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PERSPECTIVE

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MUTUAL FUND REGULATION: FORGING A NEW FEDERAL AND STATE PARTNERSHIP

by Matthew Fink, President
Investment Company Institute

Summary

The Institute and its members have always supported strong and effective regulation of the mutual fund industry to preserve the confidence of the investing public. Over time, however, it has become clear that the existing dual system of fund regulation, characterized by duplicative and inconsistent federal and state regulation, disserves the very investors it is designed to protect. Despite good intentions, unnecessary state regulation frustrates national policies designed to benefit fund shareholders, hinders innovative and beneficial products and services, imposes needless compliance burdens, and diverts state oversight resources away from critical consumer protection efforts.

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1401 H STREET, NW • SUITE 1200 • WASHINGTON, DC 20005 • 202/326-5800

Recent proposals for federal legislative reforms in this area[1] recognize the distinctly *national* character of today's mutual fund market, and the need to regulate it accordingly. The proposals offer an excellent opportunity to remedy the worst aspects of the current system while retaining its best features.

Specifically, Congress should enact legislation that would reserve to the federal regulators exclusive authority over mutual fund prospectuses and advertising, as well as over the structure and operations of mutual funds, including what funds can invest in. At the same time, Congress should reserve to the states the right to receive notice filings, collect fees, and exercise jurisdiction over fraud and sales practice abuses.

> ***"The fact that fund sales are national . . . makes a good case for national regulation. Some of the stories told about the current system sound like Kafka: what is a national investment company supposed to do when several states impose investment limitations that conflict with federal law—and conflict with one another?"***
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> *—Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, speaking on overlapping fund regulation in October 1995 before the North American Securities Administrators Association*

The Current Framework for Mutual Fund Regulation

Today, virtually every mutual fund sells its shares to investors in every state. The mobility of American investors, the use of new technologies to communicate with shareholders, the development of national distribution networks, and the extensive coverage of mutual funds by the media—among other factors—make the mutual fund marketplace quintessentially national in character. It is therefore appropriate that mutual funds are subject to a uniform regime of regulation imposed at the federal level.

Federal Oversight. No segment of the securities industry is more strictly regulated at the federal level than mutual funds. Funds are subject to four federal securities acts: the Securities Act of 1933, which covers the registration of fund shares, requires prospectus disclosure, and strictly regulates the contents of advertising; the Securities Exchange Act of 1934 and the regulations of the National Association of Securities Dealers, Inc., which regu-

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[1] The Capital Markets Deregulation and Liberalization Act of 1995 (H.R. 2131).

late distributors of mutual funds as brokers and dealers; the Investment Advisers Act of 1940, which provides for the registration and regulation of investment advisers to mutual funds; and the Investment Company Act of 1940, written specifically to oversee mutual funds. [2]

> ***"While there is clearly a role for states, particularly in the area of enforcement, regulators and market participants alike would benefit from a more efficient and cost-effective division of duties."***
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> *—J. Carter Beese Jr., former Commissioner, U.S. Securities and Exchange Commission, and current Vice Chairman Alex. Brown International, "Confessions of a Securities Regulator,"* Wall Street Journal, *September 19, 1995*

Unlike the other federal securities laws, designed to protect investors primarily through *disclosure*, the Investment Company Act imposes a series of detailed, *substantive* requirements and restrictions on the structure and day-to-day operations of mutual funds. Its core objectives are to: (1) ensure that investors receive adequate, accurate information about the mutual fund; (2) protect the physical integrity of the fund's assets; (3) prohibit or regulate forms of self-dealing; (4) restrict unfair and unsound capital structures; and (5) ensure fair valuation of investor purchases and redemptions.

This extensive scheme of regulation at the federal level, under the authority of the U.S. Securities and Exchange Commission (SEC), imposes a strict discipline on mutual funds, one to which other securities issuers are generally not subject. It also provides an important source of investor confidence in the integrity of the mutual fund industry.

Moreover, it should be noted that these SEC-mandated investor protections apply to *all* fund shareholders and *all* mutual funds, regardless of the state in which they are incorporated or organized, where they or their advisers are located, or where fund shareholders reside.

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[2] In addition to the federal securities laws, almost all mutual funds qualify as "regulated investment companies" under Subchapter M of the federal Internal Revenue Code to avoid the imposition of double taxation on the funds and their shareholders. Subchapter M imposes a number of substantive requirements concerning asset diversification, sources of income, and current distribution of income to fund shareholders.

Variants on State Regulation of Mutual Funds

The Investment Company Institute (ICI) has identified eighteen variants on mutual fund regulation at the state level (see the map on page 6); the result is a crazy quilt of inconsistent and conflicting regulation. For example:

- Some states exempt all mutual funds from registering their shares for sale; most do not. Of states granting exemptions, some require funds to make a filing; others do not.
- Some states exempt only *some* funds from registration. Of these, some actively review the prospectuses of those funds that do not claim the exemption; others do not.
- Of those states that do *not* grant exemptions, some actively review mutual fund prospectuses and written advertising; others do not. Some states review prospectuses but not advertising.
- Some states impose their own restrictions on mutual fund portfolio investments; most do not.

State Oversight. On top of this extensive system of federal regulation, mutual funds must also comply with the regulations of every state in which they sell shares. In contrast to federal regulation, the manner in which the individual states regulate funds varies widely state by state (see sidebar at left).

The map on page 6 illustrates the differing state standards, highlighting a pattern of regulation that varies not only across state borders, but also year by year and, not infrequently, fund by fund.

A state that has previously commented on fund prospectuses, for example, may decide to defer to SEC review of these documents. At the same time, another state *not* previously conducting its own review may suddenly elect to issue comments. Such philosophical shifts are rarely preceded by changes in states' rules and often simply reflect the approaches taken by different state regulatory personnel. Moreover, two different mutual funds, even within the same fund complex, can be treated very differently by the same state at the same time.

The Crux of the Debate

State regulatory action proves problematic in two ways: 1) substantive limitations on fund investments are inconsistent with federal standards and 2) requirements for additional rewrites, supplements, and reordering to SEC-approved fund disclosure are unnecessary and counterproductive.

> ***"The substance of state merit standards . . . is often highly questionable, since they may reflect antiquated approaches to the problems or they may depart from SEC standards without any well-articulated reason . . . ."***
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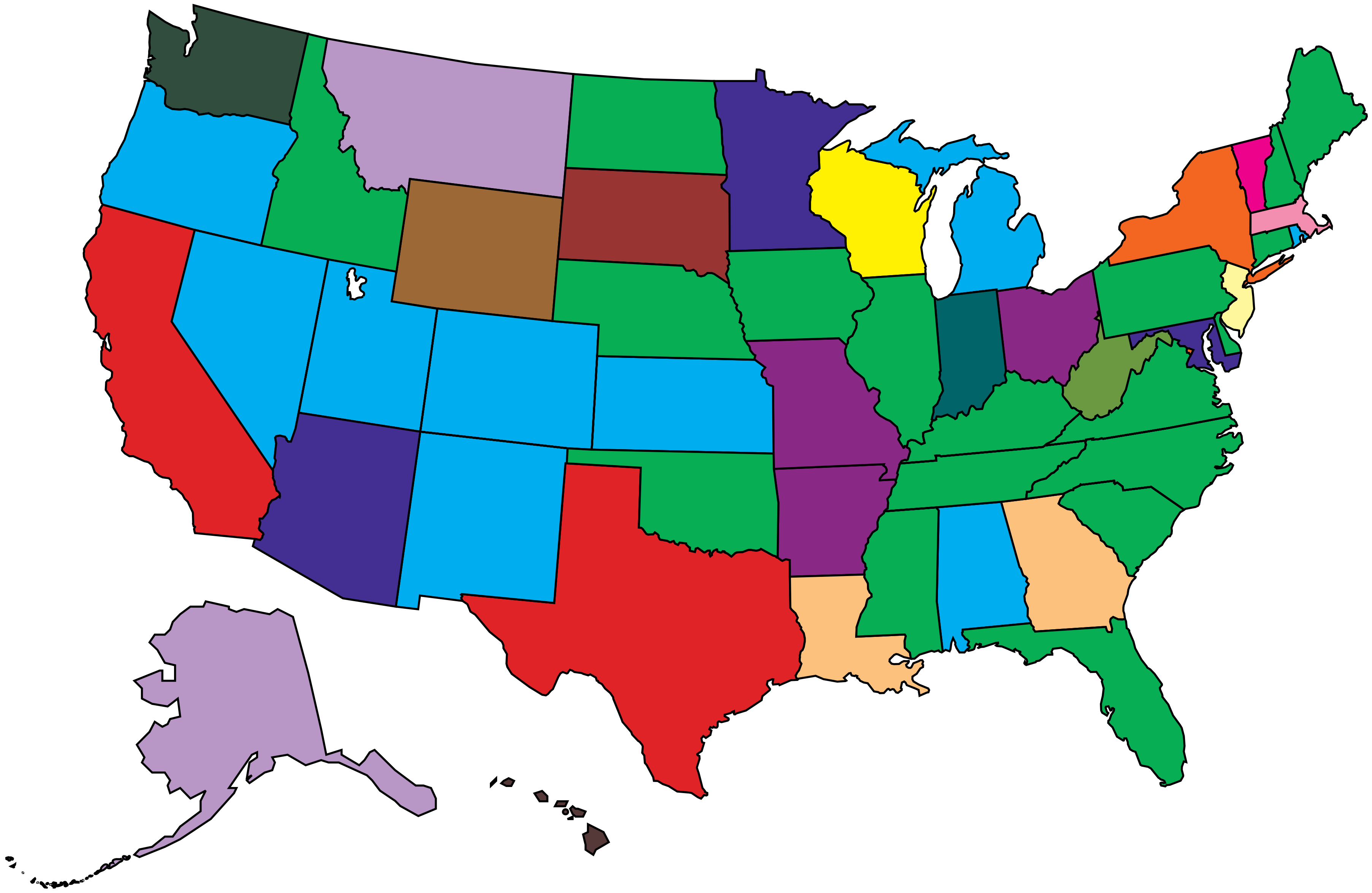
> *—Mark Sargent, Professor, University of Baltimore Law School, "Report on State Merit Regulation of Securities Offerings,"* The Business Lawyer, *Vol. 41, May 1986*

Portfolio Limitations. As noted earlier, the Investment Company Act, together with the rules and regulations promulgated by the SEC under the act, imposes detailed *substantive* standards on mutual fund operations, including limitations on certain investments and requirements for how fund investments are valued.

For example, the SEC limits a fund's investments in illiquid securities and restricts certain types of investment techniques—such as engaging in short sales and writing options. Money market funds are subject to extensive limitations on their portfolios pursuant to Rule 2a-7. Also, the rules of the Commodity Futures Trading Commission limit fund investments in certain instruments.

Despite these effective national standards, states impose unique, often contradictory, restrictions on fund management—the *essential* service provided to shareholders (see sidebar, page 8). But because funds are offered on a nationwide basis—and their portfolios must be managed identically for all shareholders regardless of where they reside—individual state-imposed restrictions dictate how the portfolio will be managed for investors in *all* states. Accordingly, if even one state insists upon restricting a portfolio manager's ability to invest in a manner consistent with federal law, *investors in all states will be adversely affected.*

The Crazy-Quilt System of State Mutual Fund Regulation



1. States with exemption for "blue-chip" investment companies
AL, CO, KS, MI, NV, NM, OR, RI, UT

2. State with the "blue-chip" exemption that comments actively on registration statements of investment companies that do not claim the exemption
NJ

3. State with the "blue-chip" exemption that comments actively on registration statements of investment companies that do not claim the exemption and imposes inconsistent substantive limitations on investment companies by rule
SD

4. State with the "blue-chip" exemption that requires filing of advertising by investment companies that do not claim the exemption but does not review advertising
WV

5. State that exempts all investment companies from registration upon the filing of a notice
WY

6. State that exempts all investment companies from registration (no notice required)
HI

7. States that do not require the registration of securities, including securities issued by investment companies
NY, DC

8. States that exempt from registration all securities registered under 1933 Act
GA, LA

9. State that requires registration of investment companies but expressly exempts investment company offerings from review
WI

10. States that require the registration of investment company offerings, but generally do not review registration statements or review them in a manner consistent with federal law and do not require filing of advertising
CT, DE, FL, ID, IL, IO, KY, ME, MS, NE, NH, NC, ND, OK, PA, SC, TN, VA

11. State that requires the registration of investment company offerings and that imposes inconsistent substantive limitations on investment companies by rule, but generally does not review registration statements or reviews them in a manner consistent with federal law
WA

12. State that requires filing of registration statements and advertising, but does not actively review registration statements or advertising
IN

13. States that require registration of investment company offerings and occasionally issue inconsistent comments, but do not require filing of advertising
AK, MT

14. States that actively review registration statements and frequently issue inconsistent comments, but do not require filing of advertising
AZ, MD, MN

15. States that actively review registration statements and frequently issue inconsistent comments and impose inconsistent substantive limitations by rule, but do not require filing of advertising
AR, MO, OH

16. State that requires filing of registration statements and advertising and actively reviews registration statements but not advertising
MA

17. States that require filing of registration statements and advertising and actively review registration statements, but not advertising, and impose inconsistent substantive limitations by rule
CA, TX

18. State that requires filing of registration statements and advertising and actively reviews registration statements and advertising
VT

At least eight states (Arkansas, California, Missouri, Ohio, South Dakota, Texas, Washington, and Wisconsin) impose substantive portfolio limitations inconsistent with federal law. Although each has been urged by the fund industry and a state regulatory umbrella group—the North American Securities Administrators Association (NASAA)—to conform to federal law, so far only one of the eight—Wisconsin—has done so. Moreover, not all limitations on fund portfolio investments are expressly provided for under state law. It is not uncommon for examiners in those states that actively review prospectuses to request, through the comment process, changes in a fund's investment program.

As one might imagine, complying with such a regulatory patchwork is not easy or inexpensive. It often requires complex and specialized compliance systems to ensure that each fund investment conforms to all applicable state limitations. More importantly, unique state restrictions can frustrate national initiatives.

For example, in 1992, the SEC issued a policy statement that not all restricted securities held by a fund would be treated as *per se* illiquid. In the three years since, every state but

Examples of State Limitations on Fund Investments

Some state limitations restrict a fund's ability to invest in various assets, including commodities, restricted securities, oil, gas or mineral programs, options and warrants, interests in real estate, and other securities. Restrictions on options and warrants include the following.

Texas prohibits a fund from investing more than 5 percent of its assets in warrants, and no more than 2 percent of this 5 percent may be invested in warrants not listed on the New York or American Stock Exchanges.

California allows a fund to invest in options only when issued by the Options Clearing Corporation, meaning that a fund may not invest in over-the-counter options or in options listed on foreign exchanges.

Arkansas allows a fund to invest up to 5 percent in options without further restriction.

South Dakota prohibits a fund from investing more than 5 percent in options, other than hedging positions or positions that are covered by cash or securities.

one has followed suit. Ohio, for almost fifteen years, has effectively overridden SEC policy. As a result, funds selling in Ohio (the sixth largest concentration of mutual fund shareholders in the nation) have been required either to conform to the unique state restriction or add a "sticker" on all prospectuses directed to Ohio residents. Such an exercise has been especially costly and administratively difficult for funds sold nationwide.

Disclosure Requirements. The key fund disclosure document, the prospectus, must be provided to every fund investor. The SEC dictates the information that must be included in a fund's prospectus, including investment objectives and policies, expenses, financial data, management information, and how to purchase and redeem shares. It also specifies the order of presentation of certain information and requires certain matters to be included on the cover page.

In addition, federal disclosure guidance recognizes the importance of presenting this information in a manner useful to investors:

> *Because investors who rely on the prospectus may not be sophisticated in legal or financial matters, care should be taken that the information in the prospectus is set forth in a clear, concise, and understandable manner. Extensive use of technical or legal terminology or complex language and the inclusion of excessive detail may make the prospectus difficult for many investors to understand and may, therefore, detract from its usefulness.* [3]

Yet despite extensive federally approved standards, approximately a dozen states *routinely* impose markedly different disclosure requirements on fund prospectuses.[4] Consequently, prospectus information must be rewritten, supplemented with additional information, rearranged, or relabeled, effectively frustrating the SEC directive to present clear, concise, and understandable prospectus information, and ignoring the thorough review by SEC staff.

The SEC requires mutual funds to organize the information in their prospectuses in a way that makes it easy for investors to understand and compare important information.

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[3] SEC Form N-1A, General Instruction G.

[4] Based on the recent experiences of ICI members, the 12 states whose examiners most frequently issue their own comments on prospectuses are Arizona, Arkansas, California, Maryland, Massachusetts, Minnesota, Missouri, New Jersey, Ohio, South Dakota, Texas, and Vermont. (New Jersey and South Dakota both exempt some funds from registration, but often comment on prospectuses of funds that do not claim the exemption.)

For example, the SEC requires that the cover page be immediately followed by the fee table, which must then be followed by condensed financial information.

> ***"A strong argument can be made that reducing [mutual fund] oversight by states will not compromise investor protection. As I see it, the investment company would be exempt from state review, but would continue to file documents with states . . . pay the same fees, [and states would] still enforce sales practice violations."***
>
> *—Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, speaking on overlapping fund regulation in October 1995 before the North American Securities Administrators Association*

Notwithstanding the SEC's requirements to ensure the prominence of certain information, state examiners frequently insist on reordering prospectus information, often resulting in overcrowded prospectus cover pages with inappropriate emphasis given to selected information.

In addition, some state comments concern the allocation of disclosure between a fund's prospectus and its statement of additional information (SAI). The SEC developed the SAI, which is available upon investor request, in 1983 to ensure that prospectuses were not needlessly encumbered with detailed information that would not prove useful for most investors.[5] Nevertheless, it is not uncommon for states to require funds to move SAI information into the prospectus.

States sometimes demand more disclosure in prospectuses and SAIs than do federal regulators. For instance, one state examiner commented that a fund intending to invest in certain real estate investment trusts must disclose that such investments could be affected by any new federal health-care regulations. Another state required a fund investing its portfolio equally among zero coupon bonds and actively managed securities to add boldfaced disclosure to its prospectus cover page informing investors that they could achieve the same investment results through other investments. Such comments make prospectuses overlong, result in the disclosure of confusing and immaterial information, and frustrate prospectus simplification efforts.

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[5] In the adopting release, the SEC stated that the information included in the SAI "does not appear to be of fundamental importance to most investors" and is intended to meet the needs of investors such as "institutional investors" and "financial analysts." *See* Investment Company Release No. 12927, Jan. 7, 1983.

Mutual fund advertising also is subject to rigorous regulation under SEC rules. In addition, most funds are required to file their advertising with the NASD, which reviews them for compliance with federal law, as well as with its own Rules of Fair Practice. (Those few funds that do not file their advertising with the NASD must file it with the SEC.) In recognition of this extensive federal regulation, most states do not require funds to file their advertising at the state level. However, six states (California, Indiana, Massachusetts, Texas, Vermont, and West Virginia[6]) require funds to file advertising, and one state (Vermont) actively reviews advertising.

Consequences to Investors

Obstructing National Regulatory Policies. The crazy-quilt state system obstructs national policies designed to benefit investors, especially those dealing with shareholder communications.

The SEC has launched several initiatives designed to enhance the readability of mutual fund prospectuses. The mutual fund industry shares this objective, and has undertaken extensive efforts to ensure that *all* shareholder communications are clear, concise, and accessible. But state intervention in the disclosure process jeopardizes the ability to achieve this objective.

> ***"It is imperative that we recognize and face up to the potential adverse effects that our dual state-federal regulatory system may have on the ability of the United States securities industry to compete internationally."***
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> *—Philip R. Lochner, former Commissioner, U.S. Securities and Exchange Commission (SEC), remarking to a joint SEC/North American Securities Administrators Association conference, April 1990*

The problem is not one of federal resources; the SEC *has* sufficient capabilities to implement effective disclosure policies in the interests of investors. What it lacks is sufficient authority. Until and unless the SEC is put squarely and exclusively in charge of fund disclosure, fund prospectuses will remain needlessly long, complex, and difficult for the average investor to decipher.

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[6] West Virginia requires only funds that do not claim the "blue-chip" exemption to file advertising.

Hindering Product and Service Innovation. Mutual funds have been leaders in providing new or improved products and services for changing investor needs during the past several decades. These services include national toll-free (800) telephone numbers; 24-hour telephone access; consolidated account statements; shareholder newsletters; shareholder cost-basis information; and investor information provided through the Internet and online computer services. State regulation, however, has made certain SEC-approved product innovations far harder to deliver to shareholders—for example, new fund structures designed to reduce shareholder expenses and achieve economies in fund management.

> ***"The states have a very strong record in attacking fraudulent practices, yet the . . . multiple filing requirements in dozens of states [are] of questionable desirability today."***
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> *—Richard Breeden, former Chairman, U.S. Securities and Exchange Commission, in a November 1990 speech at the University of Nebraska*

Today, there is serious and growing concern about potential state impediments to another innovation—the use of electronic communications. In response to growing use of personal computers among fund investors,[7] many fund groups have established Internet home pages or online service sites. The SEC has encouraged this important, fast-developing trend, issuing an official endorsement of the utilization of electronic media and setting forth national standards for such communications.[8]

The state regulatory problems endemic in the current "paper environment," however, will likely pale when applied to cyberspace. A national regulatory system is necessary to facilitate the use of new technologies and realize their potential benefits while fully protecting fund investors.

Imposing Needless Compliance Burdens. All funds are forced to bear significant additional legal and compliance costs due to state regulatory inconsistencies. In fact, many fund

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[7] A preliminary Institute survey, based on a sample of approximately 1500 randomly selected shareholders, found that more than 50 percent owned personal computers (as opposed to one third of the general population) and approximately one third subscribed to an online service.

[8] Investment Company Release Nos. 21399 and 21400, Oct. 6, 1995.

groups employ a special staff dedicated to dealing with the demands imposed by state regulators.

> ***"Years of effort by the mutual fund industry and the SEC to work with the states individually and collectively to obtain a uniform system of regulation have been unavailing. The problems are so inherent and ingrained in the current system of regulation that they can only be solved by Congress—and they should be solved now."***
>
> *—Matthew Fink, President, Investment Company Institute, testifying before the U.S. House of Representatives, December 1995.*

A modern family of mutual funds, often consisting of scores of products, can never be sure which standards will be applied to which funds by a given state at a particular time. Ohio, to cite one of many examples, has a rule prohibiting funds from investing more than 15 percent of assets in the securities "of unseasoned issuers or securities of issuers that are restricted as to disposition." When a fund wrote to the Ohio Division of Securities in 1993 asking whether the limitation was cumulative *or* allowed investments of up to 15 percent in each type of security (unseasoned-issuer *and* restricted securities), the division responded that it "does not interpret the 15 percent limitation to be cumulative." During the 1995 registration renewal process, however, the division took the opposite position, asking for a demonstrated compliance with a *cumulative* limitation.

Diverting State Resources Away from Critical Consumer Protection Efforts. A recent annual survey by NASAA identified a total of only 350 consumer complaints relating to mutual funds—nationwide—and *none* of these instances involved prospectus disclosure or advertising.[9] Most examples concerned the manner in which the funds were sold.

In a recent interview, former NASAA President John Perkins said, "States don't have large enough staffs to investigate all complaints."[10] One reason may be the unnecessary commitment of resources to the duplicative regulation of mutual fund disclosure and operations.

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[9] NASAA Investment Companies Sales Practices Committee, *Annual Survey of Investor Complaints Involving Investment Company Products*, Sept. 15, 1994.

[10] Jane Bryant Quinn, "Broker's File Can Disclose Trouble, For Now," *Cincinnati Enquirer*, Oct. 1, 1995.

The Need for Congressional Action Now

The mutual fund industry has always supported strong regulation of its practices by a vigorous and well-funded SEC. History demonstrates that an active federal authority is essential to maintaining investor confidence. State governments also play an important and complementary regulatory role in certain aspects of the securities market.

Now is the time to remedy the worst aspects of the current dual system of mutual fund regulation while preserving its best. Any enacted legislation should contain two key points.

- The regulation of prospectuses, advertising, and the structure and operations of investment companies should be delegated exclusively to the federal government[11];
- Authority to require notice filings and impose fees, and the all-important job of policing sales practices and educating investors should remain with the states.

There is strong precedent for dividing regulatory authority along these lines. In 1985, the National Conference of Commissioners on Uniform State Laws adopted a model act for state securities regulation. The model contained an exemption from state regulation for mutual funds with experienced investment advisers, but left undisturbed the states' authority to require filings, collect fees, and enforce sales practices.

Since 1985, by adopting some form of this exemption, 12 states have recognized it as an appropriate model for shared federal and state responsibility. There is every indication that investors in such states are fully protected.

> ***"We are open to a discussion as to whether or not investment companies, which truly are national offerings, ought to continue to be reviewed at the state level."***
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> *—Dee Harris, President, North American Securities Administrators Association, testifying before the U.S. House of Representatives, December 1995.*

[11] The benefits of a national marketplace have been recognized in other areas, where it has been determined that exclusive federal regulation is appropriate. For example, the Commodity Exchange Act vests the CFTC with exclusive jurisdiction over commodities transactions, but preserves the capacity of state regulators to redress fraudulent activity perpetrated in their jurisdictions. Commodity Exchange Act §§ 2(a)(1) & 6d, 7 U.S.C. §§ 2 & 13a-2(7).

In fact, investors benefit when individual state securities regulators judiciously apply resources to the areas where protection is most appropriate.

Recently NASAA indicated that it, too, recognizes that mutual funds truly are national securities offerings comparable to corporate securities traded on the major exchanges—which are exempt from state review. It is particularly noteworthy that NASAA has stated an openness to discuss federal resolution of the state review of mutual funds.

Given the critical importance of establishing uniform regulation for the benefit of fund investors, a congressional response is necessary and appropriate. A national problem requires a national solution, in the form of a new federal/state partnership.

The Institute will continue to work with the SEC, its state counterparts, leaders in Congress, and other interested groups to fashion in legislation a framework of shared regulatory authority that will serve mutual fund investors most effectively into the next century. The interests of fund shareholders and the nature of the investment company marketplace demand nothing less.

1401 H Street, NW
Suite 1200
Washington, DC 20005-2148

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