by burdens imposed on those whom we regulate, that the type of burden imposed should have a logical economic or investor protection basis, and that those who wish to save and invest their money should not be discouraged from doing so by regulatory burdens which do not provide them with offsetting benefits.

We are very much aware that many depository institutions are having difficulty attracting savings during a period when money market funds are experiencing dramatic growth. As you know, however, there were similar periods before the development of money market mutual funds whenever greater returns on savings were available elsewhere. Of course, other types of institutions are subject to the same market forces. For example, mutual funds investing in equity securities experienced not only reductions in net inflows but continual net outflows as redemptions exceeded sales for eight straight years from 1971 through 1979 because investors considering prospective risks and rewards no doubt anticipated that other investment opportunities, including those offered by banks and savings and loan institutions, were more attractive than such mutual funds.

We can understand why depository institutions would like their competitors to be restricted. We believe, however, that the consideration of legislation to impose bank-type regulatory burdens and limitations on money market funds should include an evaluation of the existing regulation of money market funds, the present protection provided to investors, and the negative impact that proposals would have on the millions of people who invest in money market funds. We recognize, of course, that once the facts are presented the policy decision of weighing the negative impact on small investors against the possible benefits to depository institutions and those whom they serve is for Congress and beyond the Commission's areas of responsibility.

Although a large part of the success of money market funds is undoubtedly due to the fact that they are a product responsive to the times and the demands of investors, we believe also that a part of that success is due to the sound and effective regulatory environment for investment companies which we administer and the public confidence which that regulatory environment helps make possible. In evaluating the adequacy of this regulation, one must bear in mind the nature of money market funds and the legal and factual distinctions between such funds and other investments.

A money market fund is an investment company. An investment company generally is an issuer that invests, reinvests and trades in securities. Most investment companies, including all money market funds, are of the type known as

mutual funds; or more precisely, open-end, diversified, management investment companies. They normally offer shares continuously to the public, and are required to redeem, on request, each shareholder's securities for his pro rata share of the fund's net asset value. Investors are attracted to investment companies in general to obtain professional investment management of their assets, liquidity of their investments, and diversification of investment risk. A money market fund concentrates its investment in so-called money market instruments, typically short-term debt obligations issued by banks, other corporations, and governmental entities.

A significant feature of money market funds is that they offer smaller investors the opportunity previously enjoyed only by wealthy investors and institutional investors to obtain convenient and efficient access to the large denomination instruments of the money market and their current high yields. In addition to offering the benefits which are characteristic of other investment companies and higher yields than might be available elsewhere, money market funds provide daily dividends and expedited methods of purchasing and redeeming fund shares through such features as telephone redemptions and "check-writing" privileges. While these money market fund services might appear to be similar to services which have traditionally been offered by depository institutions, there are critical legal and practical distinctions which must be emphasized. Money market funds and bank deposits are not interchangeable products.

A money market fund share is an equity instrument. It is common stock upon which dividends are declared and capital gains are distributed only to the extent of the investment company's net income or net capital gains. The value of an investor's interest in such a fund can fluctuate as the value of the fund's portfolio of investments rises or falls. A bank deposit is a debt instrument. It represents a liability of the bank and provides a fixed rate of return in the form of interest. The monetary value of deposits in bank accounts does not fluctuate, and, generally, these accounts are insured up to specified amounts. The Commission views these distinctions as being so important that we would consider appropriate enforcement action against any investment company or individual selling money market fund shares through improper representations that the legal relationship and safety obtainable from owning a share of a money market fund is equivalent to the legal relationship and safety obtainable from the deposit of money in a bank.

Nonetheless, the apparent similarities between the services offered by money market funds and depository institutions have led some to suggest that investors in money market funds might be better protected if those funds were subjected to bank-type regulation. The Commission does not share this view. We believe that the existing framework of regulation applicable to money market funds provides appropriate investor protection, and that imposing additional, bank-type regulation on those funds would harm the interests of investors without corresponding benefits to them.

The federal securities laws impose, as described by the Supreme Court, a pervasive regulatory framework on the operations of all investment companies, including money market funds. Specifically, the Securities Act of 1933 governs the manner in which a money market fund, like any company offering its shares for sale to the public, may offer its shares to investors. That Act requires full and fair disclosure to investors in the form of prospectuses, which must precede, or be delivered to investors with, the confirmations of their purchases. It imposes liability upon those who fail to fulfill these requirements and upon those who make materially false or misleading representations in connection with an offering of securities. Pursuant to the Securities Act, the Commission requires that money market funds in their prospectuses set forth a listing of their portfolio securities as of the date of the prospectus' financial statements. The Securities Act also effectively restricts the content and nature of investment company advertising. In addition to the Securities Act, which applies generally to companies selling securities to the public, investment companies--including money market funds--are subject to the highly detailed regulatory requirements imposed by the Investment Company Act of 1940 and the rules adopted thereunder. The Investment Company Act governs virtually every aspect of the corporate structure, operations, and activities of investment companies. For example:

--Investment policies must be established, disclosed and followed; generally, any substantial change must be approved by shareholders.

--Shareholder approval of directors, auditors and investment advisory contracts is required.

--Independent directors must be elected to serve as "watch dogs" to protect shareholder interests.

--Transactions involving persons affiliated with the investment company or its investment adviser are generally prohibited, absent prior Commission authorization or compliance with conditions of exemptive rules.

--Pyramiding of capital structure and speculative investment practices are prohibited or closely restricted.

--Pricing and valuation rules govern the manner in which investment company shares are sold and redeemed.

--Fund assets are subject to strict custodial requirements, and specified amounts of fidelity insurance must be maintained.

--Periodic reports must be sent to shareholders and filed with the Commission.

--Specified books and records must be maintained.

--Various fiduciary duties, including a duty with respect to advisory fees, are imposed on companies and persons managing investment companies.

In response to the emergence of money market funds and their mode of operation, the Commission has addressed various areas of particular regulatory concern. It issued an interpretive release discussing the appropriate methods to be utilized in computing the value of money market fund assets and the prices of money market fund shares. Extensive hearings were conducted before an Administrative Law Judge, and carefully prescribed conditions were imposed by the Commission before money market funds were permitted to continue certain valuation and pricing methods designed to achieve stable net asset values per share.

The Commission issued another release to address and control certain speculative trading practices involving financial futures which the Commission believed might violate provisions of the Investment Company Act. In addition, the Commission has amended its rule governing the time for the pricing of investment company shares for sale and redemption to include special provisions to permit money market fund shares to be priced at times during the day more appropriate for the operation of those companies and to require that shares be priced on days when the money markets are open, whether or not the securities industry generally is open for business.

In the area of money market fund advertising, the Securities Act and Commission rules have long imposed severe restrictions on investment companies wishing to advertise the sale of shares because Congress, in passing the Securities Act of 1933, intended that investors should have the benefit of the disclosure in a statutory prospectus when making securities investment decisions. Although the Commission has adopted rules to permit mutual funds, including money market funds, to convey a wider variety of information to investors in recent years, it has provided special protection for persons interested in money market funds by requiring the funds to calculate their yields using a standardized method. This makes it easier for investors adequately to compare funds.

In addition to these measures, the staff of the Commission has intensified its oversight of money market funds

through increased inspections of such funds. As a supplement to the routine and for-cause inspections normally peformed, the staff also has conducted special limited inspections of each money market fund to assure itself that no significant regulatory problems exist within the industry. Such inspections were performed during the Fall of 1979, and another series of industry-wide inspections was performed just last month. As a result of the earlier inspection the staff found only isolated problems, which were promptly corrected. And, while the staff has not finished compiling all the information obtained from its most recent set of inspections, its preliminary determination is that no significant regulatory problems exist in the money market fund industry.

In view of the thorough oversight which the Commission and its staff has exercised over the money market fund industry, including the recently completed industry-wide inspections, we are confident that the existing investment company regulatory framework is successfully protecting investors in money market funds. It has been suggested, however, that for the purpose of increasing liquidity and safety for investors, it may be appropriate to impose additional regulatory requirements on money market funds which offer a "check-writing" feature or other forms of expedited redemption procedure. For example, H.R 2591 would require money market funds with "transaction accounts" to maintain a "liquidity account" and would subject those funds to semi-annual examination by Federal Reserve Board examiners. The Commission does not believe that such provisions are necessary or appropriate to protect investors.

To begin with, money market funds with "transaction accounts," which encompass features such as the funds' "check-writing" privileges, are not essentially different from traditional mutual funds. The "check-writing" privilege is merely an alternative method of effective fund redemptions. Unless special provisions are made, redeeming one's investment in a mutual fund can be a cumbersome procedure. Without expedited means of redemption, most funds require that investors provide certain written documents, including a signature guaranteed by an investment banker or a commercial bank. After these materials are received by the fund, a redemption check is mailed to the shareholder. The shareholder may then experience additional delays in the use of his money until the redemption check is processed.

Most money market funds have sought to avoid delays to shareholders in receiving redemption proceeds, as well as in receiving credit for their investments, by establishing expedited means of effecting redemptions and investments. Most money market funds provide that shareholders may receive payment for redeemed shares and credit for money invested on the same day by wiring federal funds through the banking system. In order to effect transactions through wired federal funds the shareholder must have a previously established account at a commercial bank. As an additional means of expediting redemptions, many money market funds also provide "check-writing" privileges. To effect this type of redemption, the shareholder may write a draft payable to a third party against

a checking account which the money market fund has established with a commercial bank. It bears emphasis that the account is not the shareholder's; it is the money market fund's. When the draft is presented for payment, the bank, acting as agent for the redeeming shareholder, effects the redemption of a sufficient number of the shareholder's shares to generate the money necessary to honor the draft, depositing such money in the money market fund's account with the bank to cover the draft. Thus far, the Commission has found no evidence, either through its inspections or otherwise, of shareholders having any significant problems with the "check-writing" privilege. On the other hand, in addition to convenience, this redemption method allows the investor to earn interest on his investment in the money market fund until his money is actually available for his use. Therefore, the "check-writing" privilege appears to be a benefit without any counterbalancing disadvantages.

We turn now to the suggestion that liquidity problems might require funds to maintain a liquidity account. We do not believe that any such accounts are necessary or desirable. This is because money market funds, by virtue of the types of investments in which they invest, are highly liquid. By definition their portfolios are composed of short-term debt instruments which generally are readily marketable. Moreover, money market funds typically "stagger" their portfolio investments so that on any given day a certain number of instruments mature, thus providing the fund with cash to help meet redemptions if necessary.

While required by the Investment Company Act to redeem shares within seven days after receipt of tender, most money market funds have undertaken to provide same day redemption proceeds and thus, are obligated to maintain sufficient liquidity to meet that undertaking. Although the Commission has never believed it necessary to require that money market funds maintain a certain percentage of their assets as cash or cash equivalents, it has given guidance on the purchase of restricted securities through a series of interpretive releases, and has prohibited money market funds utilizing the amortized cost method of valuing their assets from purchasing illiquid securities. Moreover, the Commission would consider appropriate enforcement action against any money market fund which did not maintain sufficient liquidity to meet its obligations. Because of the Commission's vigorous adherence to these principles, money market fund liquidity has never been a significant problem.

Under H.R 2591, money market funds with transaction accounts would be required to maintain specified amounts in liquidity accounts. In our view, liquidity account requirements are not only unnecessary but actually would be harmful to investors. Although H.R. 2591 does not define what a liquidity account would be, since money market funds are already highly liquid because their portfolios consist of short-term, readily marketable debt instruments, I assume that this liquidity account would consist of uninvested cash. Such a requirement would reduce the amount of assets available for investment

and thus would have the effect of reducing the yield to investors. In the Commission's view, this reduction in yield would not be justified by any corresponding increase in liquidity. In addition, the Commission believes that this liquidity account requirement might have an unintended anti-competitive effect within the money market fund industry. Because the requirement prescribes a minimum amount of $2.5 million to be set aside, regardless of the size of the fund (except for lesser amounts permitted by the Board of Governors of the Federal Reserve System to allow a money market fund to effect redemption of its shares or meet other obligations), it would have a greater negative impact on smaller money market funds thus increasing the advantages of larger funds. This requirement would also create a barrier to entry of new money market funds into the market place, causing a potential reduction in the number and variety of funds available to the investing public.

Under the provisions of H.R. 2591, certain money market funds would be subject to, and required to finance, examinations by Federal Reserve Board examiners. In light of the Commission's inspection presence which I discussed earlier, it is unclear what function the Federal Reserve Board examiners would perform. It appears that they would monitor compliance with the requirements of this bill, but if the proposed examinations are designed to enhance investor protection, assigning such a task to Federal Reserve Board examiners would be inefficient and would result in unnecessary

duplicative regulation. Persons performing investment company inspections must possess a thorough understanding of the securities laws and practices of the securities industry. The Commission staff deals with these matters on a daily basis. In view of this fact, and in view of the fact that our staff has been equal to the task of providing adequate inspections of money market funds, I do not believe that any benefits to be gained by having Federal Reserve Board examiners examine the funds would justify the costs which the funds, and thus their shareholders, would have to bear in order to finance such examinations.

Despite our belief that the current regulatory scheme provides appropriate protection for investors, the Commission is aware that there is some concern that the operations of money market funds raise other public policy considerations respecting the operation of the banking system and the administration of monetary policy.

The provisions in H.R. 2591 require the Federal Reserve Board to impose reserve requirements on the assets of money market mutual funds in such amounts and under such terms as the Board imposes on transaction accounts in depository institutions. Such requirements would have a different effect on money market funds than they do on depository institutions. Reserve requirements placed on banks have no direct effect on the return paid to bank depositors in that the rate of return is guaranteed. The money market fund shareholder, on the other hand, receives a

proportionate share of the return on his investment after expenses. If reserve requirements are imposed, less money is available for investment which results in a lower yield to the investor. Therefore, unless a reserve requirement would provide increased safety to the investor, he is not benefited by such a restriction. Because the investor is entitled only to a proportionate share of the total assets of the fund, not to any specific amount, and because a money market fund normally confines itself to relatively low-risk investments, it is difficult to determine how a reserve requirement would provide the investor with increased safety.

Moreover, it is well known that reserves required by the Federal Reserve Board are not intended as a source of liquidity or safety and cannot be used for the purpose of meeting unexpected cash withdrawals without violating the legal reserve ratio. Instead, legal reserves facilitate the clearing of checks written against demand deposits and are a means by which the Federal Reserve Board can influence the lending ability of depository institutions and thus the money supply. For monetary measurement and control purposes, the Federal Reserve Board does not categorize money market fund shares along with currency or commercial bank demand deposits or with negotiable order of withdrawal accounts at banks or thrift institutions, draft accounts at credit unions, or demand deposits at mutual savings banks. Instead, money market mutual fund shares are categorized along with small denomination time deposits in depository institutions.

Mutual fund industry figures, which indicate that the turnover rate of money market fund accounts is about 2.9 annually or approximately the same as time deposit accounts and much lower than demand deposit accounts in commercial banks, give support to this differentiation.

If proposed reserves on money market funds are not needed for investor protection and would not serve the normal purposes for which the Federal Reserve Board sets required reserves for depository institutions, it would appear that the questions remaining for Congress are: (1) would the imposition of such reserves enhance the relative attractiveness of depository accounts sufficiently to bring about a significant increase in the flow of money into depository accounts, and; (2) if that is so, would the benefits of that result outweigh the detriment of precluding investors from receiving the benefits presently available from money market funds.

In this connection, implementation last year of Executive Order 12201 by the Board of Governors of the Federal Reserve System, provides some guidance on the effect of reserve requirements. Beginning in March of 1980, money market funds were required, in general, to maintain varying proportions of their assets--something under 15 percent--in special non-interest bearing accounts with Federal Reserve Banks. The amount of the required reserve was later reduced and eliminated altogether by the end of July 1980. Whatever the effect, if any, that these actions by the Federal Reserve Board might have had on inflationary pressures or the nation's

money supply, under the prevailing circumstances, the temporary reserve requirement, which resulted in a reduction in yield of perhaps 1 percent, does not appear to have been great enough to slow sales of money market funds to any significant extent.

The fact that a money market fund share is an equity, rather than a debt, instrument also causes serious questions with respect to the proposed section requiring the Deregulation Committee to establish a maximum rate of return payable on funds invested in money market mutual funds. Essentially, the dividends paid to a money market fund investor represent the money earned by the company from its investments reduced by the company's expenses. If the amount of dividends payable were artifically restricted to less than such earnings, the "excess" money could not be retained by the owners of the fund, as is the case with the owners or stock holders of the equity securities of a bank or any other company, because the shareholders whose return would be restricted are themselves the owners of the fund.

From an economic and legal standpoint, we find it difficult to imagine how the rate of return might be restricted. The company might consider finding some way either to increase its expenses, or to reduce its earnings from investments, or both. For a money market fund to increase its expenses artificially--by, for example, raising the adviser's fee to unnecessarily high levels--would not only be unjustifiable as an economic matter, but also a breach of the fiduciary duties

imposed upon investment advisers and directors of investment companies under the Investment Company Act. As a practical matter, then, compliance with regulations limiting the return payable to investors would probably necessitate a money market fund's artificially reducing its earnings by keeping some portion of its assets uninvested. Thus, a ceiling on dividends would amount to little more than a reserve or "liquidity account" requirement under a different name, and I have already indicated the Commission's view that such requirements would hurt, not help, investors in money market funds.

In considering whether it would be in the public interest to disadvantage investors by restricting the maximum rate of return payable by money market funds, no doubt Congress would like to assure itself that the depository institutions which some believe may be disadvantaged by money market fund competition would receive the benefits. We do not have evidence that such would be the case. Industry figures, which we have no reason to question, indicate that an overwhelming percentage of total money market fund assets is in accounts over $10,000 and thus would be able to obtain money market rates elsewhere. That is to say, one cannot reasonably assume that a major portion of money market fund assets is being diverted from passbook savings accounts.

The Commission also has difficulty with the proposed requirement that money market funds disclose the location of the issuers of their portfolio securities, as set forth in

H.R. 2591. Pursuant to the Securities Act, money market funds currently are required to include in their prospectuses a list of their portfolio securities. This portfolio composition disclosure includes the name of the issuer of each instrument in the securities portfolio except for an amount not exceeding 5 percent of a fund's assets which may be listed in one amount as "miscellaneous securities." From this information, investors can, for most of the portfolio, determine where the issuers are located.

In the past, the Commission has proposed that information concerning portfolio composition of money market funds be updated on a quarterly basis. However, in response to negative public comments, the Commission determined to forego requiring such disclosure, in part because of the added cost that would be involved and in part because the commentators did not indicate that additional disclosure as to portfolio composition would be helpful to investors. Moreover, the Commission staff is presently engaged in a comprehensive review of investment company prospectus requirements with a view toward making prospectuses more useful for investors while at the same time less costly for issuers. The staff's preliminary view is that investment company prospectuses could be improved, not necessarily by increasing the number of required items, but rather by decreasing them in certain respects, thus making prospectuses shorter and more readable.

I anticipate that the Commission will, within the next year, publish for public comment a proposal to revise

investment company prospectuses. If the Commission receives indications, in the public comments on such a proposal or elsewhere, that investors are interested in the geographical locations of issuers of the instruments in money market fund portfolios, the Commission will of course consider requiring such information. However, in view of the fact that there has been no indication in the past that investors are concerned about the location of issuers, coupled with the staff's belief that investment company prospectuses may already be too long and complicated to be of maximum usefulness to investors, the Commission believes that this provision of H.R 2591 would not be beneficial to investors in money market funds.

One further point that I would like to make regarding H.R. 2591 goes to the scope of the bill. Although the bill is apparently intended to affect only money market funds, due to its definition of a money market fund, it may have a far broader impact. While the Commission considers money market funds to include those investment companies which have an investment policy calling for investment of at least 80 percent of their assets in debt securities maturing in 13 months or less, under the provisions of H.R. 2591 any investment company which has a transaction account, regardless of its investment policies or existing portfolio, would be subject to the provisions of the bill. Thus, the requirements of the bill could apply to a number of traditional mutual funds other than money market funds.

In conclusion, this testimony and the Commission staff report evidence our assessment that the federal securities laws, as we administer them, fulfill the vital Congressional objective of protecting investors in money market mutual funds without imposing undue costs and burdens. The facts indicate that many investors have purchased shares in money market funds to receive investment benefits which otherwise would be unavailable to them. It is the Commission's view that the imposition of additional requirements upon these funds is not necessary for purposes of investor protection and could set barriers to certain investors' participation in the money markets and deprive smaller investors of investment benefits larger investors could still obtain.

Moreover, the information available to us suggests th the restrictive requirements being considered may not contribute significantly to the resolution of the problems banks and thrift institutions are having attracting needed savings. Any adverse effects on banks and savings and loan institutions attributable to the growth of money market funds are part of a much broader problem--high rates of inflation and accompanying high interest rates, coupled with legal restrictions on returns that can be paid by depository institutions. In recent years these factors have lessened the relative attractiveness of deposits in banks and thrift institutions. Any legislative solution to such adverse effects that is narrowly focused on imposing restrictions on money market funds is unlikely to be effective.

We recognize, however, that there are diverse and possibly competing social objectives which Congress must weigh in establishing public policy. We stand ready to provide the Subcommittee with any assistance which it believes useful in undertaking that task.

I thank you for this opportunity to present our views. Mr. Goldberg and I would be pleased to respond to any questions which the members of the Subcommittee may have.