TESTIMONY OF

ARTHUR LEVITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING THE INVESTMENT COMPANY INDUSTRY

BEFORE THE SUCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

NOVEMBER 10, 1993

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

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Chairman Dodd and Members of the Subcommittee:

On behalf of the Securities and Exchange Commission, I am pleased to appear before this Subcommittee to present the Commission's perspective on the investment company industry, an industry of increasingly critical importance to this nation's economy.

For more than fifty years, this industry has been governed by the provisions of the Investment Company Act of 1940. When Congress enacted this law, it recognized that a regulatory scheme more extensive than the disclosure requirements of the existing federal securities laws was needed to govern companies that are large pools of liquid assets. Because of the great potential for abuse where individuals have easy access to liquid assets, among other things, the Act requires the safekeeping and proper valuation of fund assets, restricts transactions with affiliates, limits leveraging, mandates equitable treatment of shareholders and gives investors a voice in the management of the company. The investment company industry has remained remarkably responsible and responsive to the needs of its investors, in large part due to this regulatory framework.

The Investment Company Act has stood the test of time because it has been flexible enough to accommodate the tremendous growth and change in the investment company industry, particularly in the last several years. Through the Act's broad rulemaking and exemptive authority, the Commission has been able to permit the development of innovative fund management techniques and entirely new types of funds, such as money market funds.

This Subcommittee has recognized the importance of a strong Commission regulatory presence in the industry, and has vigorously supported our administration of the Act. I look forward to working with you, the other Members of the Subcommittee and your staff as we consider the important issues facing the Commission and the needs of investors.

I will address four major areas in my testimony. First, I will discuss the state of the investment company industry today, focusing especially on the explosive growth the industry has experienced over the last decade. Second, I will review the effect of this growth on the structure of the investment company industry and the operation of the securities markets. Third, I will examine the effect of the industry's growth on the Commission's ability to carry out its regulatory duties. Finally, I will highlight the administrative and legislative initiatives that the Commission is considering.

State of the Investment Company Industry

The growth and success of the investment company industry in recent years has been dramatic. Since 1980, investment company assets have grown at a compound annual rate of 22.4%, doubling every four years. By far the most popular form of investment company is the open-end management investment company, commonly known as a mutual fund.[1] Mutual

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[1] The other two major types of investment companies are closed-end funds and unit investment trusts. Closed-end funds issue a fixed number of shares. Unlike mutual fund shareholders, closed-end fund shareholders do not redeem their shares through the fund. Instead, following the fund's initial public offering, investors buy and sell shares on a secondary market, usually a stock exchange. Closed-end funds are often used as vehicles for investing in foreign securities, which may not be sufficiently liquid to enable mutual funds to meet their obligation to redeem their shares. More recently, the closed-end fund sector has been fueled by the tremendous growth in bond funds, primarily municipal bond funds.

Like mutual fund shareholders, unit investment trust investors may redeem their shares through the fund, although sponsors often choose to maintain a separate secondary market. Unlike mutual funds, however, unit investment trusts hold a relatively fixed portfolio of securities that is not actively managed. Unit investment trusts are particularly popular vehicles for investing in municipal bonds. This segment of the investment company industry is dominated by a few major sponsors. As of August 31, 1993, there were 14,297 unit investment trust portfolios with approximately $104.3 billion in assets. Unit investment trusts became very popular during the high interest rate periods of the early to mid-1980s. Growth in this sector

(continued...)

funds now account for 85% of the $2.2 trillion in investment company assets (Chart 1).

In August 1993, there were 4,320 separate mutual fund portfolios, an increase of 666% from the 564 that existed at the beginning of the 1980s. During that same time period, total mutual fund assets soared from $135 billion to over $1.9 trillion, an increase of more than 1,300% (Chart 1). On average, since January 1993, roughly $23 billion of new money has flowed into mutual funds each month (Chart 2).

Investors increasingly choose mutual funds as their primary cash management and investment vehicle. From 1980 to 1992, the percentage of U.S. households that own funds quadrupled from 6%, or 12.1 million accounts, to 27%, or 86 million accounts (Chart 3). Mutual funds hold almost 16% of all household discretionary assets, more than twice the figure of ten years ago.

Some of the growth in the mutual fund industry can be attributed to changes in the way individuals and institutions invest for retirement. During the 1980s, mutual funds became an important vehicle for retirement savings, as defined contribution plans became increasingly popular.[2] In addition, Individual Retirement Accounts (IRAs) have assumed a significant role in retirement planning. The mutual fund is the most popular form of IRA investment vehicle, with over $211 billion in IRA assets invested in mutual funds, or about 29% of all IRA investments (Chart 4). By the end of 1991, the influx of IRA and 401(k) money propelled retirement plan investments in mutual funds to over $270 billion. We expect retirement money to continue to flow into mutual funds as more employers replace defined benefit plans with

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[1](...continued)
has recently stalled, however, because of lower rates and the growing popularity of closed-end municipal bond funds.

[2] In a defined contribution plan, an employee's retirement income is linked to the level of employee and employer contributions, and the performance of the investment vehicles selected by the employee. Most employee-directed, defined contribution plans are organized in accordance with the provisions of section 401(k) of the Internal Revenue Code. Unlike a defined contribution plan, a defined benefit plan contemplates an employer promising to pay retirement benefits based generally on an employee's salary and length of service.

401(k) and other defined contribution plans.

The rechanneling of money from other financial services intermediaries also has fueled the growth of the investment company industry. Between 1980 and June 1993, for example, assets of life insurance companies grew only 21% as fast as mutual fund assets. During this same period, bank deposits grew only 11% as fast (Chart 5). One analyst estimated that as much as 40% of mutual fund net cash inflow has come from bank deposits.[3] Because of the current sustained period of low interest rates, bank depositors have sought higher rates of return. Banks have responded by expanding their presence in the mutual fund business. During the past five years, bank mutual funds have grown from 213 portfolios with $35.4 billion in assets to 1,156 portfolios with $194.7 billion in assets. Today, more than 110 banks or their affiliates offer mutual funds and this number is growing almost weekly. Bank-managed funds are now one of the fastest growing segments of the mutual fund industry, comprising almost one quarter of all mutual fund portfolios (Chart 6).[4]

Effect of Growth on the Investment Company Industry and the Operation of the Securities Markets

A. Changes in the Structure of the Investment Company Industry

The growth of the investment company industry has been accompanied by dramatic changes in the industry's structure. Before 1975, the industry was characterized by single or stand-alone funds operated by a founding entrepreneur, and small groups of three or four funds. Mutual fund sponsors were almost exclusively broker-dealer or investment advisory firms. A severe bear market in 1973 and 1974 caused mutual fund assets to shrink 40% and caused many to wonder about prospects for the future of the industry.

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[3] *Banks Offer New Investment Products to Stem Consumer Exodus From CDs*, The Wall Street Journal, March 25, 1993, at A-2 (quoting George Salem, Banking Analyst, Prudential Securities).

[4] *Id.* Many banks also sell funds managed by other sponsors.

New products and enhanced investor services invigorated the fund industry. Money market funds first appeared in the mid-1970s, and municipal bond funds appeared shortly thereafter. The 1980s saw an unprecedented proliferation of the number and variety of fund products available to the public so that, by the end of the decade, investors had quick and easy access to practically every type of investment instrument through the medium of an investment company. Today, one well-known mutual fund tracking service, Lipper Analytical Services, Inc., identifies 32 separate types of equity mutual funds, and 49 types of funds that invest primarily in debt and money market securities.

Most mutual funds now are components of investment company "complexes," large groups of mutual fund portfolios covering a wide range of investment objectives with a common investment adviser, underwriter, or sponsor. Over 600 such complexes now exist, ranging in size from the largest complex of 203 portfolios and over $200 billion in assets to the smallest with two portfolios and $5 million in assets. The 100 largest complexes manage about 84% of the industry's assets.

Because of the increasing diversity of mutual fund investors, many fund complexes have focused on improving the economy and flexibility of their distribution channels. The fund industry recently has developed two new methods of distribution: "multiclass" portfolios and "master-feeder" funds. In a multiclass arrangement, a mutual fund offers portfolios that have several classes of shares, with each class subject to a different distribution arrangement, but representing interests in the same pool of investments. The classes are often targeted to different groups of potential shareholders and usually differ with respect to distribution expenses and the way shares are purchased and redeemed. The multiclass structure enables a fund to sell different share classes through different intermediaries, such as banks, brokers, and financial planners. These multiclass arrangements also give investors various options regarding the types of services they receive and the method of paying distribution charges.

In a master-feeder system, a fund sponsor organizes and offers separate fund portfolios. These feeder portfolios are identical except that, like the classes in a multiclass structure, each is sold to different groups of similarly situated customers, who may have different investment constraints and may require different services. These feeder portfolios do not invest directly in securities, but rather invest in a single master fund, which, in turn, invests in securities. In essence, this structure unbundles the usual investment company functions into two components. The activities relating to investment management and custody are performed by the master portfolio, while the activities relating to marketing, distribution and shareholder servicing are performed by the feeder and tailored to meet the needs of its investors.

B. Effect of Investment Company Growth on the Capital Markets

Mutual funds and other investment companies have had a profound effect on the daily operation of the financial markets. Stock mutual funds have become a dominant force in the markets as individuals increasingly choose mutual funds as their stock market investment vehicles. Stock mutual funds are by far the largest net purchasers of U.S. equities. In 1992, stock funds accounted for 96% of the new money flowing into exchange-listed stocks.[5] On some days, the country's largest mutual fund manager and its brokerage subsidiaries generate as much as 10% of the total trading volume on the New York Stock Exchange.[6]

Mutual funds and other investment companies have become significant purchasers not only of equity securities but also of municipal securities. The participation of these funds has resulted in significant savings for municipalities. One source estimated that municipalities saved $230 million in 1992 because they were able to place large amounts of their municipal securities with a small number of mutual fund purchasers.[7]

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[5] *The Power of Mutual Funds*, BUSINESS WEEK, January 18, 1993, at 64.

[6] *Mutual Funds Have Become Dominant Buyers of Stock*, The Wall Street Journal, May 22, 1993, at C-1.

[7] *The Power of Mutual Funds*, *supra* note 5.

During the 1980s, the range of mutual fund portfolio investments expanded to include new types of financial instruments such as mortgage- and other asset-backed securities. Government securities funds, and other income funds, are major purchasers of these securities. Approximately 154 mutual fund portfolios with almost $105.5 billion in assets now invest primarily in mortgage-backed securities. Billions of additional dollars of Ginnie Mae, Fannie Mae and Freddie Mac securities -- which are essentially securitized consumer mortgages[8] -- are held by mutual funds that invest in U.S. government agency securities of all types. By investing in these securitized loans, mutual funds play a significant role in ensuring that adequate funds are available for homeowners.[9]

Over the last several years, this process of securitization has gradually extended to consumer lending, increasing the role mutual funds play in providing consumer credit. Banks and other consumer lending institutions are increasingly securitizing and selling their loans in the secondary market, where investment companies are a leading purchaser. Fund investment in these asset-backed securities frees up capital that can be used to extend more credit.

The fund industry has contributed to the market in derivative securities as well. Many international funds, and other funds with significant foreign securities holdings, use derivatives to hedge against the risk of foreign currency fluctuations. In addition, some domestic stock and bond funds use stock index futures or interest rate futures to attempt to hedge against a future decline in the general level of stock or bond prices without incurring the considerable expense of liquidating large portfolio positions. Other funds write covered call options to generate additional portfolio income. In short, the growth of investment company assets has significantly

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[8] "Securitization" is generally defined as the process by which funding that traditionally was obtained from commercial lenders, such as banks and finance companies, is obtained instead through the use of securities. *See Protecting Investors: A Half Century of Investment Company Regulation*, Division of Investment Management, U.S. Securities & Exchange Commission at 2, n. 3 (May 1992).

[9] An additional $13 billion in unit investment trusts that invest in mortgage-backed securities were offered from 1980 through 1991.

increased liquidity in many sectors of our capital markets.

Investment companies have not just contributed to our expanding domestic capital markets; particularly in the last decade, they have opened the foreign markets to investors. Since 1981, assets of funds that invest primarily in foreign markets have skyrocketed from under $2.5 billion to $108.5 billion. Over 530 investment companies invest a majority of their assets in securities of non-U.S. issuers. Investment companies also have been an important source of capital for emerging markets. Seventy-seven open-end and closed-end international funds with $13.5 billion in assets concentrate their investments in emerging markets in Latin America, Asia and Eastern Europe.

Some recent articles have suggested that the presence of mutual funds could contribute to instability in the financial markets.[10] For example, certain observers believe that, in the face of a declining market, large numbers of shareholders in equity funds would redeem their shares, exacerbating the decline. In past periods of market stress, however, shareholders in equity funds have not responded so uniformly: some redeemed their shares for cash; some moved their holdings to a money market fund or other fund portfolio within their complex; and others apparently viewed these periods as opportunities to purchase additional fund shares. At least one analysis suggests that retail fund investors have had more staying power during unstable markets than some institutional investors.[11] Nevertheless, we recognize that the past is not necessarily a good predictor of future events in the financial markets.

One of the principal attractions of a mutual fund for investors is the ease with which its shares can be bought and sold. Under the Investment Company Act, mutual funds must redeem their shares on demand and pay redemption proceeds within seven days. Many fund complexes have enhanced these redemption rights by paying redemption proceeds within a shorter period

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[10] *See, e.g.*, Lappen, *Fund Follies*, "The Big Scare", Institutional Investor, October 1993, at 42.

[11] "A Mutual-Fund Mania?," *Morningstar Mutual Funds* (October 1, 1993).

of time and by permitting telephone redemptions and exchanges. Recent news accounts have suggested that a redeeming mutual fund shareholder might not receive cash, but might be forced to accept portfolio securities upon redemption through a "payment in kind."[12] Under current Commission guidelines, fund managers must structure their portfolios in order to meet redemption requests and, if necessary, to reduce portfolio holdings in an orderly fashion. For example, at least 85% (90% for money market funds) of a fund's assets must be invested in liquid securities.[13] Normally funds have a much higher percentage of their assets in liquid instruments. Furthermore, in the wake of the dramatic market decline in October 1987, many mutual funds began holding a significant portion of their assets in instruments readily convertible to cash so that they would be better able to meet redemptions. Consistent with sound portfolio management practice, funds currently maintain an average of 7% of their assets in cash equivalents such as overnight repurchase agreements and treasury bills. This cash cushion makes it more likely that a fund will be able to meet redemption requests in cash. Although the Investment Company Act permits mutual funds to make in-kind redemptions, the Commission is not aware of any instance where a fund could not redeem its shares in cash due to a market decline.

Commission Resources Available to Regulate and Monitor Investment Companies

The continued growth of the investment company industry and the stability and safety of the markets depend largely on the Commission's ability to monitor fund activities and respond to developments in the industry. Unfortunately, at a time when more and more investors are entrusting their savings to investment companies, the SEC's resources have lagged far behind industry growth. In 1983, the SEC had approximately 127 staff to oversee 6,400

[12] Antilla, *In the Face of a Fund Panic* . . . , N. Y. Times, June 27, 1993, sec. 3 at 13.

[13] A liquid asset is one that can be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the fund has valued the investment. See Guide 4, Form N-1A.

investment company portfolios with aggregate assets of about $360 billion -- an average of 50 portfolios and $2.8 billion of assets under management for each staff member.[14] Despite a 105% increase in investment management staff to 260 over the past ten years, by last year there were almost 21,000 investment company portfolios, or 79 portfolios and $8.85 billion in assets per staff member.[15]

To maintain an adequate inspection capability in the face of the enormous growth in the size and complexity of the investment company industry, the Commission has gradually reallocated its investment management staff to inspections from other important activities, such as reviewing prospectuses, and handling exemptive, interpretive and no-action requests. In 1983, 43 investment company examiners -- approximately one-third of the investment management staff -- were each responsible for $7.9 billion of investment company assets and 148 portfolios. In 1993, approximately one-half of our staff -- 133 examiners -- was devoted to investment company inspections, yet each examiner was still responsible for a staggering $16.9 billion of investment company assets and 158 portfolios. The strain on our inspection staff has not come about simply because of the increase in the size and number of investment company portfolios; it is also the result of the many new types of funds, the complex financial instruments in which they now invest, the changing organizational and distribution structures of funds and the geographical dispersion of fund service providers, including the entry of foreign investment managers.

Thus, even though staff levels have risen, the Commission has been forced to reduce the scope and the frequency of examinations over the past decade. Although there are now almost 21,000 portfolios, only certain non-money market portfolios within the 100 largest fund complexes, 1,070 money market funds, and 156 medium and small complexes were inspected

[14] Numbers of "staff" or "examiners" are based on staff years (or full-time equivalent) as used in the Commission's budget.

[15] This figure includes the portfolios of closed-end investment companies and unit investment trusts as well as open-end companies. *See supra* note 1 and accompanying text.

in 1993. Virtually all of these inspections were limited in scope, focusing primarily on portfolio management to determine whether fund activities were consistent with the information given investors and whether funds accurately valued their shares. Fund marketing and shareholder services, for example, were rarely scrutinized.

The vitality and continued success of the investment company industry, to a great extent, rests on public trust and confidence. Typically, investments in funds are neither insured nor guaranteed. Nevertheless, Commission resources for investment company supervision have been far more scarce than resources available to other financial regulators. Even though the investment company industry is two-thirds the size of bank, thrift and credit union assets, the entire Commission had only 260 staff for its 1993 investment management program compared to almost 21,000 staff available for the oversight of banks, thrifts and credit unions.[14] The ratio of $8.8 billion in investment company assets per staff member is thus 59 times larger than the $150 million in bank, thrift and credit union deposits per staff member.

These figures reveal a serious shortfall in the Commission's resources to oversee one of the fastest growing and most important segments of the financial services industry. In this era of budgetary restraint, we continue to look for new ways to meet this challenge. In the past month, for example, we have shifted the emphasis of our fund inspection program from examining annually funds in the 100 largest complexes to focusing upon small and medium investment company complexes that may not have compliance systems as developed as the larger or more established complexes. During these inspections, the staff now obtains as much data as possible in an electronic format to eliminate worker-intensive data entry in order to analyze fund activity. While most funds try to accommodate the staff's request, incompatible computer systems, lack of software and uniform formats for data often prevent funds from

[14] This figure represents fiscal year 1992 staff levels at the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration. This figure does not include, however, Federal Reserve staff figures, which are not publicly available.

providing data electronically.

In another effort to use scarce resources as efficiently as possible, we also intend to consider a risk assessment system for all investment companies. Such a system would contemplate frequent reporting by all management investment companies of their portfolio transactions and positions. This data could be analyzed to identify trends for review earlier than is now possible and to target for inspection companies whose activities are at great variance with those of their peers.

Despite our best efforts at resource management, the Commission needs more and better trained people to deal with the growing complexity of this industry. If nothing is done to add to our ranks, the task the staff faces may become too great to provide any real measure of deterrence or investor protection. Additional resources would permit the Commission to add significantly to the size of its examination staff. With 150 new staff members, for example, comprehensive inspections of the over 600 medium and small fund complexes could be done once every three years, rather than the current cycle of limited inspections every four to five years. These broader and more frequent inspections would focus on the many new entrants in the business that often have less developed internal compliance systems. In addition, comprehensive inspections of all funds and all activities within the 100 largest fund complexes could be performed on a regular basis such as a two-year cycle. These comprehensive examinations would provide an additional level of comfort that is now sacrificed with the limited scope examinations.

More resources in other areas of the investment company program could be used to increase the number of prospectuses and other disclosure documents reviewed, an important step in ensuring that investors receive the information they need to make investment decisions. Currently, the Commission staff reviews approximately 20% of all investment company filings. Increased resources also would enable the staff to devote more time to exemptive applications and no-action and interpretive requests, and to accelerate the development of rules to address the many changes in the industry during the last decade.

Additional appropriations will not necessarily address a more fundamental budgetary concern. The Commission cannot continue to play an effective role in the safe and orderly growth of the investment company industry unless the current manner in which it is funded -- through a combination of appropriations and offsetting fee collections -- is changed. I believe it is critical that this Congress proceeds with legislation already approved by the House to institute a full cost recovery system of self-funding for the Commission.[17] At present, funds registering under the federal securities laws pay far more in fees than the Commission spends on investment company regulation. Last year, for example, the Commission collected over $91 million in fees from the industry, but expended only $23.4 million on regulation of these entities. Among other things, the full cost recovery system of funding would link the Commission's services and regulation to the growth of the industry, as reflected by filing fees.

To keep pace with the enormous growth of the investment company industry, however, it is not enough simply to focus on the Commission -- additional regulation by the industry itself is necessary. In the past, the investment company industry has had a relatively scandal-free record. For this to continue, however, funds must be diligent in examining their internal procedures on an ongoing basis to ensure the highest level of compliance. New initiatives in self-compliance may need to be considered and adopted. For example, investment companies may need to appoint compliance officers with internal audit responsibilities. Finally, some form of self-regulatory organization for investment companies may be necessary.

[17] H.R. 2239, 103th Cong., 1st Sess. (1993).

Commission Initiatives

Against this backdrop, I would like to touch briefly upon some of the important regulatory initiatives that the Commission is considering. These initiatives reflect our efforts to use the Commission's scarce resources as effectively and efficiently as possible to keep pace with growth and developments in the investment company industry.

A. Improved Disclosure

The proliferation of types of mutual funds, the instruments in which they invest and the various fee structures used to pay for distribution have given investors more choices than ever before. Choices that cannot be understood by the typical investor, however, offer no choice at all. Thus, it has become increasingly incumbent on the Commission to make every effort to see that investors have sufficient information, in an understandable format, to assess the risks and potential rewards of their investments and to make informed choices.

Much attention has been given recently to the need for "plain English" prospectuses. I agree that mutual fund prospectuses should be easy to read. But while some fund prospectuses are long and hard to read, it is important to recognize that prospectuses are far more readable now than in the past, thanks to a number of steps the Commission has taken to improve mutual fund disclosure. Ten years ago, the Commission shortened mutual fund prospectuses by separating much of the information that is not of interest to most investors and placing that information in a separate document, the Statement of Additional Information. Five years ago, the Commission required prospectuses to include the so-called "fee table," which appears at the front of the prospectus and lists key transaction expenses, such as sales charges and operating expenses. This year, the Commission added two additional important disclosure requirements: first, the prospectus must identify a fund's portfolio manager; second, either the prospectus or the annual report must discuss a fund's performance and provide a graph comparing the performance to an appropriate broad-based securities market index.[18] Last November, the Commission also amended the registration form for closed-end investment companies to incorporate many of the improvements made in open-end registrations over the past ten years.[19]

We can do more, however. It is no secret that some prospectuses are more readable than others. This is frequently the case when a prospectus is a fund's primary selling tool. Many direct-marketed funds, for example, have demonstrated that prospectuses can be understandable. We cannot simply mandate "plain English" prospectuses because regulators cannot appropriately write a fund's offering documents. We can, however, create incentives for funds to improve their prospectus disclosure -- perhaps by encouraging greater use of these documents as selling tools.

The Commission staff continues to consider ways to shorten and simplify mutual fund prospectuses. For example, even though money market funds are the safest type of mutual fund, their prospectuses tend to be lengthy and complex, primarily because the current disclosure requirements were not designed for these funds.[20] The staff believes it can rework these requirements so that a short readable prospectus can be written containing all the information a typical money market investor needs to know. The complicated details still would be available from the fund, but only upon request.

I would like to mention two other areas in which the Commission is developing specific initiatives to improve the flow of information to investors.

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[18] *Disclosure of Mutual Fund Performance and Portfolio Managers*, Investment Company Act Release No. 19382 (Apr. 6, 1993), 58 FR 19050 (Apr. 12, 1993).

[19] *Registration Form for Closed-End Management Investment Companies*, Investment Company Act Release No. 19115 (Nov. 20, 1992), 57 FR 56826 (Dec. 1, 1992).

[20] For example, a fund is required to describe the types of instruments in which it invests. For a typical stock fund, the response is simple: common stock. Money market funds, however, invest in a growing array of short-term instruments issued by different types of institutions. To describe them all often takes several pages of complex terminology in frequently overwhelming detail.

1. Simplified Prospectuses

In March of this year, the Commission proposed amendments to the investment company advertising rules to permit funds to use a simplified prospectus (sometimes referred to as a "summary" or "off-the-page" prospectus). This proposal would give investors the option of purchasing mutual fund shares directly from advertisements containing an order form. To use this format, funds would have to include in their simplified prospectuses 21 items of specific, detailed information about the fund, including risks, standardized presentation of rates of return, and a table showing all fees and expenses. All of that information would be based upon information appearing in the longer prospectus. Very little of this information currently appears in most mutual fund advertisements.

A primary objective of this proposal is to provide investors a concise presentation of the most essential information relevant to an investment decision; with this information and format, investors would be able to make comparative judgments about their investment alternatives. Because the information disclosed should be more readable, the simplified prospectus should not encourage impulsive investment decisions.

Under current Commission advertising rules, investors reading a mutual fund advertisement must first call or write to request the longer prospectus; only after they receive that prospectus can they fill out an order form and send it to the fund. The proposal would allow investors to choose between waiting for the longer prospectus or investing directly. Investors still could request the longer prospectus before buying fund shares. In all cases, they would receive the longer prospectus with the confirmation of the sale.

The public comment period for this proposal closed at the end of June. The Commission received approximately 200 comment letters, many suggesting specific modifications to the proposal. The Commission will carefully consider all these comments before it takes any action upon the proposal.

2. Proxy Disclosure

The staff is reviewing its proxy rules under the Investment Company Act that supplement the basic proxy disclosure requirements under the Securities Exchange Act of 1934. These provisions -- relating to shareholders' election of directors and approval of a fund's advisory contract -- have not been comprehensively reviewed since they were adopted in 1960. The staff is considering ways to improve fund proxy statements, such as requiring additional disclosure of compensation paid to fund directors and incorporating a variation of the fee table to assist investors in assessing the effects of proposed fee increases.

I fully support all efforts to improve the readability of prospectuses and the accessibility of information to investors. We will continue to explore ways to improve prospectuses and other disclosure documents in order to pursue the paramount goal of making sure that investors receive clear, accurate information.

B. Tax-exempt Money Market Funds

The Commission continues to place a high priority on the safety of money market funds. In 1991, in response to defaults of commercial paper held by several taxable money market funds, the Commission amended its money market fund rule to establish portfolio quality and diversification standards for these funds. The Commission did not apply these standards to funds that limit their investments to tax-exempt instruments because of certain unique characteristics of the market for these instruments. For example, because of the limited number of issuers in many states, few tax-exempt funds investing in instruments issued by municipal entities in a single state could operate under the diversification requirements applicable to other money market funds. In addition, the principal issuers of tax-exempt instruments, state and local governments, present questions regarding credit quality different from the issuers of commercial paper purchased by taxable funds.

The Commission will soon consider further revisions to its money market fund rule to set forth appropriate diversification standards for funds investing in tax-exempt instruments.

The revisions will likely include credit quality standards for tax-exempt funds designed to address, among other things, the differences between instruments issued by a governmental entity, such as a city, and "conduit" bonds in which the underlying obligor is a corporation or other non-governmental project. These revisions will be designed to provide investors in tax-exempt funds the same degree of safety of principal that the rule provides for taxable funds.

C. Wrap Fee Programs

Wrap fee programs have become increasingly popular among broker-dealers, advisers, and investors and may be the fastest growing segment of the investment advisory industry.[21] In a typical wrap fee program, an investor receives a bundle of investment services including asset allocation, portfolio management, custody of funds and securities, execution of transactions, and monitoring of portfolio manager performance, for a single "wrap" fee, generally a percentage of assets under management.[22]

The Commission is continuing to monitor these programs and will soon consider guidelines under the Investment Advisers Act of 1940 and the other federal securities laws for investment advisers providing services in wrap fee programs. The Commission also will consider requiring a discrete disclosure document, or "brochure," that would provide investors clear and concise information about wrap fee programs.

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[21] *See, e.g.*, Antilla, *What Won't Wash About Wraps*, N.Y. Times, May 16, 1993, at F15; *Shedding Light on Those Hot Wrap Accounts*, Boston Globe, May 13, 1993, at 61; White, *As Money Rolls In, Meet the "Kings of Wrap"*, The Wall Street Journal, Apr. 22, 1992, at C1.

[22] The wrap fee client is not charged brokerage commissions on a transactional basis. The sponsor, often a broker-dealer or an affiliate, selects or assists clients in selecting an investment adviser (who may or may not be affiliated with the sponsor) to manage the client's portfolio and periodically reviews the performance of the portfolio manager.

Legislative Initiatives

I would like also to mention a few subjects for possible legislative action. Some of these recommendations are from the report issued by the Commission's Division of Investment Management in May 1992, *Protecting Investors: A Half Century of Investment Company Regulation*. Others are more recent responses to developments in the industry.

A. Bank Sales of Mutual Funds

One of the most significant developments in the investment company industry is the dramatic growth in sales of mutual funds by banks. About one-third of all mutual funds are available through banks.[23] A significant challenge for the Commission, as well as for bank regulators, is seeing that adequate steps are taken to avoid potential confusion regarding the nature of investments in funds by bank customers. In May of this year, the Commission's staff sent a letter to all funds registered under the Investment Company Act expressing our concern that investors in bank advised and bank sold mutual funds may be misled into believing that their investments are guaranteed or insured like bank deposits. The staff advised funds having names similar to federally insured institutions, and all funds advised, sold, or marketed by or through these institutions that they must prominently disclose, on the cover of their prospectuses, that shares in the fund are not deposits or obligations of, or guaranteed or endorsed by, the bank, and that the shares are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other agency.[24]

This was an important first step to help ensure that investors in bank-advised or bank-sold mutual funds do not believe that their investments are guaranteed or insured. We are not

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[23] In a recent ICI study, 1,100 funds out of 3,523 reported sales through banks in 1991; 1,253 funds out of 3,657 reported sales for the first half of 1992. *See* ICI Research Department, *Mutual Fund Statistics for the Bank Distribution Channel*, MUTUAL FUND RESEARCH IN BRIEF (May 1993).

[24] The Commission has required similar disclosure in money market fund prospectuses since 1991. *See Revisions to Rules Regulating Money Market Funds*, Investment Company Act Release No. 18005 (Feb. 20, 1991).

alone in our efforts to address this issue. The banking regulators also have emphasized the responsibility of banks to take steps to avoid confusion regarding the nature of investments in funds sold by banks.[25] Just this past weekend, the Comptroller of the Currency reaffirmed the importance of clear disclosure in this area.[26] These steps by the Commission and the bank regulators may not be enough to deal with the potential for confusion. I note that the House is considering a ban on the use of common names altogether. I look forward to working with the Subcommittee on this issue and with the bank regulators to develop additional safeguards as well.

Even though the Commission can regulate bank sponsored or advised funds registered under the Investment Company Act, its ability to regulate the persons who advise and sell interests in those funds is circumscribed. Banks that sell mutual fund shares are still not regulated as broker-dealers because they are excluded from the definitions of broker and dealer under the Securities Exchange Act of 1934. Thus, the Commission's ability to regulate a banks' sales of mutual funds in their lobbies is limited. Furthermore, banks are not subject to the suitability and sales practice rules applicable to broker-dealer sales of mutual funds. Similarly, though many banks advise mutual funds, these banks, unlike all other mutual fund investment advisers, are not regulated as investment advisers because they are excluded from the definition of investment adviser under the Investment Advisers Act of 1940. For this reason, even though the Commission can inspect the records of a bank advised fund, it may not be able to examine other records of the bank that may be relevant to a review of the fund's portfolio transactions. The Commission historically has maintained that these exclusions should be removed. I, too, advocate that organizations providing similar products and services should

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[25] *See* Comptroller of the Currency Banking Circular 274 (July 19, 1993); Letter from Richard Spillenkothen, Director, Federal Reserve Board, to Supervisory Officers (June 17, 1993).

[26] *See* Eugene A. Ludwig, Comptroller of the Currency, Remarks before the Annual Convention of the American Bankers Association (Nov. 7, 1993).

be subject to the same regulation. The notion of functional regulation is not new to this Subcommittee. In 1991, the full Senate Committee on Banking, Housing, and Urban Affairs approved legislation calling for just this type of regulation.[27] The increasing involvement of banks in mutual fund activities has made such legislation even more critical now.

B. Small Business

I would like to reiterate the Commission's support for "The Small Business Incentive Act."[28] This legislation, which was approved by the full Senate just last week, is designed to increase participation in all types of private funds, including the so-called "private" venture capital funds, that provide vital capital to small businesses, by removing regulatory constraints that are unnecessary for investor protection. The legislation would create a new kind of investment company whose securities are owned exclusively by highly sophisticated or "qualified purchasers." The new fund would not be subject to Investment Company Act regulation on the basis that financially sophisticated investors can appreciate the risks associated with pooled investment vehicles, without the Act's protections. I would also like to express our appreciation for Chairman Dodd's leadership, and the efforts of the entire Committee, in connection with this legislation.

C. Independent Directors

The *Protecting Investors* report recommended raising the percentage of independent directors required to serve on investment company boards. Independent directors serve as the "watchdogs" for fund shareholder interests. Currently, 40% of an investment company's board

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[27] *See* S. 543; S. Rep. 167, 102d Cong., 1st Sess. (Oct. 1, 1991). On November 4, 1993, Chairman Dingell, together with Congressmen Markey, Moorehead and Fields, introduced the Securities Regulatory Equality Act of 1993, H.R. 3447. This bill would require functional regulation of bank brokerage activities and certain bank advisory activities.

[28] S. 479, 103d Cong., 1st Sess. (Mar. 2, 1993). *See The Small Business Incentive Act of 1993: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong., 1st Sess. (Mar. 4, 1993).

must be independent. To strengthen the independence of fund directors as a group, the report recommended that this be changed to a majority. This change appears warranted given the vital role accorded independent directors under the Investment Company Act and the increased emphasis the Commission has placed on independent directors.

D. Unified Fee Investment Company

One of the most innovative proposals in the *Protecting Investors* report concerns investment company fee structures. This proposal would create a new type of fund that would charge a single or unified fee. As an alternative to current practice in the investment company industry in which funds pay a variety of fees for different services, the new fund -- the unified fee investment company or "UFIC" -- would have only one, fixed fee set by the investment manager. There would be no separate sales charges or redemption fees. The UFIC's fee would be prominently disclosed on the cover page of the prospectus and in all advertisements. The UFIC structure should enable investors to appreciate more readily the costs associated with their investment, and to "comparison shop" among different funds.

E. Defined Contribution Employee Benefit Plans

In its *Protecting Investors* report, the Division observed that the regulation of certain pooled investment vehicles for defined contribution employee benefit plans (*e.g.*, bank collective trust funds and separate accounts) under the Employee Retirement Income Security Act of 1974 and Regulation 9 of the Comptroller of the Currency generally provides sufficient protection to plan participants. Because interests in these vehicles are exempt from registration under the federal securities laws, however, they are not required to provide disclosure to plan participants. The Division therefore expressed concern that plan participants investing in these vehicles may not receive sufficient information on which to base their investment decisions. The Division also expressed concern more generally that plan participants investing in pooled vehicles subject to the federal securities laws may not receive enough information regarding their investment.

To improve the information provided to plan participants, the Division made a number of recommendations, which have sparked a lively debate among regulators and various industry groups.

Like the Commission, the Department of Labor, which is charged with the protection of employee benefit plan participants and beneficiaries under ERISA, has also given attention to the need to improve the flow of information to those participants and beneficiaries. The Commission intends to work closely with DOL to see that investors receive similar information regarding an investment vehicle whether they invest in it directly or through the medium of a defined contribution plan.

F. Access to Records

I would like to address one final legislative issue specifically relating to investment companies: increasing the Commission's examination authority. Currently, the Commission can examine only those records required to be retained by an investment company, and the Commission can require an investment company to retain only those records that support its financial statements. This is a much narrower recordkeeping and inspection authority than Congress has provided the Commission for broker-dealers and investment advisers.[29] In addition, to facilitate expanded use of computers in investment company examinations, the Commission needs authority to specify that books and records be kept, and provided to examiners, in a particular format or medium. These relatively modest recommendations should permit the Commission to improve the quality and efficiency of its investment company examination program.

[29] Section 17(a)(1) of the Securities Exchange Act of 1934 and Section 204 of the Investment Advisers Act of 1940 permit the Commission to require such records as "may be necessary or appropriate in the public interest or for the protection of investors."

G. Self-Funding

As the investment company industry grows in size and complexity, the Commission must continue to monitor developments in that industry. To do so effectively, we will need more resources for people, training and equipment. In the present budgetary climate, it is very difficult to obtain additional appropriations. In fact, the Commission's resources could be reduced. Either situation -- a no growth budget or a funding cut -- will exacerbate the current lack of sufficient staffing and increase the potential for investor losses.

To ensure that the Commission has adequate resources it must be self-funded. Under a self-funding arrangement known as full-cost recovery, the Commission would be authorized to use filing and transaction fee collections to fund all agency operations instead of using annual appropriated funds. The Commission currently produces substantial net revenue through the collection of registration, transactional and filing fees, which is deposited in the U.S. Treasury. While the Commission estimated that in 1993 it would collect $440 million in fees, it received only $253 million in funding. In 1992, the Commission collected $406 million in fees compared to total funding of $226 million.

I should emphasize that self-funding would not remove the Commission from Congressional oversight. Nor would it involve using any fines or disgorgement payments resulting from our enforcement actions. Under the self-funding mechanism approved by the House on July 20th of this year, the Commission would received a fixed appropriation amount that would be offset by fee collections.[30] In addition, the Commission would be required to continue to generate a surplus totaling $888 million for the U.S. Treasury for deficit reduction over a five year period. After fiscal year 1998, the Commission's fee collections will be closely matched to its annual appropriation and fee estimates. Thus, one of the benefits of the self-funding legislation is that ultimately it will better link the fees paid by registrants and regulated entities to the services provided by the Commission.

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[30] H.R. 2239, 103th Cong., 1st Sess. (1993).

I strongly encourage the adoption of this self-funding mechanism as an essential step in ensuring that the Commission has the resources necessary to oversee fairly and efficiently the investment company industry and the capital markets in the United States.

Conclusion

I appreciate the opportunity to testify with respect to the state of the investment company industry. As the Commission addresses these and other important issues facing this industry, we will consider carefully the views of members of your Subcommittee and all of Congress, the industry, investors and other interested parties. I would be happy to answer any questions you may have.

Chart 1
Growth in Total Net Assets of the Investment Company Industry
December 1980 - August 1993

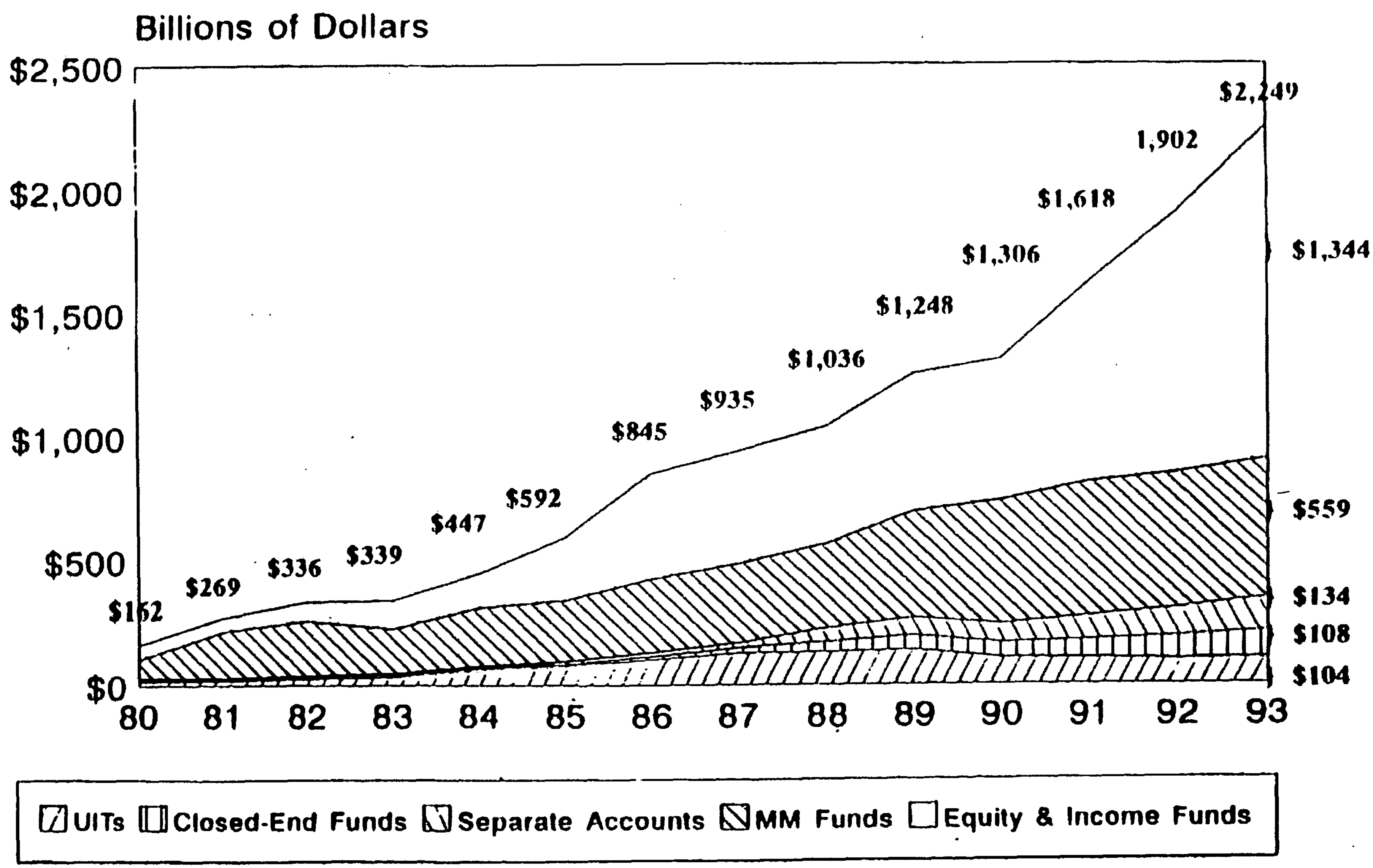
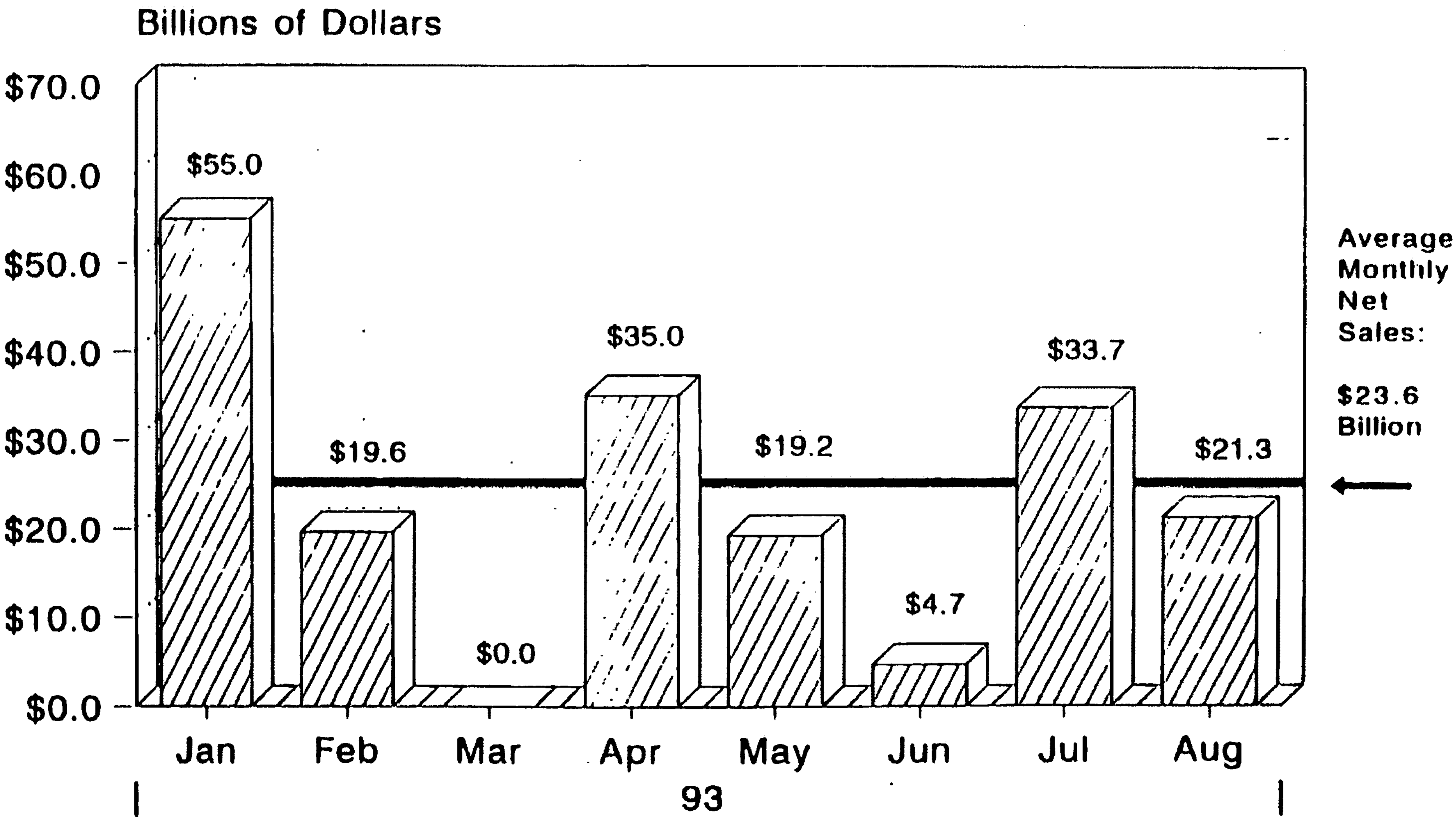
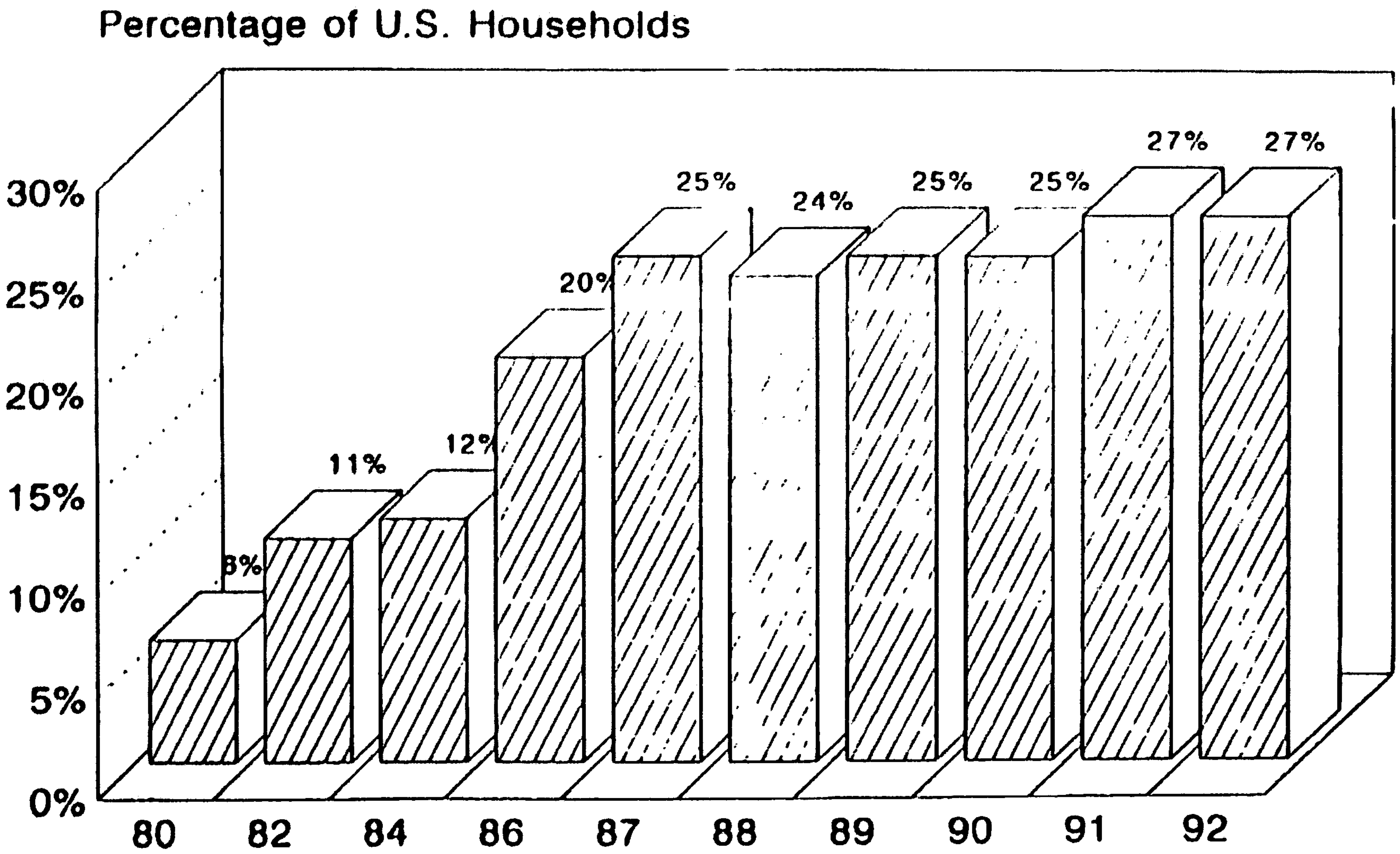


Chart 2
Net Sales of Mutual Fund Portfolios
January 1993 - August 1993



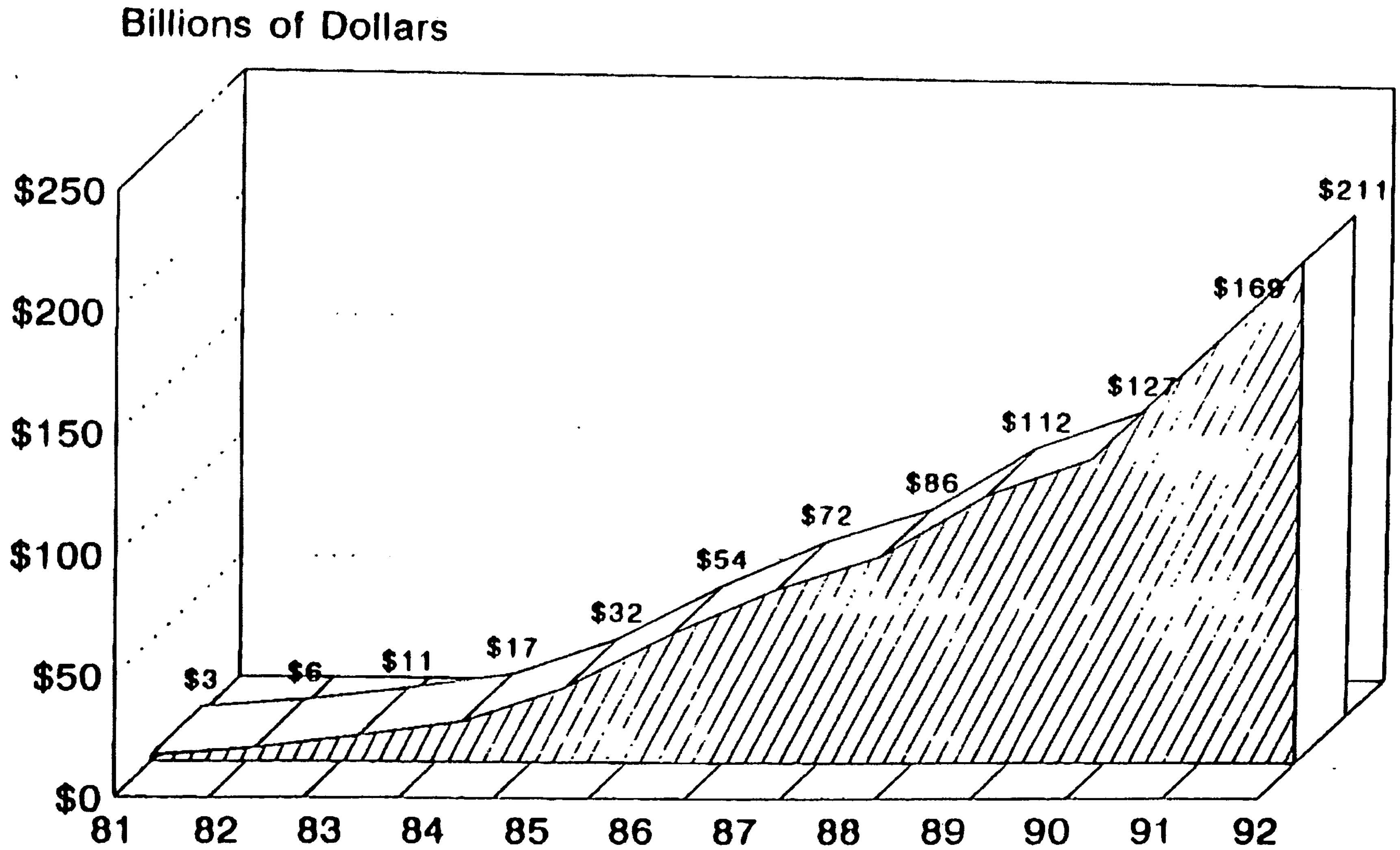
Source: Investment Co. Institute

Chart 3
Ownership of Mutual Funds Among U.S. Households
1981 - 1992



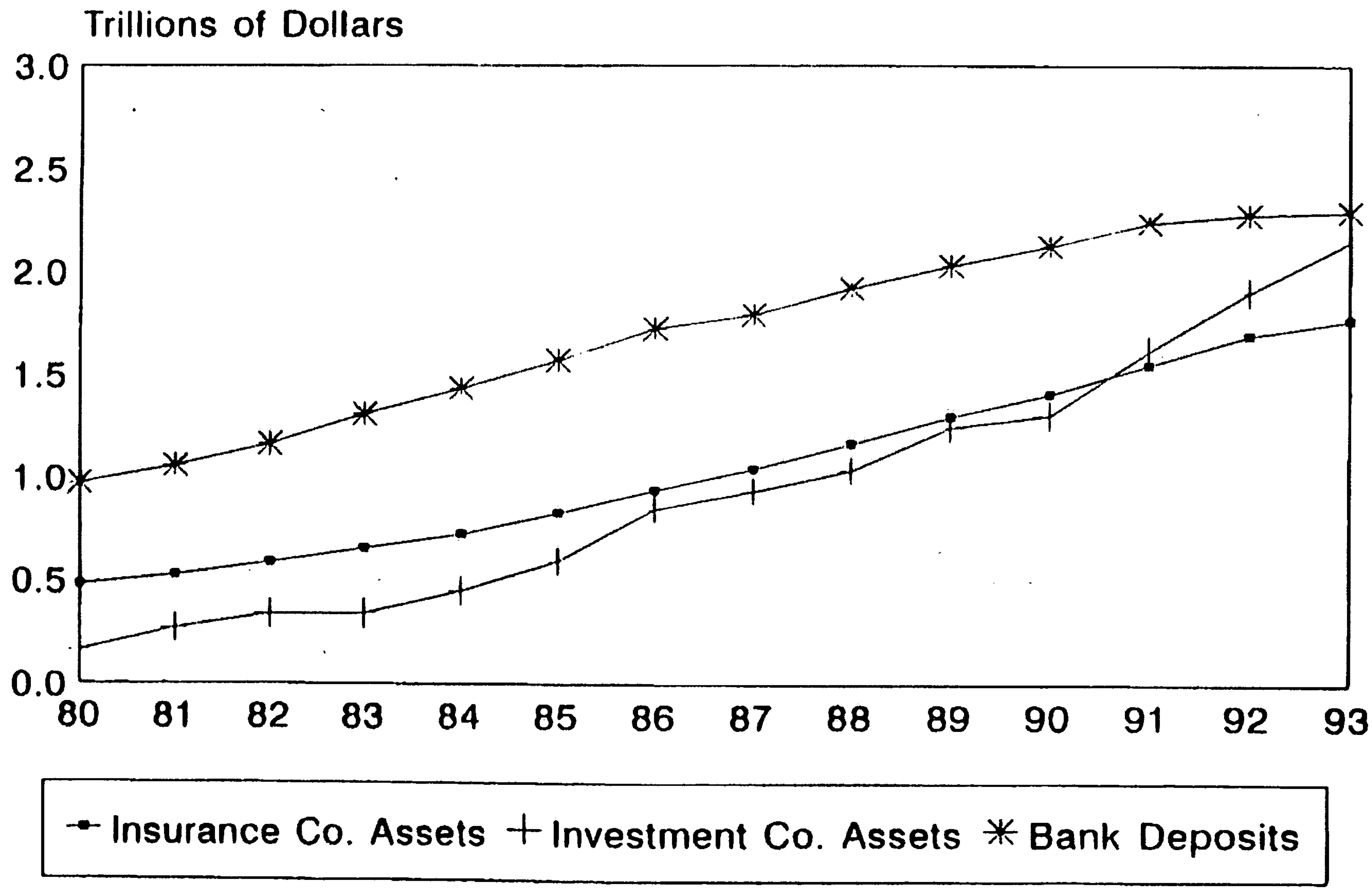
Source: Investment Company Institute

Chart 4
Growth in the Assets of Mutual Fund IRA Plans
1981 - 1992



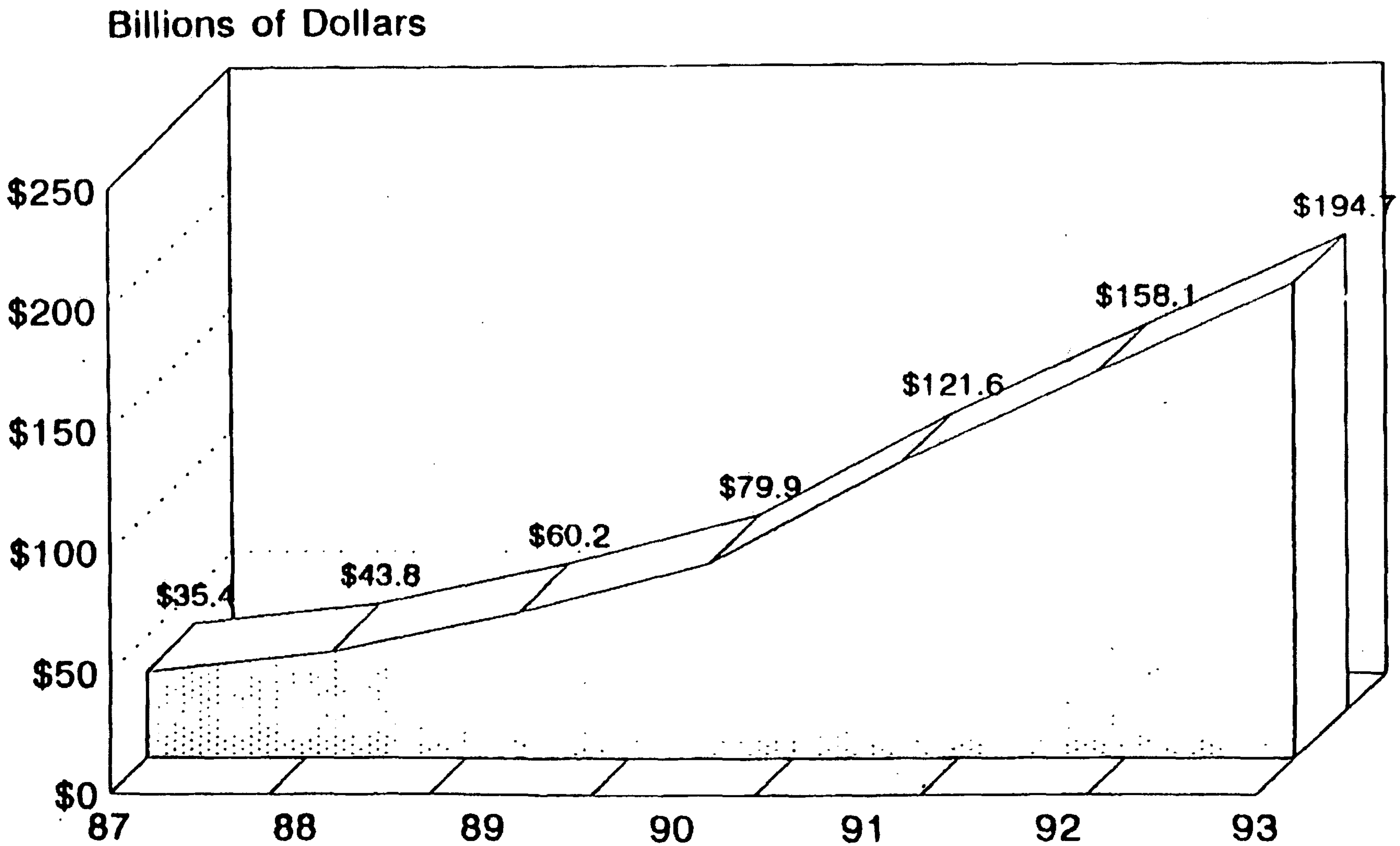
Source: Investment Company Institute

Chart 5
Growth in Insurance Company Assets, Investment Company Assets and Bank Deposits
December 1980 - June 1993



Sources: Federal Reserve Bulletin and Investment Company Institute and American Council of Life Insurance

Chart 6
Growth in the Assets of Bank Portfolios
December 1987 - June 1993



Source: Lipper Analytical Services