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MUTUAL FUNDS AND THE INTERNATIONAL MARKETPLACE: A REGULATORY CHALLENGE*

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Good evening. It is my pleasure to be with you. It is also an honor for me to deliver the Second Annual John W. Hager Memorial Lecture. I understand that Professor Hager was a master teacher, a consummate professional, and an inspiration to his students. As a former law school professor and dean, I know that these are special qualities.

I see from the Conference agenda that you will be covering many of the cutting edge issues concerning international business. This evening, I would like to consider an area of regulatory challenge that the international marketplace presents—the regulation of mutual funds.

As a Commissioner at the Securities and Exchange Commission ("SEC"), I am responsible for protecting the interests of American investors while promoting an environment where businesses can flourish. The challenges that the SEC faces in carrying out these responsibilities will be the focus of my comments.

Over the last several decades mutual funds have taken on tremendous importance in the lives of everyday Americans. I am sure that many of you here tonight invest in funds, either directly or through your retirement plans. For many of you, mutual funds are the primary investment vehicle for saving a down payment on a home, preparing to send your children to college, and planning for retirement.

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† Commissioner, United States Securities and Exchange Commission. Commissioner Hunt wishes to acknowledge the significant contributions of Robert A. Robertson, Counselor in the Commissioner's Office, to the original speech and this article.

Let's look at the big picture. One out of every three American families invests in mutual funds—that's more than 30 million households.[1] Fund assets, at approximately $3.5 trillion,[2] exceed insured commercial bank deposits, which stand at about $3.1 trillion.[3] Americans today have more wealth invested in funds than in real estate. A few years ago this would have been unthinkable. Millions of fund investors across the country read magazines and watch television programs that are devoted to personal finance topics such as mutual funds.[4] And, billions of dollars in retirement savings are invested in mutual funds. As a matter of fact, approximately half the assets in the world's largest mutual fund—Fidelity's Magellan Fund—are comprised of investments through 401(k)-type retirement plans.[5]

As you can see, the United States mutual fund industry is as American as Tulsa barbecue and high school football. Fund groups have become household names. And some of their television ads are as memorable as ads from companies that have come to symbolize America such as IBM and Coca-Cola.

The pervasive scope of the United States fund industry has been good for Americans. We have more investment options and are now able to participate in a stock market that was once like a private club. Mutual funds have also been good for business because of the new money being invested in our capital markets.

In addition, funds have enabled Americans to invest in the international marketplace like never before. American investors now own more than $450 billion of foreign stocks; this is up from approximately $40 billion in 1985.[6]

Along with these opportunities come added challenges for regulators. From the point of view of protecting our citizens as they look for investment opportunities in the international marketplace, we have two concerns. First, when American fund groups, such as Fidelity, Vanguard, and T. Rowe Price, invest in foreign securities, those assets should be held in a safe manner and valued properly. And, whatever added risks are involved when a domestic fund invests in foreign issuers, American investors should understand those risks. Second, when foreign funds, such as those sponsored by European and Asian companies, want to sell their shares to the American public, Americans should have the same protections that come with investing in domestically sponsored mutual funds.

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1. *See The Seismic Shift in American Finance*, THE ECONOMIST, Oct. 21, 1995, at 75, 75.
2. *See* John R. Dorfman, *Review of Finance: Bigger Firms and Fatter Assets Dominate World of Money Managers*, WALL ST. J., Jan. 2, 1997, at R36.
3. *See* James R. Kraus, *Big Banks' Piece of Pie Growing at Record Rate Series: 2*, AM. BANKER, Oct. 28, 1996, at 1, 1.
4. *See* Dave Kansas, *Taking Stock: One Hundred Years Ago, Only Gamblers and Manipulators Dared Venture Into the Stock Market; It Has Been a Long, Steady Climb to the Mainstream*, WALL ST. J., May 28, 1996, at R1.
5. *See* Lauren Young, *Few Magellan Fund Investors Bail Out Despite Vinik's Move: Retirement Money Is Factor as Outflows Are Moderated in Latest Reporting Week*, WALL ST. J., June 3, 1996, at A9.
6. *See* Michael R. Sesit, *Going Global: International Investing Is Hotter Right Now Than It Has Been for a Long Time*, WALL ST. J., May 28, 1996, at R23.

Like most publicly sold securities in the United States, mutual fund shares are subject to disclosure requirements under the Securities Act of 1933.[7] To sell shares, a mutual fund must have an effective registration statement on file with the SEC, and it must deliver a prospectus to each investor.[8]

We at the SEC are engaged in an ongoing campaign to make fund prospectuses more user-friendly. In connection with this effort, the Commission recently proposed a major overhaul of the existing prospectus form.[9] We hope to make prospectuses easier for investors to use and easier for funds to prepare. The Commission has also proposed to provide investors with a "fund profile"; this would be a short document that would summarize key fund information.[10] The primary disclosure document would continue to be the prospectus.[11]

In both the fund prospectus and the summary fund profile, we hope to provide investors with better risk disclosure. You should consider the risks associated with an investment—as well as its potential return. We want to emphasize the risk of a fund's investments as a whole. This would be a shift away from today's approach of giving detailed, technical descriptions of the risks of individual securities that the fund holds, which tell an investor little about how risky a fund may be.

Good risk disclosure takes on heightened importance when a United States fund invests in foreign securities. Funds that invest in foreign securities take on risks that are not ordinarily associated with domestic investments. For instance, changes in foreign currency rates will, to the extent a portfolio is not adequately hedged, affect the value of a fund's portfolio securities. There may also be the possibility of a foreign government imposing exchange controls. In some countries, there may be the possibility of a government expropriating assets.

Moreover, there may be less publicly available information about a foreign company in comparison to an American company, and some foreign companies may not have to comply with accounting, auditing, and financial reporting requirements that are comparable to those required of United States companies. The trading volume of some foreign issues may be low. Consequently, the market for certain foreign securities may be less liquid and share prices may be more volatile.

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7. 15 U.S.C. §77a (1994).
8. *See* 15 U.S.C. §77e (1994).
9. *See* Jeffrey Taylor, *SEC Approves Plan to Overhaul Rules on Fund Disclosure*, WALL ST. J., Feb. 28, 1997, at C25.
10. *See id.*
11. *See id.*

But not all of these risks apply to all foreign securities. Through appropriate disclosure, we want investors to have a good understanding of the risks associated with the securities held by a particular fund. For example, the primary risk of a fund buying shares of a foreign issuer in developed countries, like Germany or Japan, most likely would be foreign exchange rate risk. For example, the price of a particular foreign company's stock may be increasing; but because of the value of the American dollar relative to the currency in the foreign county, an investor may lose money. On the other hand, in emerging market countries, less rigorous accounting and financial reporting practices in addition to currency exchange risks may present significant risks.

Another area of concern when a United States fund invests in foreign securities is the safe custody of the fund's portfolio securities. Fund assets must be safe and secure. We want to make sure that assets are in today's equivalent of a vault, and not behind a screen door. Generally, a bank regulated under the laws of the United States may serve as a fund custodian.

The SEC adopted a rule under the Investment Company Act of 1940[12] that permits funds to maintain their assets with certain categories of "eligible foreign custodians."[13] These include financially sound foreign banks, transnational foreign securities depositories and centralized securities depositories.[14]

The Commission has been aggressive in helping fund groups to be successful overseas. Sometimes we have to address special custody situations that are presented by certain countries. For example, Russia has a unique share registration system. Securities of Russian issuers are maintained in book-entry form by an estimated three thousand registrars located throughout Russia. In a no-action letter, the staff of the Commission stated that the Templeton Russia Fund could hold equity securities of Russian issuers with these registrars in accordance with certain procedures to safeguard fund assets.[15] These safeguards included a written agreement between the Fund's custodian and the registrar of each issue. In addition, the Fund's board would provide enhanced oversight.

12. 15 U.S.C. §80a-1 (1994).
13. 17 C.F.R. § 270.17f-5(a) (1996).
14. *See* 17 C.F.R. § 270.17f-5(c)(2) (1996).
15. *See* Templeton Russia Fund, Inc., SEC No-Action Letter, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,020 (Apr. 20, 1995).

A third compliance concern that has heightened importance in the international marketplace is the proper valuation of portfolio securities. The price of a mutual fund's shares are a direct reflection of its portfolio securities. For example, if a mutual fund held five shares of IBM stock and the stock was trading at $100 per share, the aggregate value of the fund's shares would be $500. A U.S. fund manager is required to ensure that a fund's portfolio securities, including its foreign issues, are priced correctly. In developed markets, pricing is relatively easy—the last trade price is used. However, in emerging markets, pricing gets a bit more tricky. In Pakistan, for instance, a stock trade takes six months to settle. This situation presents more of a challenge in determining the correct price at which a fund should carry the stock on its books. Should the security be carried at the sale price? Or should it reflect the possible effects of exchange rate movements six months down the road? Our objective, of course, is to ensure that portfolio shares are correctly priced so that investors receive the correct price when they buy or sell a fund's shares.

Let me shift gears for a minute and address investor protection from a different perspective—the perspective of a foreign fund that wants to sell its shares to United States investors. In this regard, the SEC believes that Americans should have the same protections that come with investing in domestically sponsored mutual funds.

The Investment Company Act prohibits a foreign fund from selling its securities in the United States in a "public offering" unless the SEC approves the transaction.[16] The Act authorizes the Commission to give this approval only if we find that it is both legally and practically feasible to enforce the provisions of the Investment Company Act against the foreign fund, and that the issuance of the order is consistent with the public interest and the protection of investors.[17] Congress has indicated this provision was intended to subject foreign funds that access the United States market to the same type and degree of regulation that applies to United States funds. The SEC has issued very few orders to permit foreign funds to publicly sell their shares here.

As a case study of the difficulties that may arise, let's consider two foreign funds that had some compliance problems reported in 1996. A Hong Kong fund, which is managed by Jardine Fleming, got into trouble with its trade allocations. Jardine Fleming is a prominent money manager based in Britain. The fund had a rogue trader who would buy portfolio securities—and wait a couple of days before he allocated them. If the trade turned out to be profitable, the trader would allocate the security to his personal account or Jardine Fleming's flagship mutual fund. If, however, the trade lost money, the trade would be allocated to another public fund.

16. *See* 15 U.S.C. §80a-7(d) (1994).
17. *See id.*

The firm's management found out about the rogue trader's activities in 1993; however, the regulators did not become aware of the problem until 1995. British and Hong Kong regulators fined the firm several million dollars, and now the firm is trying to regain its reputation by instituting a strong compliance program.

In the other case, a foreign fund got into trouble because it didn't follow its stated investment objective and it incorrectly priced its portfolio securities. This fund was sponsored by Morgan Grenfell, an old-line London merchant bank, which is owned by Germany's Deutche Bank. The fund's manager invested a high proportion of the fund's assets in a little known high-tech company whose shares were unlisted. Problems resulted because these investments were improperly valued on the fund's books, and they violated the fund's investment objective. When the investments took a dive, the fund's sponsor was left to pick up the tab.

The recent problems of Jardine Fleming and Morgan Grenfell are not unique to foreign funds. Our domestic funds have had similar problems in the past. However, what is important is that if foreign funds publicly sell securities to United States investors, the SEC must have jurisdiction to enforce the United States federal securities laws.

Foreign funds, however, may sell their shares in the United States though "private" sales. Private sales to a few select investors do not raise the same policy concerns as offerings to the general public. In 1984, the staff of the Commission issued a letter that concluded that a foreign fund could make a private offering in the United States without violating the Investment Company Act if, after the private sales, the fund's shares were held by no more than one hundred persons who reside in the United States.[18]

Congress recently amended the Investment Company Act to create another type of private investment company—one that sells its shares only to "qualified purchasers."[19] In general, a qualified purchaser is defined to be a person with at least $5 million in investments or an institution with $25 million or more in investments.[20] Last week, the Commission staff issued a letter that stated the staff's view that a foreign fund could also rely on the qualified purchaser provision in making private sales in the United States.

18. *See* Touche Remnant & Co., SEC No-Action Letter, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,810, at 79,141 (July 27, 1984).
19. 15 U.S.C.A. §80a-3(c)(7)(A) (West Supp. 1997).
20. *See* 15 U.S.C.A. §80a-2(a)(51)(A) (West Supp. 1997).

With these two limited exceptions from the jurisdiction of the Investment Company Act, you can imagine that American law has been a bone of contention with many foreign funds that would like access to the American market. Nevertheless, our citizens must be protected.

Mutual funds have presented terrific opportunities for you and me. We get professional money management at a reasonable cost. Americans have entrusted a great deal of their assets to the mutual fund industry—and the fund industry has been good for American business.

Earlier, I talked about the amount of money in funds: $3.5 trillion. Sometimes, numbers of this magnitude don't resonate unless they're put in context. Let me give some idea of how big this number is. In 1996, General Motors' net income was $4.9 billion.[21] However, the dollars in American funds was 713 times this amount. The dollars in funds are more than twice the size of the 1995 capitalization of the fifty stock markets located in emerging markets. Lastly, the cost of a new F355 Spider Ferrari is about $150,000. At this rate, the money in the fund industry is equal to 23.6 million Ferraris.[22] That's a lot of money. These numbers mean that U.S. regulators must shoulder a great deal of responsibility.

In my many years of studying the federal securities law, I have yet to see an exception to the risk/reward dynamic of investments. The international marketplace presents new opportunities, along with some additional risks. We at the SEC will do our best to keep these risks to a minimum. Thank you.

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21. *See* Robert L. Simison, *GM's Profit Tumbled in the 4th Quarter, But Its Cash Position Increased Sharply*, WALL ST. J., Jan. 29, 1997, at A3.

22. *See Ferrari Takes Advantage of Its New F355 by Building One of Its Best Convertibles Yet*, AUTOWEEK, June 19, 1995, at 19, 21.