



UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

May 13, 1993

The Honorable John D. Dingell  
Chairman  
Committee on Energy and Commerce  
U.S. House of Representatives  
Washington, D.C. 20515-0115

Dear Chairman Dingell:

At the end of my term as Chairman, I want to bring to your attention a matter that represents one of the areas of greatest concern for the future of our capital markets and the interests of investors. This matter is the growing inadequacy of resources of the SEC for the examination and oversight of mutual funds and other investment companies. This problem is becoming more significant every day with the explosive growth of public investment in mutual funds.

At least one-quarter of all American households have used their savings and retirement dollars to purchase interests in investment companies. Over \$2.1 trillion in assets are now held in more than 77 million accounts. Net sales of equity and debt mutual funds during 1992 were over \$200 billion. However, despite this vast size and rapid growth, the SEC's current budget funds the equivalent of only 130 full-time examiners for the direct inspection of investment companies.

The investment company industry generally has a very good track record for operating in a lawful and ethical manner, especially when compared with the scandals and illegal activities that have plagued other areas of our financial markets. At least in part as a result, investors have entrusted their savings to entities that operate without deposit insurance or any other form of government subsidy or government guarantee.<sup>1</sup> Independent boards of directors, daily mark-to-market accounting and a strong industry consensus in favor of good business ethics have also helped prevent problems from occurring. Finally, the Investment Company Act of

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<sup>1</sup> Indeed, the shift of funds into investment companies has greatly benefited the U.S. taxpayer by reducing the contingent liabilities of the deposit insurance system. With mutual fund investors, not the FDIC, assume the market and credit risks of these portfolios.

1940, with very strict prohibitions against self-dealing and conflicts of interest, has also proven effective in preventing financial abuse.

It is axiomatic, however, that a law can only be as good as compliance with it. Here the examination and inspection program of the SEC is the only on-site means for oversight of fund activities. Unlike the case of broker-dealers, there are not any self-regulatory organization inspections to form the first line of detection for problems. With investment companies (as with investment advisers), the SEC inspection force is not only the first line of official oversight, it is also the last line of official oversight.

With over 3,500 investment companies as of March 1993 and 19,000 separate investment portfolios, the current level of examiners is stretched very thin. Indeed, during my tenure the number of investment companies rose by roughly 25%, and their aggregate assets rose by 77%. Though the SEC has increased its inspection resources during this time, that increase has lagged far behind industry growth. Indeed, each full-time examiner of the SEC is today theoretically responsible for inspecting over 592,000 investor accounts holding in excess of \$16 billion in assets.

To stretch examination resources, the staff has cut back on the frequency and the scope of examinations. Today every money market fund is inspected annually, along with at least one fund out of each of the 100 largest fund complexes. Those examinations only cover a portion of the fund's activities, however. In addition, many medium-sized and smaller fund complexes have not been inspected for several years. Even more disturbing is the fact that some newer fund complexes have never been inspected.

The oversight of mutual funds could easily be improved, but that will require more examiners. Especially if current rates of growth continue, the SEC should be adding 150-450 new examiners over a period of 2-3 years, not fighting to add 5 or 10 examiners each year. Indeed, under the proposed budget for FY 1994, the only way I could expand the number of fund examiners was to lay off staff in other areas. This should not be the case, because investors already pay more than enough in fees to fund a first-class inspection program.

Last year, investment companies (and indirectly their investors) paid \$80 million in fees to fund the oversight program. This amount would be enough to field roughly 1,000 examiners, if actually spent for that purpose.<sup>2</sup> However, our budget only allows

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This is greater than the number needed, but gives an idea of the magnitude of the diversion.

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the SEC to spend \$18 million on investment company oversight. The surplus is not saved for future mutual fund oversight, but rather is diverted to pay for wholly unrelated federal spending. This budgetary sleight of hand might better be known as "The Great Mutual Fund Fee Robbery."

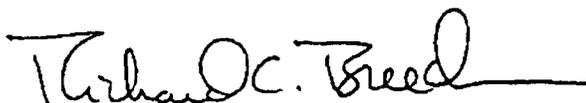
The total cost of adding 300 new fund examiners, for example, would be around \$25.6 million per year. Thus, a top-notch examination program could be fully funded without any need to increase the current fee rate, and there would still be a significant surplus in the program. In this area investors have already paid the needed fees. We just need to spend the money on the purposes for which it was collected.

This area is a prime example of the importance of establishing some form of trust fund for fees (though not for fines) collected by the SEC. Fees not spent in any year for SEC oversight programs should be saved for the future or returned to investors, not simply spent on every other government program.

The growth of the investment company industry has been spectacular, and this sector of our capital market is now one of the most important sources of financing for the U.S. economy. It has provided an efficient and safe means for investors to participate in our market, in the process providing capital for business growth without any need for government subsidy or even a single dollar of government underwriting.

The safety of this enormous pool of funds can be enhanced by improving the frequency and comprehensiveness of inspections. This would reduce the chances that illegal activity could someday result in a shock to public confidence in the integrity of funds. Public confidence in this area is very important, and we should do everything reasonable to strengthen the justification for that confidence.

Sincerely,



Richard C. Breeden  
Chairman