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

BEFORE THE ANNUAL MEETING OF THE
INVESTMENT COMPANY INSTITUTE

MAY 24, 1991

Once again I am delighted to address the General Membership meeting of the Investment Company Institute. After having me with you last year, your invitation this year was above and beyond the call of duty. I realize that the invitation may have been offered out of politeness. If so, it just proves the wisdom of Mark Twain's warning: "be careful what you ask for -- you may get it."

At the outset, I would like to salute David Silver on the eve of his retirement. Many of us here in Washington are "legends in our own minds." Dave is truly a "legend in his own time." To mention just one of Dave's numerous triumphs, he was one of those principally responsible for bringing money market funds to the public -- and for keeping them there in the face of attempts by competitors to legislate them out of business. Today more than 20 million account holders can thank you for helping to make it possible to have a safe and convenient market rate savings instrument.

Dave also spearheaded many other efforts that benefitted not just the mutual fund industry, but the investing public as well. Of course one of Dave's most direct contributions to the investing public came during his years as a member of the staff of the Securities and

Exchange Commission. Dave, congratulations on your outstanding career and leadership, and I know that I speak for the Commission in wishing you every success in the future.

The world has changed greatly since the Investment Company Act was enacted in 1940. In Europe, the Battle of Britain was about to begin. In Asia, Japan's military forces had conquered much of China. As we all know, the United States was still a year away from entering the terrible conflict engulfing the world. Against the backdrop of the momentous events taking place throughout the world, it is not likely that too much attention was paid to a small group of people in Washington who were crafting a piece of legislation that came to be known as the Investment Company Act of 1940.

At the time, there were only a small number of largely "closed end" funds and trusts. No one could have predicted that in the next half century the "investment company" industry would grow to include more than 3,500 investment companies with over $1.3 trillion in assets. Nonetheless, predicted or not, today one in every four United States households keeps at least a part of its savings in investment companies. Many Americans also participate in investment companies indirectly through pension funds and similar vehicles. Throughout this time, the growth of the industry has come without a single penny of taxpayer subsidies or taxpayer underwriting of risk.

Public confidence has been critical to the industry's success. In part that results from the standards that industry participants have set and maintained over the years. Public confidence is also to a significant degree derived from the protections provided by the Investment Company Act. For example:

- 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 conflicts of interest like funds buying securities from sponsors or other affiliates. Many of the worst abuses are specifically and absolutely prohibited by statute.

- 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 and their sponsors must make full and accurate disclosure.

- An investor who buys an investment company share is protected against unsound financial structures -- the Act prevents investment companies from engaging in excessive leveraging.

As successful as the Act has been in allowing for the development of widely varied and safe investment products for the public, a half-century of change in the markets has also produced many issues that were simply never contemplated when this statute was drafted. Therefore, shortly after I became Chairman, I asked the Division of Investment Management to commence a thorough "zero base" study of the Investment Company Act.

In asking for this review, my goal was, quite simply, to determine whether legislative or other changes in the Act would be beneficial. In pursuing this study, the Division was also under clear instructions to remember that vital adage that "if it ain't broke, don't fix it." Thus, we were not pursuing change for the sake of change, but rather seeking to determine where we could make a very good tool for meeting the financial needs of the public even better.

The Division's effort has been wide-ranging and detailed. While the Division's report is not yet complete, it will address a number of wide-ranging topics. These include the securitization of credit, the internationalization of the markets, private investment companies for sophisticated investors, bank-sponsored investment pools, the corporate governance structures of investment companies, transactions with affiliates, repurchases of shares of closed-end investment companies, and disclosure and distribution activities, including investment company advertising.

I would like to emphasize that the Division has not yet completed its recommendations in final form. Much discussion of their recommendations lies ahead with industry, members of the bar and Congress, and others, before those recommendations will be finalized. Much discussion among the members of the Commission will also be required. Therefore, though I cannot describe final proposals to you, I would like to highlight some of the issues that remain under active consideration.

The Investment Company Act has created a favorable climate for mutual funds and other traditional types of investment companies. However, it inadvertently creates difficult or impossible regulatory conditions for some other pooled investment products.

Securitized credit issues, for example, are subject to regulatory treatment that often varies dramatically depending on the type of assets being securitized. That is inconsistent with a fundamental tenet of “functional regulation”, under which we should try to provide the same type of protection to equivalent activities. It is worth noting that last year, securitized credit volume constituted more than one-half of all domestic issues (both debt and equity) and close to two-thirds of all domestic corporate bond issues.

Most securitized credit offerings sold publicly in the United States rely on section 3(c)(5) of the Act, a section included in 1940 to except factoring, discounting, and mortgage banking businesses. In addition, the Commission has provided exemptive relief to certain mortgage-related products and federal government loan sales programs.

Many other securitized credit issuers, however, must offer their securities either outside the United States or in private placements because they would not otherwise be excluded from the Act, but could not comply with it for a variety of business reasons (like the requirements to provide daily pricing, for example).

In practice, therefore, the coverage of the Act is not consistent across functionally-equivalent products. The practical effect is a rather capricious 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. It would be desirable to avoid unnecessary coverage of products that do not really raise the types of problems intended to be solved by the Act, while making sure that the Act does apply more consistently where there is a potential for certain types of abuses of investors.

Some 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." One can certainly question whether the limits of section 3(c)(1) make sense for pooled investment vehicles owned exclusively by sophisticated investors. The Commission does not limit the number of investors in a Rule 144A offering, and an arbitrary limit on the number of sophisticated holders of an excepted fund may not be necessary.

Another serious problem is the difficulty of selling U.S. managed funds in markets overseas. Various tax provisions are an important obstacle to such "exports" of mutual funds. In other cases, foreign laws may create significant other obstacles to marketing U.S. owned or managed funds. However, our ability to encourage other countries to remove their internal barriers against sales of U.S. mutual funds is weakened by the inability to allow comparable foreign firms to operate in the U.S.

Section 7(d) of the 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."

For foreign investment companies organized in countries with regulatory schemes substantially different from our own -- almost universally the case -- this standard has proved impossible to meet. One possible modification of the statute might permit foreign investment companies to sell shares here if they are subject to regulation in their home country that provides "substantially equivalent" investor protection. Of course change in this area should ideally be approached on an international basis, so that market access is improved for all competitors at an equivalent time.

From the taxpayer's perspective, I have long thought that it might be wise to at least consider prohibiting or limiting the ability of depository institutions to offer a federally insured instrument at an interest rate materially higher than yields on comparable Treasury securities. At the same time, to avoid consumer loss of alternatives for current yield, the depositories should be allowed to offer their customers a money market fund without either a limit on rates or deposit insurance protection. In this manner we could begin to place somewhat greater reliance on extremely safe instruments protected by the trust and other safeguards of the 1940 Act, and to reduce the exposure of the taxpayers. However, for any such approach to be even remotely attractive, banks would have to be required to follow the requirements of the 1940 Act. You can call that “functional regulation”, or simply equal regulation for equal activities.

Today, many protections provided by the securities laws are not available to participants in bank sponsored investment companies. For example, registered investment companies must provide shareholders with a current prospectus that contains comprehensive information about the funds’ performance, expenses, investment objectives, and fundamental investment policies. Common trust funds need not provide participants with any disclosure document. Investment companies are generally prohibited from participating in transactions with affiliates. Federal banking law prohibitions against self-dealing are neither as extensive nor as comprehensive as those in the Investment Company Act.

We are also considering whether any changes would be appropriate to promote a more functional regulatory approach for the funding vehicles for defined contribution pension plans. The emergence of these plans, which give individuals a greater say in the investment of their retirement savings, 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 is almost certain to 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 the securities laws. Since for millions of American workers these choices may be the most important investment decisions they will make, at a minimum, plan participants should have sufficient information to make meaningful investment decisions.

It is probably safe to assume that human nature hasn't changed very much in the past 50 years. Many of the same types of abuses that prompted the passage of the Act long ago could reoccur in the absence of sensible preventative measures.

For example, the risks of allowing insiders to deal directly with the investment companies they manage are as obvious now as they were half-a-century ago. Consequently, I would be very surprised to see any sweeping changes to the conflicts of interest requirements of the Act recommended by the Commission. At the same time, however, certain kinds of transactions, such as those between the fund and "remote affiliates," could be permitted subject to oversight by the fund's board of directors rather than requiring advance approval in every case from the Commission.

At present the Act creates a rigid separation between open-end and closed-end investment companies. This 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. To permit greater innovation, we are considering whether and how to increase the flexibility of choice that can be offered to investors rather than the two mutually-exclusive categories of open and closed end funds. One way to do this would be to create a third category of "periodically open" funds. These funds might be closed-end funds traded on an exchange that offered an opportunity to redeem at NAV once per quarter, or some other interval.

We have also reviewed whether more should be done to adjust the requirements of the Securities Act that unnecessarily inhibit informative communication by investment companies. The advertising restrictions applicable to mutual funds are especially severe. Mutual fund advertisements generally may contain only information "the substance of which" is in the statutory prospectus. We should consider steps to allow more informative communications, including advertising, as a step to encourage vigorous competition and thereby to reduce costs.

The Commission's own procedures have not escaped scrutiny. I am not satisfied with the length of time that is required for the Commission to process exemptive requests. In part, we can improve our performance through greater staffing and better management of the Division. Happily, during the past year the Division has been successful in cutting the number of pending applications by 30%.

However, part of the problem lies in having too many areas where administrative approvals are required in advance of business actions. Careful attention has to be given to areas where it may be possible to provide an exception or exemption except where the Commission takes affirmative action against a particular practice. While we must not weaken investor protection in any material respect, it is important to do more to speed consideration of applications, consistent with investor protection.

It is my hope that the final recommendations of the Division on these and other issues will be presented to me and the other Commissioners during the next 2-3 months, and that we will be able to have a wide-ranging discussion of these ideas with all interested parties. Hopefully this would leave the Commission in the position of forwarding legislation with a broad base of support to the Congress later this year.

I have great faith in the strength and creativity of the investment company industry in meeting the investment needs of customers and the financing needs of our markets. The responsibility for the continued health and well-being of the industry rests, in part, with the Commission. It also rests with you. We have benefited from your suggestions as we review and revise the laws and policies pertaining the investment company industry. If we continue to work together, the United States investment company industry should be able to look forward to another half-century of growth, innovation, and successful service to tens of millions of investors here at home. Hopefully the next half-century will also be the time that you are able to provide your products to investors in every corner of the world. If so, 50 years from now it will be time to again reconsider the Act from the perspective of updating a successful statutory framework. I will be 92, but I hope that you will consider asking me back to join you at that time for your discussions!

Thank you very much.