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ARTHUR LEVITT, CHAIRMAN
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TELECOMMUNICATIONS AND FINANCE
COMMITTEE ON ENERGY AND COMMERCE
UNITED STATES HOUSE OF REPRESENTATIVES

BODY:

Chairman Markey and Members of the Subcommittee:

I am pleased to appear today to testify on behalf of the Securities and Exchange Commission ("Commission") concerning regulation of the investment company industry. I will address two issues the Subcommittee has requested us to consider: personal investing by portfolio managers of investment companies and the use of derivative instruments by investment companies. In addition, I will describe what I believe will be the general focus of the Commission' s regulation of the industry in the coming months.

As I am sure you are aware, the investment company industry has grown dramatically in recent years. Since 1980, investment company assets have grown at an annual rate of 23.1%, doubling every four years. Mutual funds, the most popular form of investment company, now account for 86% of the $2.4 trillion in investment company assets. In June 1994, there were 4,901 separate mutual fund portfolios, an increase of 769% from the 564 that existed at the beginning of the 1980s. During that same time period, total mutual fund assets soared from $135 billion to over $2 trillion, an increase of more than 1,445 go.

In 1993, net sales of mutual fund shares (including reinvested dividends) averaged $23 billion per month. Contrary to some predictions, fund assets have continued to grow in 1994, although at a slower rate than in 1993. During the first six months of 1994, net sales of mutual fund shares have averaged $15.1 billion per month ($6.9 billion per month from February through June). In none of those six months was there a net outflow of money from mutual funds.

Perhaps more significant than the growth in the number of funds or the assets they hold is the increasing role of mutual funds as an investment vehicle for middle-class Americans. A number of factors, including low interest rates for bank deposits and the popularity of Individual Retirement Accounts and 401 (k) plans, have caused the percentage of U.S. households that own funds to more than quadruple from 6%, or 12.1 million accounts, in 1980, to approximately 27%, or 97.7 million accounts today. Mutual funds hold more than 17% of all household discretionary assets, more than twice the figure of 10 years ago.

This type of growth would not have occurred without a high degree of investor trust in mutual funds. The fund industry has been relatively free of major scandal in recent years. The Investment Company Act of 1940 (the "Investment Company Act"), the principal federal statute under which the industry is

regulated, has to date been proven effective in preventing abusive practices that harm fund shareholders. The industry itselfalso deserves some of the credit for its generally clean record, which has generated trust by middle-class investors, and, in turn, has fueled the industry's growth.

The industry' s past record does not reduce the importance of vigilant oversight of the industry by the Commission. On the contrary, the growth of mutual funds renders the protection of fund investors all the more important, and I have made oversight of the fund industry one of the Commission's highest priorities. As the industry grows and is relied on by more and more Americans, the importance of preventing and, if necessary, punishing abusive practices grows commensurately. The Commission is committed to using both its preventive and punitive capabilities so that investors can continue to invest in mutual funds with the confidence that their trust will not be abused.

The Commission cannot properly oversee the fund industry without adequate resources to devote to the task. While the Commission's staff devoted to overseeing the fund industry has grown significantly since 1983, this growth rate is far slower than that of the industry itself. In 1983, there were $2.6 billion in assets for each staff member; today, there are $8 billion in assets per staff member.

The Commission is concerned about the issues highlighted by today's hearings 'personal investing by fund portfolio managers and the use of derivatives by funds - as each has the potential to undermine investor confidence in the industry. Investors will continue to have trust in the industry only if they can be confident that portfolio managers will not use their positions to profit in the securities markets at the expense of the funds they manage. Investors also must be assured that funds appropriately manage the risks of their investments in derivatives and adequately disclose the nature and extent of these investments and the risks associated with them.

Personal Investing by Fund Personnel

Fund managers' personal investment activities and the ethical standards maintained by the fund industry became the focus of media attention early this year. In response to an inquiry from Chairman Markey, I stated last February, and I reaffirm here today, that these issues are of the utmost importance to the Commission and that the Commission will not hesitate to take action against any fund manager or other insider who places his personal interests ahead of a fund's.

Because of my concern over possible ethical lapses in the mutual fund industry, I instructed the Commission's staff to conduct a special examination to ascertain the extent of personal investing by fund managers and to examine how closely those investments are linked to a fund's investments. From April through July of this year, the staff obtained extensive data from 30 fund groups that collectively managed over $500 billion. The staff examined the personal securities transactions of 622 fund managers employed by those 30 fund groups and compared them to the securities transactions of the 1,053 funds they managed during 1993, the year targeted by the special examination. The staff focused particularly on uncovering evidence of front-running,s which occurs when a person engages in a securities transaction ahead of a fund with the expectation that the fund's transaction will have a favorable effect on the price of those securities. The special examination servedas the basis for a comprehensive report concerning personal investments by fund insiders (the "Personal Investment Report" or "Report"), a copy of which is being provided to the Subcommittee today with my testimony.

The Report sets out the results of the staffs special examination and contains recommendations designed to improve the oversight of the personal investment activities of fund insiders and to enhance ethical standards throughout the

fund industry. The Report also analyzes the federal regulatory framework that governs personal investing by fund personnel, principally section 17(j) of the Investment Company Act and rule 17j-1 thereunder. Finally, the Report assesses the recommendations contained in a report by the Investment Company Institute' s Advisory Group on Personal Investing (the "ICI Report").I would like to highlight for the Subcommittee the most significant findings of the staff' s special examination. The vast majority of the 30 fund groups reported moderate to
infrequent investment activity by their fund managers, with few potentially abusive transactions. A small number of fund groups, however, reported extensive personal investment activity by their fund managers, including some purchases and sales of securities shortly ahead of the manager's funds. The staff currently is examining all potentially abusive transactions.
The data collected from the 30 fund groups indicated that:
The fund managers whose activities were covered by the examination generally did not invest extensively for their personal accounts. Of the fund managers whose transactions the staff examined, 75 % engaged in ten or fewer transactions, while 43.5 % did not buy or sell securities at all. The typical manager made only two personal transactions during 1993.
Potential conflict of interest situations caused by fund managers buying and selling securities ahead of their funds appear to be infrequent. The overwhelming majority of fund managers did not buy or sell securities during the ten days preceding the purchase or sale of those securities by their funds. In less than 1% of all personal transactions reported to the staff a fund manager purchased or sold securities at a better price than his fund received during the ten days following the manager's transaction. In less than 2 % of all personal transactions a fund manager received a better price than some fund in the same fund complex.
Potential conflict of interest situations caused by a fund's purchase or sale of securities already held by the fund's manager appear to be infrequent. Less than 3 · of all equity securities purchased by the funds examined were, at the time of purchase, also owned by the fund's manager. Many of these securities were issued by large capitalization companies, and therefore provide a minimal potential for conflict.
A large percentage of personal transactions generally, and of transactions that mirrored fund transactions within a short time frame, were effected by fund managers employed by four of the 30 fund groups.
.· The data collected from the 30 fund groups may overstate the extent of personal investing and the number of potentially abusive transactions in the mutual fund industry generally. Three of the four fund groups whose managers accounted for most of the personal transactions were included among the 30 fund groups examined specifically because the staff was aware, based on past inspections, that their managers traded actively for their personal accounts.
On the basis of the Personal Investment Report's findings, the Commission has concluded that the regulatory scheme governing personal investing generally has worked well, but should be improved. We intend to move forward quickly to put in place several of the Report's recommendations. We believe that these initiatives will enhance the protection of fund shareholders by (1) making available to the public additional information about fund policies on personal investment by fund personnel, (2) increasing the amount of oversight by fund boards of directors or trustees over codes of ethics and compliance matters relating to the codes, (3) making it easier for both funds and the Commission staff to monitor the personal transactions of fund personnel, and (4) extending the scope of section 17(j) and rule 17j-1 to include instruments other than securities. We believe that these initiatives, together with the industry's general acceptance of the principles

reflected in the ICI Report, will enhance ethical standards throughout the fund industry and thereby bolster investor confidence. I will now describe in more detail each of the Commission's initiatives.

First, the Commission believes that funds should be required to disclose publicly their policies regarding personal investing by their investment personnel. Recent press accounts have questioned whether fund shareholders fully understand the potential conflicts of interest presented when fund managers invest for their personal accounts and have stated that many fund groups are unwilling to make the terms of their codes of ethics available tothe public. Correspondence received by the staff indicates that some fund shareholders want information about their fund's personal investment policies.

We believe that fund shareholders have a right to know whether or to what extent their fund managers are permitted to invest for their own accounts. We therefore propose to require a fund to briefly describe its personal investing policies in its prospectus and to file its code of ethics with the Commission as part of its registration statement. These changes would make information about fund policies available to fund shareholders and also to the media, which could analyze and compare codes for use by the general public.

Second, the Commission intends to propose amendments to rule 17j-1 that would require a fund' s board of directors or trustees to review annually all codes of ethics applicable to the fund and compliance matters related to the codes. This proposal is designed to enhance the board' s oversight of fund insiders' personal investment activities. As I have stated repeatedly and reiterated just last Friday to a group of fund independent directors, fund boards have an obligation to ensure that funds are managed responsibly and ethically. Boards should be satisfied that personal investing is desirable and is not inconsistent with the interests of shareholders. If personal investing is permitted, boardsshould ensure that the fund's code of ethics contains comprehensive safeguards against abusive trading and conflicts of interest.

Third, the Commission intends to propose an amendment to rule 17j-1 that would require fund insiders to disclose their personal securities holdings at the time at which the insider is first employed by the fund or its investment adviser. Conflicts of interest can arise whenever a fund insider holds the same securities as his fund, regardless of when he acquired the securities. As currently written, rule 17j-1 does not expressly require fund insiders to report their existing personal securities holdings at the time they commence employment with a fund or an adviser. Without such information, a fund's ability to monitor overlap between the manager's personal holdings and the fund's investments is impeded. By requiring such reporting, we believe that funds will be better able to monitor potential conflicts of interest involving personal investing and reduce the potential for abusive investing by fund insiders.

Two of the Commission's other initiatives will require coordination with the National Association of Securities Dealers, Inc. CNASD"). The Commission believes that funds and their advisers will be better able to monitor the personal investment activities of fund insiders if the NASD adopts a rule requiring its member firms to notify a fund or investment adviser whenever one of the fund's insiders opens an account with the member, and upon request of the fund or adviser, to transmit duplicate copies of the insider' s trade confirmations and account statements. For a fund or adviser to monitor effectively its insiders' investment activities for conflicts of interest with the fund, each insider, as required by rule 17j-1, must report all of his securities transactions to his employer. If brokersfurnish an insider's employer with the insider's account information and trade confirmations, funds and advisers will have a means of independently verifying the information reported by their employees. The NASD has agreed that it would be useful to consider

such a rule amendment.
In addition, the Commission believes, and the NASD agrees, that it would be useful to consider prohibiting the participation by certain fund insiders in "hot issue" public offerings. Hot issues are public offerings of securities that are expected to trade at a premium in the secondary market when secondary market trading begins. Hot issues can be made available to fund insiders by broker-dealers who seek to do business with the fund, potentially interfering with the equitable distribution of the securities and creating at least an appearance of impropriety.
The ability of investment company and investment advisory personnel to purchase hot issues currently is limited somewhat by the NASD's Free-Riding and Withholding Interpretation of its Rules of Fair Practice. We recommend that the NASD consider whether the current restrictions should be replaced with an outright ban that prohibitsinvestment company and investment advisory personnel from purchasing hot issue securities from any NASD-member broker-dealer.
Finally, the Commission believes that Congress should amend section 17(j) to cover purchases and sales by fund insiders of property other than securities. The Commission's existing rulemaking authority under section 17O) to define and proscribe fraud is limited to transactions involving securities. Increasingly, funds are engaging in transactions involving instruments other than securities, such as futures and other commodities. Because the types of abusive conduct to which section 17(j) was addressed can occur with respect to these financial instruments, we are recommending that Congress amend section 17(j) to cover purchases and sales by fund insiders of property other than securities.
In developing these initiatives, the Commission considered, but decided not to pursue, two possible courses of action that have been the subject of public discussion: imposing a ban on all personal investing by fund insiders, and mandating by Commission rule that certain restrictions and procedures governing personal investing, such as those recently advocated in the ICI Report, be incorporated into every fund's code of ethics.
After careful consideration, the Commission has determined not to advocate prohibiting all personal investing. Our conclusion is based on an analysis of three related issues: the extent of abusive securities transactions by fund insiders; the potential harm to fund shareholders caused by insiders' personal investment activities; and the likelihood that a ban would curb further abusive trading by insiders.
First, the results of the special examination are consistent with the experience of the Commission's examination staff that potentially abusive transactions comprise a small percentage of all personal securities transactions by fund insiders. Second, the majority ofpersonal transactions do not create the potential conflicts of interest with fund shareholders that section 17(j) and rule 17j-1 were designed to prevent. Indeed, rather than preventing harm to fund shareholders, a ban on personal investing could hurt fund shareholders by causing talented individuals to abandon public funds and work for other money managers, such as banks, pension plans, and institutional investors, where they could continue to invest. Third, we are not convinced that a ban would necessarily curb further abusive trading by fund insiders. Such trading already is illegal. Any person who is willing to break the law to engage in front-running or other illegal trading practices probably would not be discouraged by an outright ban.
The Commission's decision not to recommend an industry-wide ban on all personal investing is not intended to indicate that it would be inappropriate for individual funds to prohibit investing by some or all of their personnel. Moreover, a fund's board of directors or trustees, in determining the appropriate restrictions to place on personal investing, shouldconsider

whether to ban all personal transactions. In particular, the board should ask fund management for an explanation of the purpose personal investing serves. Even if the board is satisfied that personal investing is not inconsistent with the interests of shareholders, the board should ensure that the fund's code of ethics contains strict safeguards, reporting requirements, and verification procedures.

The Commission also considered but rejected the idea of incorporating specific investment restrictions and procedures into a Commission rule. ConFess and the Commission consistently have acknowledged the need for flexibility in designing codes of ethics because no one set of standards is appropriate for every fund. For example, in adopting rule 17j-1 in 1980, the Commission noted that "the variety of employment and institutional arrangements utilized by different investment companies renders impracticable a rule designed to cover all conceivable possibilities. The Commission concluded that "the current approach [embodied in rule 17j-1] is more desirable [than mandating or suggesting particular standards] because it gives maximum flexability to the entities which must design the codes of ethics. A fund that invests primarily in securities of large capitalization companies traded over major exchanges, for example, may not need as many restrictions in a code of ethics as a fund that invests in thinly traded securities of smaller capitalization companies. In addition, a fund that seeks to mirror the performance of a particular index may not require the same restrictions as a fund that invests primarily in a particular industrysector or in the securities of companies located in a foreign country. We believe that the need for flexibility is even more compelling today than it was in 1980 because today there is a greater variety of fund types.

Although the Commission does not believe that we should mandate one set of standards for the entire fund industry, we believe that the code of ethics provisions recommended by the ICI advisory group are a decisive initiative addressing the conflicts of interest that result from personal investing by fund insiders. All of the recommendations in the ICI's Report should be considered by the management and board of each fund. We believe that, absent special circumstances, funds should adopt these recommendations, in whole or in substantial part, tailored as necessary to meet each fund's individual characteristics. The ICI expects that 85-90 % of the industry will revise their codes of ethics to meet the standards of conduct reflected in the ICI Report.

The Commission, in addition to moving forward with the initiatives described above, will continue to monitor whether the regulatory scheme governing personal investing by fund personnel adequately protects fund shareholders, and whether fund officers and directors are adopting strict personal investment policies and scrutinizing the personal investment activities of their employees. As part of its monitoring, the Commission will request preliminary information from the ICI within sixty days regarding the number of funds that have adopted or plan to adopt the advisory group's recommendations. The Commission will then request a final report on this topic from the ICI within the next six months. If, in light of these reports, it appears necessary or appropriate in the public interest, the Commission will propose rule amendments or recommend legislation to impose stricter and more uniform standards on the fund industry. I note that the Personal Investment Report, like section 17(j) of the Investment Company Act, addresses only those actual and potential conflicts of interest that arise when a fund insider purchases or sells securities for his personal account. The Commission is well aware, however, that there is a wide variety of unethical and potentially fraudulent practices in which fund insiders may engage. A fund manager creates a potential conflict of interest with fund shareholders, for example, when he invests fund assets in a company that employs or otherwise is associated with the manager or his family members, friends, or business

associates, even if the manager does not own the company's securities. I want to emphasize that practices by which a fund manager places his own (or a third party's) interests ahead of the fund' s interests are prohibited by the antifraud provisions of the federal securities laws.

I assure you that, through our inspection and enforcement programs, we will seek to discover and deal with severely those who engage in abusive or unethical practices, as well as any fund personnel whose investing activities place their personal interests ahead of their funds. The Commission believes that an aggressive inspection and enforcement program is the most effective deterrent to abusive trading. Inspections and enforcement actions will continue to be effective, however, only if sufficient resources are allocated to these programs.

Mutual Funds and Derivative Instruments

I will now turn my attention to another area of concern to this Committee and the Commission -- mutual funds' use of derivatives. Mutual fund investments in derivatives raise significant investor protection concerns in a number of areas -- disclosure, pricing,liquidity, leverage, and risk management. The term "derivative" may cover a wide variety of instruments, however, and public debate concerning the issues raised by mutual fund use of derivatives is often complicated by imprecision regarding the instruments that raise a particular issue. Indeed, the public debate about "derivatives" sometimes suggests that a "derivative" is any complex instrument that has caused losses. I would urge the Subcommittee, as it studies the significant issues raised by mutual fund use of derivatives, to focus on the specific instruments that raise investor protection concerns and on the specific issues raised.

A. Mutual Fund Use of Derivative Instruments

Mutual funds, other than money market funds, use derivative products for a wide variety of purposes, including hedging interest rate, currency, and other market risks: substituting for a direct investment in the underlying instrument; or increasing returns. Money market funds also invest in debt instruments sometimes referred to as derivatives that have interest rates that are adjusted periodically based on changes in market interest rates. Many non-money market funds have the authority to use derivative instruments, but our inspections to date suggest that the use of derivatives by most of these funds is limited. There are exceptions, however, to this general observation. Funds primarily investing in mortgage-backed securities, for example, generally have significant investments in derivatives. Long-term municipal bond funds use derivatives to seek increased tax- exemptreturns. In addition, funds investing internationally may use derivative investments to lessen currency risks.

A recent industry survey of non-money market funds also suggests that mutual fund use of derivatives is limited." The survey reported that the total market value of all derivatives held by participating funds was $7.5 billion, representing 2.13% of the total net assets of all funds reporting derivatives holdings and 0.78% of the total net assets of all funds participating in the survey. The survey also indicated that the level of use of derivatives varied by fund type, with fixed income funds accounting for 84 % of the total market value of all derivatives held by reporting funds."

B. Investor Protection Concerns

Although the use of derivatives by mutual funds generally appears to be limited, some funds have recently experienced problems relating to derivative investments. Several short-term government bond funds have experienced significant losses from mortgage derivatives. In addition, losses in the value of certain adjustable rate notes held by some money market funds have resulted in the funds' advisers electing to take actions, includingcontributing capital or purchasing instruments held by the funds, to prevent the funds' per share

net asset values from falling below $1.00. Although the reported problems have affected a limited number of funds and fund types, they raise investor protection issues that merit serious consideration.

Months before these reports surfaced, the Commission expressed concern about investor protection issues raised by mutual fund investments in derivatives. Since the summer of 1993, the Commission has taken a multi-faceted approach to mutual fund use of derivative instruments, focusing on a broad range of issues, including disclosure, pricing, liquidity, leverage, and risk management. A staff task force has examined the derivatives disclosures of 100 investment companies, representing a broad sample of complexes and fund types, and the Commission's fund disclosure review staff has given heightened scrutiny to derivatives disclosure in prospectuses. In addition, the Commission's inspection staff is examining and reporting on the derivatives activities of each fund inspected, and has conducted special examinations of certain funds holding significant positions in derivatives. In the coming months, we plan to take additional steps to address mutual fund use of derivative instruments.

I. Disclosure

The Commission believes it is critical that investors receive understandable disclosure about the manner in which a mutual fund uses derivatives and, in particular, the associated risks. Fund prospectuses convey a range of information to investors, including the fund's investment objectives and policies, permitted investments, and associated risks. The Commission's goal is that this information, taken together, communicate to investors a comprehensible and accurate picture of the fund's investment strategies and its risk/return profile.

In reviewing fund prospectuses, we have found that funds generally provide investors with a list and technical description of instruments, including derivatives, that are permissible fund investments. Funds often describe the purposes for using particular derivative instruments (e.g., to hedge currency risks), but typically provide only the most general information on the risk level of the fund taken as a whole or on how derivative instruments, taken as a group, modify that risk level.

To address disclosure issues, last February the Commission staff issued a letter to all registered funds, noting that in many cases fund disclosures regarding derivative instruments are unduly lengthy and technical. The letter encouraged funds to identify areas of derivatives disclosure that could be modified to enhance investor understanding of the risks associated with derivative instruments.

The Commission continues to work to improve derivatives disclosure through our review of fund prospectuses. In addition, we intend to take steps to enhance the quality of risk disclosure provided to investors. In particular, we are considering a requirement that mutual funds disclose some form of standardized, quantitative risk measure in their prospectuses. Such a measure could have significant benefits for investors by providing a means of comparing risks across and within fund types, particularly for fixed income funds whose market risks may be less well understood by investors than those associated with equity funds. The Commission intends to issue a release early next year that will seek public comment regarding whether funds should be required to disclose a quantitative risk measure and what that measure should be.

B. Pricing and Liquidity

Mutual funds must stand ready to redeem shares daily and make payment for redeemed shares within seven days after a shareholder tenders his shares.4x They must compute their share price daily based on market values of fund assets and sell and redeem fund shares at the price next computed after receipt of an order to purchase or redeem. To meet these obligations and maintain investor

confidence, mutual funds must maintain highly liquid portfolios consisting of instruments that can be valued accurately.

Some derivatives may be illiquid or difficult to price under certain market conditions. This has been the case, for example, during recent months in the market for certain collateralized mortgage obligations, where decreased liquidity has resulted in the deterioration of accurate market pricing information. The Investment Company Act and Commission rules contain significant safeguards designed to prevent problems resultng from pricing difficulties and portfolio illiquidity.

As described above, mutual funds are required to sell and redeem their shares at a price based on the current value of portfolio assets. When reliable market quotations are not readily available for a fund's assets, the fund is required to use fair values as determined in good faith by its board of directors. In addition, the Commission has published a guidelinerequiring that mutual funds generally limit their investments in illiquid assets to 15 % of net assets (10% in the case of money market funds). An asset is considered to be illiquid for these purposes if a fund cannot dispose of the asset in the ordinary course of business within seven days at approximately the value at which the fund has valued the investment. Whether a particular asset is illiquid generally must be determined under guidelines and standards established by the fund' s board of directors or trustees.

The Commission is not persuaded that legislative changes are needed at this time to address pricing and liquidity issues raised by derivatives. We intend, however, to continue to evaluate these issues in our inspections and will perform targeted examinations to obtain more information on them. If appropriate, we will consider issuing rules to address proper procedures for pricing and liquidity determinations. In addition, I have directed the staff to prepare a release for the Commission's consideration that will modify the guidelines to reduce the limit on non-money market fund illiquid holdings from 15% to 10%.

E. Leverage

The Commission is concerned by the leverage that is potentially made available to mutual funds through the use of certain derivative instruments. The potential for increased volatility from such leverage may result in significant losses to investors.

The Commission believes that one of the most effective means for addressing leverage concerns associated with mutual fund use of derivatives is improved risk disclosure along the lines discussed above. The risk/return profile of a mutual fund may be affected significantly by derivatives that introduce leverage, and the Commission believes that it is absolutely critical that fund investors understand this profile.

The Commission is also reexamining the Investment Company Act's limitations on a fund's use of leverage, which were intended in part to limit the volatility of mutual fund shares.so The Commission and its staff have applied these limitations to mutual fund investments in certain derivative instruments The leverage restrictions, however, wereoriginally designed to address a different problem, and they have proven to be a somewhat crude tool for addressing the leverage issues raised by derivatives. For this reason, we intend to issue a release that will seek public comment on appropriate regulatory and legislative solutions to address the issues raised by leverage resulting from fund use of derivatives.

F. Money Market Funds

The Commission has paid particular attention to the use of derivatives by money market funds. Money market funds form a particularly important segment of the mutual fund industry because, despite the disclaimers, individual investors

often perceive these funds as the functional equivalent of insured bank accounts. Over the past two-and-one-half years, the Commission has been looking at money market fund use of financially engineered instruments that may be able to achieve their intended results only in a favorable interest rate environment. In particular, we have been concerned that money market funds have purchased new types of adjustable rate instruments whose market values may not return topar at the time of an interest rate adjustment, with the result that fund share price stability could be threatened.

The Commission raised this issue last December in proposing amendments to rule 2a-7 under the Investment Company Act, the Commission's money market fund rule.ss Several months ago it became apparent that some funds continued to hold these types of securities. Because of an increase in interest rates, the volatility of these instruments continued to increase. In June, I raised this issue in correspondence with the chief executive officers of the 50 largest fund complexes. Later that month, the Commission staff provided money market funds and their advisers with additional guidance concerning investments in adjustable rate securities.

Adoption of the Commission's proposed rule 2a-7 amendments and the guidance that the staff and I have given should provide additional protection for money market fund investors. No rule text, however, can anticipate events that may result in a fund's net assetvaule falling below $1.00. To date, a number of sponsors or advisers of money market funds with positions in the types of adjustable rate securities identified in the Commission's December 1993 proposal have taken actions to cause the net asset values of those funds not to fall below $1.00. The Commission believes that the potential continues to exist that a sponsor or adviser of a fund holding these or other types of adjustable rate instruments that pose similar risks will be unable or unwilling to take similar actions, and that the net asset value of such a fund will fall below $1.00.

The Commission will continue to be vigilant in enforcing compliance with all provisions of rule 2a-7. In addition, we will persist in our efforts to impress upon investors that money market funds are not insured or guaranteed.

G. Commission Ability to Monitor Mutual Fund Use of Derivatives Through its inspection process, the Commission can and does monitor fund policies and portfolios, including derivatives activities. Generally, the Commission inspection staff can obtain complete information concerning the purchase and sale of portfolio instruments, detailed information concerning each portfolio instrument (including information concerning the valuation of portfolio instruments), and information relating to fund risk monitoring and fund portfolio strategies. The Investment Company Act requires funds to maintain and provide to the Commission records reflecting much of this information. Generally, funds voluntarily provide the Commission staff with additional documents and access to fund personnel to facilitate the inspection process.

The recordkeeping, reporting, and inspections provisions of the Investment Company Act, however, impose some limits on the Commission's authority to obtain informationrequired to monitor mutual funds. In practice, these limits often do not hinder the Commission's fulfillment of its responsibilities, but they may do so in some circumstances, including, for example, when a fund does not voluntarily cooperate with the Commission; when, in times of market stress, rapid access to fund information is important; when the unavailability of electronic records in a format usable by the Commission interferes with an efficient inspection; or when a fund does not maintain records that, if available, would improve Commission understanding of the fund's. operations. The Commission intends to seek legislative clarification and expansion of its existing recordkeeping, reporting, and inspections authority. I will now discuss this recommended legislation in more detail.

First, as a general matter, the Commission currently may require funds to keep records forming the basis for the preparation of financial statements. The Commission recommends amending the Investment Company Act to authorize the Commission to require funds to keep records "necessary or appropriate in the public interest or for the protection of investors." This is the same grant of recordkeeping authority that Congress has provided to the Commission with respect to broker-dealers and investment advisers. Second, the Investment Company Act's recordkeeping provisions do not specifically address the medium in which records are required to be kept. The Commission would like specific authority to require that fund records be kept in an electronic medium. The Commission recommends amending the Investment Company Act to specifically authorize the Commission to specify the medium and format in which records must be kept, including electronic media. hid, under section 31(b) of the Investment Company Act, there currently is no explicit requirement that funds provide the Commission records that are not required to bemaintained under a specific provision of the Investment Company Act or Commission rules. The recommended legislation would amend the Investment Company Act to require explicitly that funds provide the Commission with all records that are kept by a fund, whether or not required by Commission rule to be kept. Fourth, the Commission is authorized to require reporting by funds no more frequently than quarterly. The recommended legislation would amend the Investment Company Act to authorize the Commission to specify the frequency of reporting by funds. This authority would, for example, assist the Commission in its oversight of the fund industry by providing more timely access to information on fund portfolios and sales and redemption activity in limes of market stress.

The Commission's ability to monitor the fund industry is constrained not only by statutory limits on the Commission's access to relevant information, but principally by limits on the resources available to hire the necessary personnel. The increasing use of derivatives and other complex portfolio strategies has heightened the Commission's need to hire, train, and retain a highly skilled mutual fund inspection force.

H. Management and Board Responsibilities

The Commission has acted, and will continue to act, to enhance investor protection in the area of mutual fund derivative investments. In the first instance, however, responsibility for managing a mutual fund's derivative investments falls on the fund's management and board of directors.

Adequate risk management systems are critical to a mutual fund' s ability to monitor the risks associated with derivatives. Adequate management controls also are important to accurate pricing of derivative instruments, which may, on occasion, be a difficult task. The Commission staff has found, during inspections, that a number of funds appear to have strong risk management systems and other management controls in place, but we remain concerned that these funds may not be fully representative of the industry. We will continue to inspect funds' management controls and will consider rulemaking, as appropriate, to encourage better management controls.

I have urged fund directors to exercise meaningful oversight of fund derivative investments, involving themselves in portfolio strategies, risk management, disclosure and pricing issues, accounting questions, and internal controls. While the Commission's resources are sufficient to permit it to scrutinize the derivatives activities of individual mutual funds on only a periodic basis, the directors of each fund are well-positioned and obligated to protect the interests of the fund's shareholders on an ongoing basis.

Other Commission Priorities

As reflected in my testimony, the use of derivatives in portfolio management of funds and personal investing by fund insiders are issues on which the

Commission has spent and will spend considerable tune and attention. I am quite sure other questions will arise from time to time on which the Commission will need to focus. I believe it is important, though, for the Commission not only to react to issues as they arise, but also to chart a course tofollow in fulfilling our regulatory responsibilities. I want to conclude my testimony today by outlining the course we hope to follow in the coming months.

Investor Education -- Investors should be educated about fund operations and, more generally, the risks and rewards of investing. The Commission will continue to devote resources to investor research initiatives designed to allow us to better understand the needs of investors, and to develop educational materials intended to meet those needs. We also hope to initiate novel outreach programs. Such programs may include participation of Commission staff in the preparation of educational materials relating to mutual funds for employee benefit plan participants and beneficiaries, and for high school and college students.

In the area of disclosure, the Commission will accelerate its efforts to develop rules designed to present investors with clear and comprehensible information on the key elements of fund investing -- the objectives, the costs, the rewards, and the risks. The Commission also will work with the fund industry to make, on a voluntary basis, communications comprehensible and more useful to investors.

Fund Industry Responsibilities -- The Commission will continue to communicate to fund managers and fund boards of directors the need to fully understand novel investment products prior to their use, as well as the need to clearly explain the risks of these products to investors.

We will continue to work with the fund industry to ensure that good sales practices in particular, and compliance matters generally, are deemed to be essential elements of the fund business, and not simply afterthoughts. The Commission's inspection staff will be encouraged not only to uncover deficiencies in compliance with the technical rules of the Investment Company Act and the other federal securities laws, but also to work with fund managers to develop compliance systems and practices designed to better protect investors. Ethical Standards -- The Commission will continue to emphasize the need for high ethical standards in the investment management business. We will be supportive of the efforts of private groups in articulating those standards.

In working to achieve these goals, the Commission will continue to seek to identify ways in which it can serve investors, rather than simply reacting to consumer problems as they occur. We will work with the fund industry to achieve high ethical standards and better serve investors. We will consult with consumer groups in attempting to define investor needs. Finally, we will coordinate our regulatory efforts with our fellow federal and state regulators, as coordination will best serve the interests of fund consumers.

From the beginning of my tenure, I have identified improving the oversight of mutual funds as a priority for the Commission. In the coming months, we will maintain our focus on traditional investor protection issues, while also working to implement a more consumer- oriented program. This dual focus will make the Commission more responsive to the investors it serves.

The Commission will not be able to achieve these goals or fully carry out its regulatory responsibilities without adequate funding for the oversight of the fund industry. The Commission greatly appreciates the Subcommittee's efforts to obtain adequate funding for the Commission. It cannot be emphasized too strongly, however, that more resources are needed for the increasingly important task of overseeing the mutual fund industry.

Conclusion

I appreciate the opportunity to testify about these important issues affecting the investment company industry and to emphasize that investors will continue to haveconfidence in the industry only if it operates free of abuse and fraud and

its ethical standards are beyond reproach. As the Commission addresses issues regarding investment companies, we will consider carefully the views of the members of this Subcommittee and all of Congress, investors, the industry, and other interested parties. I would be happy to answer any questions you may have.
END

LANGUAGE: ENGLISH

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