

MEMO# 5326

November 11, 1993

SEC CHAIRMAN, INSTITUTE AND INDUSTRY WITNESSES TESTIFY AT SENATE HEARING ON MUTUAL FUND INDUSTRY

November 11, 1993 TO: BOARD OF GOVERNORS NO. 102-93 FEDERAL LEGISLATION
COMMITTEE NO. 38-93 FEDERAL LEGISLATION MEMBERS NO. 35-93 MEMBERS - ONE PER
COMPLEX NO. 76-93 SEC RULES COMMITTEE NO. 106-93 MUTUAL FUND HEARINGS ISSUES
GROUP RE: SEC CHAIRMAN, INSTITUTE AND INDUSTRY WITNESSES TESTIFY AT SENATE
HEARING ON MUTUAL FUND INDUSTRY

On November 10, the Securities Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs held an overview hearing on the mutual fund industry. Testifying were SEC Chairman Arthur Levitt, Robert Graham, President, AIM Management Group Inc.; James Riepe, Managing Director, T. Rowe Price Associates, Inc.; and Mark Williamson, Mutual Funds Group Executive, NationsBank, and the Institute. SEC Testimony Chairman Levitt's oral testimony focused on, among other things, the results of a survey that the SEC had released that morning concerning the degree to which investors understand the risks associated with mutual funds. He stated that the survey findings were preliminary but demonstrated a misunderstanding by fund buyers through banks that money market mutual funds sold through banks are federally insured. Levitt added that the SEC and Comptroller of the Currency intend to explore this issue further to determine what can be done to ensure that investors of mutual funds sold through banks fully understand the nature of the products in which they are investing. In additional testimony, Chairman Levitt stressed the need for increased SEC resources to ensure continued, effective oversight of the mutual fund industry. He noted that the current shortfall of resources has forced the SEC to reallocate its investment management staff to inspections from other important activities, such as reviewing prospectuses, and handling exemptive, interpretive and no-action requests. Even with this reallocation, however, Chairman Levitt stated that the SEC's ability to perform thorough mutual fund inspections of all complexes on a frequent basis is still limited. To ensure that the SEC is adequately funded to effectively oversee the mutual fund industry, Chairman Levitt urged that legislation be enacted to allow the SEC to become self-funded. Chairman Levitt also stated that in addition to increased funding for the SEC, there is a need for greater self-regulation by the industry. Specifically, he stated: 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 compliance

officers with internal audit responsibilities. Finally, some form of self-regulatory organization for investment companies may be necessary. Chairman Levitt also identified several areas for possible legislative action. One area that he focused on was bank sales of mutual funds. Chairman Levitt stressed the importance of taking steps to avoid potential confusion regarding the nature of investments in funds by bank customers. He stated that an important step would be for Congress to repeal the bank exclusions from the definitions of broker and dealer under the Securities Exchange Act of 1934 to enable the SEC to regulate banks' sales of mutual funds and to subject banks to the suitability and sales practices rules applicable to broker-dealer sales of mutual funds. In addition, Chairman Levitt expressed support for (1) "The Small Business Incentive Act", which would create a new type of investment company whose securities would be owned exclusively by "qualified purchasers" and that would be exempt from the Investment Company Act, (2) the recommendation in the staff's Study on investment company regulation to increase the percentage of disinterested persons required to serve on a mutual fund's board to a majority from forty percent, (3) expanding the SEC's recordkeeping and inspection authority under the Investment Company Act and (4) the recommendation in the staff's Study for a unified fee investment company ("UFIC"). Chairman Levitt also stated that the SEC intends to work closely with the Department of Labor to ensure that investors in defined contribution employee benefit plans "receive similar information regarding an investment vehicle whether they invest in it directly or through the medium of a defined contribution plan." Finally, Chairman Levitt's testimony mentioned several regulatory initiatives that the SEC is currently considering, including improving prospectus disclosure to ensure that investors have sufficient information in an understandable format to make an informed decision. Chairman Levitt suggested that one way to achieve this would be through the use of the proposed summary prospectus. In addition, Chairman Levitt stated that SEC staff is considering (1) amendments to the rule governing tax-exempt money market funds and (2) guidelines and disclosure requirements for wrap fee programs.

Institute Testimony In its testimony, the Institute provided an overview of the mutual fund industry. As part of the overview, the Institute described the growth of the industry since the enactment of the Investment Company Act of 1940, noting that the growth has been due to both capital appreciation of portfolio securities and to new sales. The Institute testified that the factors that have contributed to new sales include: new types of products and services designed to meet new investor needs; increased investment in mutual funds by retirement plans and by institutional investors; new channels of distribution, such as banks; a shift by individuals from direct investment to investment through mutual funds; and additional purchases by existing fund shareholders. The Institute stressed, however, that "the single most critical reason for the industry's success is the high level of public confidence in the industry, which has been fostered by the strict regulatory regime to which mutual funds are subject." The Institute testified that this regulatory scheme continues to serve investors well, and that there is no need for broad legislative changes to the basic statutory scheme. Instead, legislation should be enacted to extend this successful scheme to new entrants into the fund industry. Specifically, the Institute recommended that Congress enact comprehensive legislation to accommodate bank entry into the mutual fund business, and to ensure that all fund investors receive appropriate protections under the federal securities laws. Similarly, legislation should be enacted to subject insurance company and bank pooled funds sold to participants in defined contribution plans to the Investment Company Act and the Securities Act of 1933. Most importantly, however, the Institute recommended that legislative action be taken to ensure that the SEC is provided with adequate resources to oversee the mutual fund industry in the years ahead. Specifically, the Institute expressed strong support for legislation to implement a self-funding mechanism for the SEC. The Institute also suggested several regulatory changes, including adoption of: (1) the summary prospectus proposal;

(2) amendments to the quality and diversification requirements applicable to tax-exempt money market funds, similar to those adopted for taxable money market funds; and (3) a multiple class exemptive rule. * * * Copies of the SEC's, the Institute's and the other witnesses' testimony are attached. We will keep you informed as developments occur. If you would like further information, please call the Legislative Affairs Department at (202) 955-3544. This memo can also be found on FUNDS, the Institute's Fund User Network and Delivery System, under "Legislative Affairs; Washington Update." Matthew P. Fink President Attachments (in .pdf format) 5120KB

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