



**PROTECTING INVESTORS: A HALF CENTURY
OF INVESTMENT COMPANY REGULATION**

REMARKS OF

**RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION**

**THE INVESTMENT COMPANY INSTITUTE
WASHINGTON, D.C.**

May 21, 1992

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

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Ladies and Gentlemen:

Today the Commission is releasing a 500-page report entitled Protecting Investors: A Half Century of Investment Company Regulation. Nitpickers in the crowd might note that the law has been on the books for 52 years. Well, a half century plus 2, and two score plus 12 both seemed a bit ponderous, so we took a little poetic license. Actually, I asked the staff to start the report at the half century mark, and two years of work went into the project. Looking at the length of the report, if I had given them three years there might not have been any trees left on the North American continent. Seriously, it is an excellent report filled with thoughtful analysis.

I should stress that this is the Division's report, and they deserve the credit for its quality. I should also confess, though, that there is one critical respect in which this is not the report the Division would have issued, if left to its own devices. There was strong sentiment, in the Division, for a

cover of Duke blue, or of North Carolina blue. I refused to allow such parochialism, and the actual selection of the color for the cover was based on a thorough evaluation of the various alternatives, and careful reflection on the potential symbolic impact of different choices. The fact that the final choice turned out to closely resemble cardinal red and white -- Stanford's colors -- is purely happenstance.

The world, as you know, has changed since 1940, when the Investment Company Act was passed. In many respects, though, people have not changed since 1940. There is still a temptation, when one has control over other people's money, to use it in ways that one would not use one's own money. There is still a tendency for promoters to tell investors less than they need to know about performance, fees or related party transactions. There are still people who will simply steal from innocent investors.

That is why the federal securities laws, and in particular the Investment Company Act of 1940, are still necessary. The protections offered by the Act have helped to control abuse, and in so doing to foster customer confidence. The result is a product -- mutual funds -- that is used by tens of millions of people (68 million accounts, to be specific). Perhaps even more remarkably, an industry of only \$2 billion in 1940 has grown to more than \$1.5 trillion without relying on one dollar of public

subsidy or taxpayer underwriting. Completely without deposit insurance we have created an investment industry that is now the nation's third largest, behind banks and insurance companies. It might also interest you to know that this huge industry is regulated by approximately 300 people with a budget of about \$25 million. That is a tiny fraction of the colossal size and cost of the bank regulatory establishment of the federal government -- which helps explain why mutual funds have so few failures and such a high success level in the market.

Though the SEC's direct regulation of mutual funds is already extremely streamlined, it is important for us to consider whether there are ways in which the indirect regulation of the securities laws and rules can be made more flexible, more efficient, and more modern. Of course this needs to be done without compromising the protection of investors that is the Commission's central mission.

I would like to discuss today a few of the recommendations in the Division's report, as well as a few other issues facing the investment company industry.

Interval Funds

One of the most interesting and important recommendations would allow for new kinds of investment companies to close the gap between open-end and closed-end funds. Our current

regulatory system provides no real intermediate alternatives between the high investment liquidity, but relatively constrained portfolio management features, of open-end funds, and the low investment liquidity, but more flexible portfolio management features, of closed-end funds. The report recommends three options to help "fill the space" between open and closed-end funds.

One option would be an "extended payment" open-end fund. Like a regular open-end fund, it would redeem its shares continuously, but it would have more than seven days -- say a month -- in which to redeem shares.

Another option would be an "interval fund." This type of open-end fund would allow shareholders to redeem their shares at net asset value at fixed regular intervals, but not every day. In other words, one fund might allow a shareholder to redeem shares on the first of the month but not any other day of the month; another fund might allow a shareholder to redeem only once a quarter.

A third option would be a closed-end fund with regular repurchases. Shares of such a fund would trade on the secondary market, but the market and investors would know that, on some regular basis, the fund would repurchase shares. This could,

perhaps, help reduce the discounts that have been so common for so many closed-end funds.

Extended payment and interval funds would make it easier for funds to invest in securities that are somewhat liquid but not liquid enough to ensure seven-day redemption. Such a fund could invest, for example, in securities issued by small businesses that are not yet traded in a public market. It could also, perhaps, take more sizeable positions in publicly but thinly traded securities of other businesses. An interval fund would also seem ideally suited to investing in the securities of developing stock markets, where liquidity sometimes comes and goes like the monsoon rains.

Any regulatory changes to permit the creation of such funds must ensure that investors understand that they offer more limited redemption rights than do standard mutual funds. Similarly, investors should understand clearly the terms of any periodic repurchase arrangements and that such arrangements are not equivalent to a right to redeem at net asset value. My sense, though, is that investment company investors are sufficiently sophisticated to understand such concepts.

We are not sure that these new types of funds will prove popular: we are sure that they are worth considering. The

Division will thus be presenting a rule proposal along these lines to the Commission quite soon.

Advertising

Changes in modern communications also call into question whether more can be done to permit effective communications between mutual funds and potential investors. The amount of information about potential investments available to U.S. investors through the print and electronic media is greater than ever before. And more and more financial publications are focusing on mutual funds.

In recognition of these changes, the report recommends two changes in the regulation of mutual fund advertising.

First, the report recommends that advertisement not be limited to information that is already in the prospectus filed with the Commission, as long as those advertisements are subject to prospectus liability. This change would enable mutual funds to advertise more creatively, while still assuring that advertisements remain truthful. It also would ensure that the full prospectuses are not cluttered with unhelpful information.

Second, the report recommends that funds be permitted to sell using an "off-the-page" prospectus. Of course, investors still could request and receive the full prospectus before

investing, and in any case would receive it with their confirmations. For investors who do not want to wait for delivery of the full prospectus, off-the-page purchases could ease the process of making a mutual fund investment.

Not all mutual funds will want to use these advertising options. Some funds probably will want to use them, however, and will offer investors lower costs as a result of their reduced mailing costs. If we can increase the number of choices, particularly low-cost choices, for investors, without reducing critical investor protections, we should do so.

Corporate Governance

In the area of governance requirements for mutual funds, some have recommended that we dispense with the corporate structure mandated in the Act. After careful study, though, the Division does not recommend it.

State laws have already streamlined investment company governance requirements making the current system a relatively inexpensive safeguard. A number of states, for example, no longer require annual shareholder meetings, and the vast majority of mutual funds are organized in those states. Thus, the costs of organizing as a corporation have been minimized.

The report also recognizes that fund directors play an important role in investment company oversight, though a somewhat different role from that played by directors of operating companies. For instance, Rule 2a-7, which governs the operating of money market funds, places a great deal of responsibility on directors to ensure that fund advisers take appropriate action when portfolio securities are downgraded or are in default. The report recognizes that fund directors continue to play an important "watchdog" role.

In light of these factors, the report recommends few changes in the governance requirements for investment companies. The most significant is that investment companies be required to have a majority of independent directors to enhance the oversight role played by directors. This is already the trend for large operating companies, and it would be anomalous to require less for investment companies.

Securitization

One of the key trends in the world financial markets is securitization. In one sense, investment companies have been "securitizing" for many years by buying a portfolio of bonds and selling shares to investors. In another sense, though, securitization is completely new. The techniques now used to create rated, standardized, non-managed mortgage-backed securities simply did not exist in 1940, or for that matter in

1960. Today, though, we have over \$1.2 trillion worth of such securities outstanding.

Securitization has undoubtedly resulted in lower interest rates for borrowers. Securitization has allowed banks and thrifts to originate home mortgage loans without holding the loans on their books for ten or twenty years. This has made the mortgage market much more resilient.

Securitization could prove particularly important for small businesses. Yet small business loans are not being securitized today to any appreciable extent. One reason is the absence of a suitable exemption from the Investment Company Act. Securitizations really cannot proceed under the regulatory and corporate governance requirements of the Act. In most cases, those structuring an asset securitization are able to find a suitable exemption from the Act, such as the exemption for companies holding real estate mortgages. In some cases, though, there simply is no suitable exemption from the Act.

I recognize that the Institute and some of its members would like to see many or all securitizations brought under the Act and its requirements. The Division's report takes a different approach, and recommends a broad exemption from most requirements of the Act for asset backed securities. The availability of the exemption would turn on the factors that distinguish asset-

backed trusts from traditional investment companies -- factors such as the lack of ongoing management and the presence of a high credit rating -- and not turn on whether the loans in the trust are mortgage or other loans.

International

The world in which we live, and the financial markets in particular, are becoming more international. A number of the report's chapters and recommendations address these changes. For example, one of the report's recommendations is that Section 7(d) of the Investment Company Act be amended to give the Commission the flexibility to allow foreign funds to register and sell their shares in the United States.

The report suggests that, if Congress grants the Commission this authority, the Commission should use it not only to provide U.S. investors with greater access to foreign funds but also as a "carrot" to encourage foreign countries to give U.S. funds access to their investors. The idea is not to simply open our doors unilaterally, but to work bilaterally towards agreements that open doors abroad as well as here. If, as I believe, U.S. investment companies are the best in the world, they stand to gain far more from access to foreign investors than they stand to lose from allowing foreign funds greater access to U.S. investors.

We are not only seeing more funds selling to foreign investors overseas: we are seeing more investment in domestic funds that specialize in overseas investment. There are funds that invest in many different international markets, funds that invest in markets of a single region, and funds that invest in only the stocks of a single country. The number of U.S. funds investing exclusively or largely in foreign securities has increased from about 40 funds in 1985, with total assets of about \$9 billion, to over 400 funds with total assets of about \$80 billion today.

Investing overseas has risks as well as rewards. The Taiwanese stock market lost more than half its value in dollar terms in 1990 -- in part because it had more brokerage firms than it had listed companies. The markets of Turkey and Zimbabwe lost more than half their dollar value in 1991. There can be serious problems even in more "developed" markets such as Hong Kong, which had to close down for four days during the 1987 market break to deal with problems created by an inadequate clearance and settlement system and excessive options speculation.

This is not to say that investment company groups should not organize and offer international stock funds or that investors should not invest in such funds. It is to suggest that the disclosure regarding the risks of investing abroad should be very clear, so that we do not find unsophisticated investors putting

their life savings into the stocks of a single speculative foreign market.

Conclusion

Investment companies play a crucial role in our nation's financial system. More and more, investment companies are the main intermediaries between individuals with savings and corporations that need capital. Investment companies intermediate without the deposit insurance that the other principal intermediaries, banks and thrifts, rely upon so heavily and so expensively. Investment companies intermediate by buying marketable securities, rather than by making loans. While I would not want to predict the death of the bank loan, the recent track record of the banks in the third world, in commercial real estate and elsewhere is not very impressive. Investment companies have, to date, intermediated billions of dollars with a remarkable record for safety, efficiency and performance.

If our nation is to reach its economic goals in the next fifty years, though, investment companies will need to do even more and to do it even better. The savings rate in this country needs to double to fund the investments we need to build our future. To increase the savings rate, we need to provide people attractive, safe places to put savings for both the short and long term. That is where you and your products come in, and where the protections of the Investment Company Act come in.

The Division's investment company report is not an isolated event, but rather is another step in the Commission's efforts to simplify our regulations, to simplify capital formation for small business, and generally to encourage competition and economic growth.

Wealth is not created here in Washington; it is created out there in America. It is created by investors willing to invest their savings, by mutual funds that reinvest that money safely and wisely, and by the entrepreneurs who use the money, and their own ingenuity, to make products and services. Investors, intermediaries and entrepreneurs -- these are the heroes of our economic story.

It was the entrepreneurs of our country who led the rebellion against high taxes and excessive regulation, sustained us through wars and recessions, and led the United States to the frontiers of high technology. They are the men and women who can get America moving again.

It is up to us to do everything in our power to help create a renaissance of private enterprise in our country. We need to provide new incentives to save, to invest, and to take risks, so more wealth can be created at every level of our society. We need to prune away non-essential regulations, and to repeal or

reduce the counterproductive taxes, that are holding this country back.

The Division's report is part of the Commission's effort to keep America's capital markets sharp and competitive. I look forward to hearing your views on the report and to working with you on its recommendations. Together we can and will make our investment industry ready for the challenges of the next fifty years.