Remarks Of

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"Insights into the Investment Company Act Study"

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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

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REMARKS BY SEC COMMISSIONER RICHARD ROBERTS

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OFFICE OF THE COMMISSIONER OF SECURITIES

OF THE STATE OF WISCONSIN

I wish to speak to you for a few minutes today about "change." Specifically, about how "change", some of the most dramatic consequences of which now seem to fill our headlines each day, has had profound consequences for, and is requiring significant adjustments by, a critical component of America's securities markets--namely, investment companies.

Like our world generally, the American investment company has come a long way in the over half century that has passed since Congress enacted the Investment Company Act in 1940 (the "Act"). Few could have predicted, in 1940, the outcome of the global war then just beginning in Europe. Nor could many have predicted the enormous long-term economic expansion that has followed the war in the United States and in the other industrialized democracies. And few indeed could have predicted the tremendous growth of American investment companies and the role played by the Investment Company Act of 1940.

In 1940, approximately $448 million of assets was managed by investment companies. Today, investment companies manage almost $1.5 trillion of assets. There are now more than 2700 open-end investment companies - mutual funds - and over 500 closed-end investment companies. Approximately 25% of American households have over 63 million accounts in investment companies. In addition, Americans invest in investment companies indirectly through pension funds and similar vehicles. This remarkable growth has come without relying on taxpayer subsidies.

Public confidence has been critical to the investment company industry's success. To a significant degree, that public confidence derives from the protections provided by the Investment Company Act. The Act addresses investor protection in a number of ways which, taken together, have worked well over the years.

- An investor who buys an investment company share is protected against self dealing -- the Act requires investment company sponsors to manage investment companies <u>solely</u> in the interests of their public investors and not in their own self-interest.

- An investor who buys an investment company share is protected against dishonest managers -- the Act bars wrongdoers from entering the investment company business, and the Act prohibits specifically many conflicts of interest like buying securities from sponsors or other affiliates.
- An investor who buys an investment company share is protected against misleading or inaccurate financial reporting and disclosure -- the Act requires the use of sound accounting methods, such as mark-to-market asset valuation, and investment companies must make full and accurate disclosures.
- An investor who buys an investment company share is protected against unsound financial structures -- the Act prevents investment companies from engaging in excessive leveraging.

These goals remain as important today as they have ever been, and the Securities and Exchange Commission remains committed to them.

As successful as the Act has been, however, it should be recognized that "change" requires some form of adjustment and fine tuning. Last year, Chairman Breeden requested that the Division of Investment Management conduct a thorough study of the Investment Company Act (the "Study"). The purpose of the Study was to determine whether legislative, rulemaking, and interpretive changes are necessary to assure the continuation of the high level of safety that shareholders in investment companies now enjoy, while adjusting the scope and requirements of the Act in light of the changes that have occurred in our financial markets since 1940.

It must be emphasized that the market conditions confronting our investment company industry have changed dramatically since 1980, let alone 1940, with respect to such matters as, the size and scope of the markets, their increasingly internationalized character, and the multiplication of types of investment vehicles. In terms of size alone, the number of investors with mutual fund holdings jumped by nearly 150% in the last five years and by more than 400% in the last decade.

To date, the Study has been thorough and comprehensive, and the proposals are likely to include a number of bold steps. One could anticipate recommendations concerning a number of topics, including the internationalization of the markets, the securitization of credit, private investment companies for sophisticated investors, bank-sponsored investment pools, the corporate governance structures of investment companies, disclosure and distribution activities, including investment company advertising, transactions with affiliates, and repurchases of shares by closed-end investment companies.

The recommendations will and should be aimed at maintaining a high level of investor protection, facilitating competition, and encouraging innovation in our financial markets. However, the recommendations will probably leave unchanged the fundamental safeguards which have historically been contained in the Investment

Company Act. The fact remains that many of the same types of abuses that prompted the passage of the Act in 1940 could recur today in the absence of sensible prophylactic measures.

For example, the risks of allowing insiders to deal directly with the investment companies they manage are as obvious now as they were a half century ago. Consequently, I am inclined to believe that one should be cautious in revising the provisions of the Act that deal with conflicts of interest. The staff of the Commission is, however, examining whether some regulatory streamlining is appropriate. Consideration has been given to whether some kinds of affiliated transactions that present little or no risk to investors may be permitted, perhaps subject to oversight by the fund's board of directors rather than requiring advance approval from the Commission. Further, the staff is examining whether some of the regulations can be adjusted to facilitate capital formation without compromising critical safeguards.

The Study has examined, among other things, the rigid separation between open-end and closed-end investment companies. That separation today forces some companies to elect closed-end status because they invest in markets that, for various reasons, make it impractical to pay redemption proceeds within seven days. The shares of most closed-end companies, however, tend to trade at a discount from their net asset value and thus are unattractive to many investors and difficult to market. To permit a greater variety of opportunities for investors, consideration is being given to whether it is feasible to close the gap between open-end and closed-end companies, either by creating a new type of investment company or by permitting more flexible repurchase arrangements for closed-end companies.

The overriding interest in efficient capital formation also has led to a review of whether more should be done to adjust requirements of the Securities Act that may unnecessarily inhibit informative communication by investment companies. The advertising restrictions that apply to mutual funds are especially severe because of the nature of their business. Mutual fund advertisements generally may contain only information "the substance of which" is in the statutory prospectus. Is this requirement necessary as long as the liability of fund sponsors for misleading advertisements remains unchanged? I am inclined to believe that more effective and informative communications, including advertising, will encourage competition if the communications are accompanied by adequate protections. Concerning a somewhat related topic, I am also inclined to believe that the Commission should be particularly sensitive to the flow of informative communication from the investment company to its shareholders. Presently under consideration is a rule proposal requiring management discussion and analysis of, among other things, the fund's past performance and some insight into the anticipated future.

Of course, mechanisms for private capital formation under the Investment Company Act are critical. Investment products tailored specifically for sophisticated investors may be unduly constrained by the public offering prohibition and the 100 investor limit of section 3(c)(1) -- the so-called "private investment company exception." It is easy to question whether the limits of section 3(c)(1) make sense for pooled investment vehicles owned exclusively by those sophisticated investors who can adequately safeguard their interests without detailed regulatory prescriptions. There is no limit on the <u>number</u> of investors in a Rule 144A offering, and an arbitrary limit on the <u>number</u> of sophisticated holders of an excepted fund may not be necessary.

Some of the most critical issues addressed by the Study collectively concern the "scope" of federal regulation under the Investment Company Act. Generally, this concern with the Act's scope reflects the financial innovation occurring in the market place. A key characteristic of this wave of financial innovation has been the expanded role played by pooled securities arrangements in both domestic and global financial markets. This leads to the question of which products, in this myriad of new financial products, come within the Act?

Securitized credit issues, for example, are subject to federal regulatory treatment that depends fortuitously on the type of assets being securitized. Last year, securitized credit volume constituted more than one-half of all domestic issues (both debt and equity) and almost two-thirds of all domestic corporate bond issues. This year, securitized credit volume is up again, particularly the non-mortgage market, including pools of credit-card receivables and automobile loans.

Most securitized credit offerings sold publicly in the United States rely on section 3(c)(5) of the Act to avoid regulation as investment companies. That section was included in 1940 to except factoring, discounting, and mortgage banking businesses, rather than securitized credit. The Commission also has occasionally provided exemptive relief, an example being certain mortgage-related products.

Many other securitized credit issuers, however, are unable to rely on these exceptions and must offer their securities either outside the United States or in private placements. The practical effect is a skewing of the domestic market in favor of certain types of offerings, with other offerings being precluded, even though their structure and asset credit quality may be similar. A far more consistent regulatory treatment is certainly desirable to avoid regulatory gaps and distortions. I anticipate that the Commission will attempt to craft an approach that recognizes the creative and dynamic nature of these securitized credit products.

Concern about whether the regulatory scope of the 1940 Act is appropriate, in light of modern market realities, also arises when one assesses funding vehicles for defined contribution pension plans. A significant percentage of America's financial assets are pooled in pension plans. Consideration is being given to whether there should be a more functional regulatory approach to the funding vehicles for defined contribution pension plans. The emergence of these plans, which also reflects financial innovation, gives individuals a greater say in the investment of their retirement savings and is changing the way millions of Americans provide for post-retirement benefits. Increasingly, pension plans are funded with employees' own contributions, and employees choose among a number of funding vehicles. The employees, of course, bear the risk of their choices. Of those workers covered by private pension or savings plans, some 30% have defined contribution pension plans. This number will probably increase substantially by the end of the century.

Defined contribution plan participants who make their own investment decisions generally do not have the benefit of the disclosures required under our securities laws. Because for millions of American workers these choices will be among the most important investment decisions they will make, at a minimum, plan participants should have sufficient information to make meaningful investment decisions.

Any examination into the appropriate "scope" of the Investment Company Act interfaces with currently unfolding legislative developments involving other statutes, or other types of financial institutions being gripped by "change". Everyone here is well aware that developing a more coherent regulatory scheme for the investment company industry requires us to view the "1940 Act" as but one part of an emerging, new federal regulatory framework for all financial institutions. The whole, and each of the parts, of this new regulatory framework must be logically and effectively joined together.

For example, in my view, with a combination of sound statutes and a sound regulatory structure, banking institutions should be permitted to sponsor investment companies and to compete in securities activities. It is important, however, that any entity functionally equivalent to an investment company be regulated as such to provide consistent protection to investors and to avoid investor confusion, misperception and conflicts of interest.

The importance of removing unnecessary barriers to cross-border sales of investment management services should also be recognized. No one, including our investment company industry, can afford the luxury of parochialism.

However, section 7(d) of the current Investment Company Act presents a formidable challenge to a foreign fund seeking to market its securities in the United States. Section 7(d) prohibits a foreign investment company from making a public offering of its shares in the United States unless the Commission issues an order permitting it to register. To issue an order, the Commission must find that "by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of the [Act] against such company and that the issuance of such order is otherwise consistent with the public interest and the protection of investors."

As a practical matter, most foreign investment companies are organized in countries with regulation that is substantially different from our own Investment Company Act. Thus, this standard has proved impossible to meet. One alternative is recommending to Congress that the Investment Company Act be amended to permit foreign investment companies to sell shares here if they are subject to regulation in their home country that provides substantially equivalent investor protection. At the same time, the Commission should be provided with the appropriate authority to assure that United States investment companies and their investment advisers have meaningful reciprocal access to foreign markets.

Even though the 1940 Investment Company Act remains fundamentally sound, the intervening half century of change in the investment company industry, particularly the growth explosion of the 1980s, and the anticipation of continued change in that industry, requires adjustments in the Act so that it will continue to contribute positively to our capital formation process. As I have suggested, the Commission is in the process of reexamining the Act's "scope" in light of the "change" that has occurred in our capital markets over the past 50 years. Hopefully, such reexamination or "study" will eliminate any 1940 Act-induced distortions in capital formation.