

DRAFT

MEMORANDUM

January 26, 1993

To: Consuela Washington
From: Marianne Smythe
Subject: Investment Company Inspections

You have asked to discuss with us the Commission's program for examining investment companies. As the recent Business Week article suggested, the current investment company examination program is no longer adequate. Unlike the situation with investment advisers, however, our problem cannot be resolved simply by increasing investment company fees and hiring more examiners. As we discuss below, what the investment company examination program needs is access to more information about the day-to-day portfolio activities of investment companies, as well as highly trained personnel and more sophisticated means of evaluating increasingly complex portfolio strategies.

1. Data Access

The Commission needs to develop a data transmission system through which investment companies would periodically transmit to the Commission information about their portfolios. Such a system would permit the staff to screen and analyze the information provided to detect potential problems at an earlier stage. Moreover, use of computerized analysis to check for "red flags," similar to the way the IRS reviews tax returns, would help us better focus inspection resources.

The development of such a system would require an investment in computer hardware and software and either authority to contract for technical support or to hire additional Commission technical staff.

2. Improved Examination Force

Investment companies are investing in more and more complex instruments and engaging in increasingly complex portfolio strategies. To respond to this development, the Commission must hire, train, and retain a highly skilled examination force. Under existing personnel restrictions this is becoming increasingly difficult.

Currently, most examiners are hired straight out of college at the GS-7 level (\$22,000 per year) and given "on-the-job" training. Their "career ladders" are generally too low to allow paying salaries even remotely competitive with the financial engineers the private sector hires to design these new instruments. We need authority to thoroughly revamp the descriptions and pay scales for at least a portion of the investment management examination force so that we can hire the best qualified individuals at higher grade levels.

3. Training

A modest increase in training budgets would permit development of a more highly skilled examination force. The principal cost involved is transportation and housing of personnel stationed in the regions. Ultimately, development of an interactive communications network should be explored. This would permit training programs to be broadcast from Washington. Costs incurred in developing such a program would be offset, at least partially, by the reduction in travel.

4. Modest Increase in Number of Examiners

Currently, the Commission has approximately 125 examination personnel (including approximately 20 supervisors) committed to the investment company inspection program. A modest increase of 20 examiners would improve our coverage of the industry.