

Role of Institutional Investors in a Dynamic U.S. Capital Market

Executive Summary

The United States has the largest and most efficient capital market in the world. U.S. institutional investors have played an important role in the growth and development of the capital market by mobilizing savings and investing the funds accumulated in the money and capital markets. The growth of institutional investors as the dominant players in the U.S. capital market also has had important implications for the regulatory environment. Consequently, U.S. securities regulations recognize that sophisticated institutional investors normally require less protection than individual investors. The U.S. provides an interesting example of a well regulated capital market with a wide array of institutional investors, investment funds, and financial instruments that are available to mobilize and allocate savings in a cost-effective manner.

From 1960 to 1994, U.S. institutional investors' assets grew from US\$118 billion to US\$10,271 billion. As a percent of total securities outstanding in the U.S. capital market, institutional assets grew from less than 20% of securities outstanding in 1960 to 67% in 1994. This trend had a profound influence on the growth and development of the U.S. capital market. Moreover, the trend toward securitization and institutionalization of the savings and investment process in the U.S. has accelerated over the past several decades. This is a long-term trend that is likely to continue in the years ahead.

Private pension funds have ranked among the fastest growing institutional sectors. From

1960 to 1994, pension fund assets grew from US\$58 billion to US\$4,750 billion. After pension funds, mutual funds are the next largest U.S. institutional investor group followed by insurance companies and bank trust departments. It is expected that the importance of institutional investment in the form of private pensions and mutual funds will continue to grow in the years ahead. This is likely to occur because of the demographics of the population (i.e., a large segment of the population is age 40 to 50) and the process of securitization is likely to continue in the years ahead. Also, the current economic environment of historically low inflation and relatively stable interest rates is conducive to investment in financial assets.

The growth in private pension funds and other forms of institutional investment has been influenced by government policy actions that have encouraged institutional investment. Government tax policy has strongly favored investment (i.e., the income and gain on pension and insurance schemes is generally tax deferred until retirement or death) for retirement through private pension and life insurance variable annuity contracts. Also, regulatory policy has resulted in strong fiduciary prudential standards for institutional investors. The growth of institutional investment has also been aided by the efficiencies associated with institutional money managers controlling large pools of assets on behalf of individual investors and the growth in the securities markets relative to bank or savings deposits.

The development of the U.S. capital market is very much related to the demands placed on the market by institutional money managers. Today, institutional investors' holdings account for more than 50% of U.S. equity securities outstanding compared to 15% in 1960. With the passage of ERISA, corporate sponsors became more active managers and sought wider portfolio diversification. The passage of ERISA also led to the growth of a huge professional money

management industry. The growth in institutional money management also contributed to increased demand for better disclosure of financial information from U.S. corporations. Also, many institutional investors rely heavily on the ratings of debt instruments to make an investment decision. This has led to an expansion in the number of rating agencies in the U.S. and around the world.

The growth of institutional investors has influenced the development of the U.S. capital market in other ways. It has led to passive investment strategies such as indexing investment to a stock market index and the expansion in the market for derivative instruments. The growth of institutional investors has also made the U.S. private placement market more efficient. With the introduction of Securities and Exchange Commission (SEC) Rule 144A, there is now an active secondary market for privately placed securities among qualified institutional buyers. This has made the U.S. private placement market more competitive with the Eurobond market and foreign bond markets around the world. In recent years, pension fund managers and other institutional investors have also contributed to the expansion and diversity of the mutual fund industry by becoming significant shareholders of mutual funds. This contributed to the explosive growth in the number and size of mutual funds over the past decade in particular.

U.S. institutional investors are subject to varying forms of regulation by different regulatory bodies depending upon the type of financial institution that performs the investment management function or similar services. While investment companies are regulated by the SEC, other types of pooled investments are exempt from the definition of investment company and therefore are not required to register with the SEC. This includes individual and collective trust funds administered by commercial banks, private pension plans which are often

administered by banks or insurance companies, and insurance company separate accounts. Each are regulated by different regulators even though they are functionally similar to investment companies. Other U.S. Government agencies and state regulators involved in the regulation of institutional investors' money management activities are the U.S. Department of Labor, Federal and state bank regulatory agencies, and state insurance commissions. In addition, the SEC delegates certain regulatory responsibilities to the stock exchanges, the National Association of Securities Dealers, and other self-regulatory organizations.

In order to understand the regulatory standards applied to investment companies and other entities registered with the SEC, it is important to understand that the cornerstone of the U.S. securities regulatory framework is the disclosure of information to investors and the maintenance of strong prudential standards. The SEC does not engage in merit regulation. U.S. investors are expected to make their own informed decisions concerning the relative risks and rewards of a particular investment. Consequently, investment companies may include in their portfolios more speculative types of investments such as high-yield (so-called junk bonds) corporate bonds provided that this is disclosed to investors at the time the investment company's shares are registered. However, the investment objectives of the fund must be clearly disclosed to investors and they cannot be changed without shareholder approval.

In the U.S., the growth of institutional investment has been encouraged by a regulatory policy environment that has been conducive to the growth of the mutual fund industry and private pension plans. In particular, basic safeguards mandated by the Investment Company Act of 1940 have provided for a high degree of public confidence in mutual funds. Without a high level of public confidence, it is highly unlikely that the mutual fund industry would have

experienced continuous and rapid growth in every decade since 1940. It is noteworthy that the U.S. securities regulatory model, with suitable modifications to fit local conditions, is now being put in place in many countries around the world. Likewise, ERISA has contributed to the rapid growth of private pension plans in the U.S. by providing basic protection regarding the management and operation of private pension plans. One important benefit to the capital market is that large amounts of funds are available for investment. Yet, the decision making process with respect to such investments are highly decentralized.

The development of private pension plans to supplement Government sponsored national provident funds is being given a high priority in many emerging markets. This trend should result in greater liquidity in emerging markets and enhanced allocative efficiency. One of the problems in most emerging stock markets is that the local investors are normally relatively unsophisticated individual investors, while the institutional investment is primarily foreign in origin. Even in the dynamic Asian emerging markets, policy makers are trying to enhance the role of domestic institutional investors in both the money and capital market. In fact, the lack of an institutional investor base is often cited as a reason bond markets have generally lagged in the development of emerging equity markets.

In the industrialized countries, institutional investors have facilitated the development of bond markets by enhancing market liquidity through secondary market trading. If Colombia were to implement appropriate policies regarding the development and regulation of institutional investors, this could be expected to facilitate the further development of the money and capital market. In general, the U.S. capital markets have benefited from U.S. Government policy which has encouraged competition and innovation in the provision of financial services including

those offered by institutional money managers. This is reflected in the wide array of institutional investors and money management services that are available to U.S. investors. Certainly, such policies could be emulated in Colombia with appropriate modifications to fit local conditions.

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Role of Institutional Investors in a Dynamic U.S. Capital Market

I. Background and Introduction

The United States has the largest and most efficient capital market in the world. U.S. institutional investors have played an important role in the growth and development of that market by mobilizing savings and investing the funds accumulated in the money and capital markets. In many ways, U.S. institutional investors have also had an impact on the global capital markets as well. The growth of institutional investors as the dominant players in the U.S. capital market also has had important implications for the regulatory environment. U.S. securities regulations, for example, recognize that sophisticated institutional investors normally require less protection than individual investors (i.e., the enactment of Rule 144A). Also, the regulation of private pension plans gives recognition to the potential economic impact that a large pool of investment funds can have on the capital market. The U.S. provides an interesting example of a well regulated capital market with a wide array of institutional investors, investment funds, and financial instruments that are available to mobilize and allocate savings in a cost-effective manner.

The goal of this paper is to acquaint the reader with the salient features of the U.S. capital market and the important role of institutional investors in the market. The paper begins with a discussion of the nature of U.S. capital market instruments and the growth of institutional investors. Next, the paper examines the recent U.S. financial market environment and the structure and operation of the various segments of the capital market (i.e., corporate equity and debt securities, U.S. Government securities, and municipal securities). This is followed by a discussion of the major types of institutional investors -- investment companies (i.e., mutual funds), pension funds, bank personal trusts and insurance companies. Next, the paper looks at

the regulatory environment with particular emphasis on the role of the U.S. Securities and Exchange Commission (SEC) in the regulation of investment companies which play an important role in mobilizing the savings of small individual investors. Finally, the paper concludes with a discussion of the prospects for future growth in institutional investment and the lessons that might be learned from the U.S. experience that could be applied to the development and regulation of emerging securities markets such as Colombia.

A. Capital Markets Defined. The distinction between the money and capital markets is normally determined by the length of maturity of the instrument. The definition also can have implications regarding the regulation of securities markets and the issuers of securities. Common stock and preferred stock are capital market instruments issued in perpetuity. Common stock holders are the owners of the corporation. As such, they have the right to choose the board of directors, appoint the management of the corporation, and vote on important matters at the annual shareholders meeting. Dividend payments normally are not fixed but rather are subject to the discretion of the board of directors. Preferred stock differs from common stock in that the dividend paid to preferred stock holders are guaranteed and such dividends must be paid prior to the payment of dividends to common shareholders. Debt instruments with maturities of less than one year are normally defined to be money market instruments. Money market instruments include negotiable certificates of deposit, commercial paper and short-term government paper. Marketable debt instruments with maturities longer than one year are usually categorized as notes or bonds (i.e., capital market debt instruments) depending on the length of maturity. In the U.S., notes normally have maturities of one to seven years while bonds have longer maturities. However, in emerging markets, the vast majority of capital market debt instruments have maturities of one to five years and are usually categorized as bonds. In the

U.S., bonds are normally issued for a specified term at a fixed rate of interest. The price of the bond will vary according to changes in the market rate of interest. Consequently, the value of institutional investors portfolios will vary with the gains and losses in value of inventory positions.

Capital market instruments (i.e., securities) issued in the U.S. are generally regulated by the SEC, while money market instruments such as certificates of deposits, inter-bank loans, and commercial paper are generally exempt from registration. However, U.S. Government and municipal securities issued by state and local governments in the money and capital markets are exempt securities. Thus, they are exempt from registration requirements. In addition, exemptions from registration are available to securities issued or guaranteed by U.S. banks or certain agencies or branches of foreign banks. Although the lines of distinction are less clear today, commercial banks traditionally have played a leading role in the money market for private debt instruments while investment banks and securities firms more often have served as intermediaries in the capital market for debt and equity securities.

In the U.S., institutional investors such as private pension funds, mutual funds, and insurance companies are required to value their investment positions at market value. In fact, most institutional investors are required to invest a major portion of their assets in liquid securities. Mutual funds, for instance, must have 85% of their assets in liquid securities. Also, the fiduciary obligations of pension fund managers and other investment managers requires that funds be invested prudently. In general, this means that investments are limited to non-speculative marketable instruments. In the U.S., venture capital is normally provided by wealthy individuals or private venture capital funds with fewer than 100 investors. In the U.S., investment funds with fewer than 100 investors are exempt from the definition of investment

company.

B. Growth of Institutional Investors. U.S. institutional investors have experienced rapid growth over the past several decades. From 1960 to 1994, Institutional Investors' assets grew from US\$118 billion to US\$10,271 billion (See Table 1). As a percent of total securities outstanding in the U.S. capital market, institutional assets amounted to less than 20% of securities outstanding in 1960. This figure reached 43% in 1970, 55% in 1980 and 67% in 1994. This trend had a profound influence on the growth and development of the U.S. capital market. Moreover, the trend toward securitization and institutionalization of the savings and investment process in the U.S. has accelerated over the past several decades. This is a long-term trend that is likely to continue in the years ahead.

The explosive growth of institutional investors over the past 40 years has continued to accelerate in the 1990s. Private pension funds have ranked among the fastest growing institutional sectors. Since the 1950s, their rate of growth has been almost twice as fast as other types of institutional investors. From 1960 to 1994, pension fund assets grew from US\$58 billion to US\$4,750 billion. After pension funds, mutual funds are the next largest U.S. institutional investor group followed by insurance companies and bank trust departments. The growth in private pension funds and other forms of institutional investment has been influenced by changes in the country's demographics (i.e., the aging of the U.S. population) and government policy actions that have encouraged institutional investment. Government tax policy has strongly favored investment (i.e., the income and gain on pension and insurance schemes is generally tax deferred until retirement or death) for retirement through private pension plans and life insurance variable annuity contracts. Also, regulatory policy has resulted in strong fiduciary prudential standards for institutional investors. The growth of institutional investment

has also been aided by the efficiencies (i.e., economies of scale and portfolio diversification) associated with institutional money managers controlling large pools of assets on behalf of individual investors and the growth in the securities markets relative to other forms of holding financial assets (i.e., bank or savings deposits).

Table 1

Growth of Institutional Assets: 1950-1994

II. U.S. Financial Markets Environment

The development of the U.S. capital market is very much related to the demands placed on the market by institutional money managers. Today, institutional investors' holdings account for more than 50% of U.S. equity securities outstanding compared to 15% in 1960. The equity securities holdings of private pension plans, for instance, grew from about 15% of pension plan assets in 1950 to 67% by 1970. The investment patterns of pension plans changed in the 1970s in response to the passage of the Employee Retirement Income Security Act of 1974 (ERISA). With the passage of ERISA, corporate sponsors became more active managers and sought wider portfolio diversification. The passage of ERISA also led to the growth of a huge professional money management industry. By encouraging more professional management of private pension plans, ERISA helped stimulate the formation of in-house money management centers and outside pension consulting, recordkeeping, and analytical services offered by trust banks and others.¹ The growth in institutional money management also contributed to increased demand for better disclosure of financial information from U.S. corporations. Also, many institutional investors rely heavily on the ratings of debt instruments to make an investment decision. Moreover, this

¹ NYSE Institutional Investor Fact Book, New York Stock Exchange, January 1991, pp. 19-27.

is encouraged by the regulatory environment in which institutional investors must operate. This has led to an expansion in the number of rating agencies in the U.S. and around the world.

The growth of institutional investors has influenced the development of the U.S. capital market in other ways. It has led to passive investment strategies such as indexing investment to a stock market index and the expansion in the market for derivative instruments. In 1984, just two years after the introduction of cash settled stock index options and futures, 40 of the top 200 pension funds were already beginning to consider the use of the derivative markets to earn incremental returns for managed money. The growth of institutional investors has also made the U.S. private placement market more efficient. With the introduction of SEC Rule 144A, there is now an active secondary market for privately placed securities among qualified institutional buyers. This has made the U.S. private placement market more competitive with other financial markets around the world (i.e., the Eurobond and foreign bond markets). In recent years, pension fund managers and other institutional investors have contributed to the expansion and diversity of the mutual fund industry by becoming significant shareholders of mutual funds. This contributed to the explosive growth in the number and size of mutual funds over the past decade in particular.

The institutionalization of the savings and investment process has been a global phenomenon as witnessed by the growth in mutual funds based outside of the U.S.. Whereas the assets of U.S. mutual funds expanded by US\$1.1 trillion between 1990 and 1994, mutual funds based outside the U.S. grew by an almost equal amount (US\$1.0 trillion). As a result, it is estimated that the total assets of open-end investment companies around the world increased from US\$2.0 trillion in 1990 to US\$4.1 trillion in 1994. Many of these funds invest outside their home market, including emerging securities markets.

A. Expansion of U.S. Securities Markets. From 1960 to 1994, securities outstanding in the U.S. capital market grew from US\$830.6 billion to US\$15,310 billion. Corporate equities, the largest segment of the U.S. capital market, increased from US\$425 billion to US\$ 6,049 billion over this period. The Government securities market which has been growing quite rapidly over the past several decades due to the large Federal Government deficit is the second largest component of the U.S. capital market. The Federal government has consistently been the largest net issuer of securities. In 1960, at US\$ 243 billion, the U.S. Government securities market was about half the size of the market for corporate equity securities. Today, the value of U.S. Government securities outstanding (US\$5,642 billion) is nearly as large as equity securities outstanding. When combined with state and local government securities, the market for securities issued by the Federal, state, and local governments is larger than the equity market but still smaller than the market for all corporate debt and equity securities combined. The corporate bond market, which is much smaller than the U.S. Government bond market, also has expanded in recent years. In particular, asset backed securities which hardly existed in 1980, reached US\$253.4 billion at year-end 1994 (see Table 2 and Annex Tables 1 and 2).

Table 2

Securities Outstanding in the U.S. Capital Market: 1950 - 1994

The U.S. is not only the largest securities market in the world but it is the most innovative in terms of product diversity. It has a wide variety of pooled investment funds, a highly developed market in debt and equity securities, securitized assets in the form of mortgage backed securities, derivatives, and many other products and services. The U.S. securities markets historically have been flexible and open. Competition and innovation is encouraged by

the regulatory system governing the securities markets which is based on a system of full and fair disclosure of investment products rather than merit regulation (i.e., government administration or control over the capital formation process). Consequently, more speculative products such as high yield bonds (i.e., "junk bonds") and more speculative types of investment funds are allowed. The U.S. has influenced securities markets world-wide in product innovation and in its heavy reliance on private enterprise in mobilizing capital and in building corporate entities that have widely distributed their shares to public investors. Since the early twentieth century, U.S. corporations have gained wide investor support for private sector securities investments. As a result, the U.S. securities markets have included large public participation for many decades. In recent years, this has increasingly been in the form of indirect participation through private pension plans and mutual funds.

In the late 19th and early 20th century, individual investors were the most important force in the capital market. When the SEC was established in 1934, individuals were still the main players in the capital market. While the bond market has traditionally been an institutional market, in the late 1960s the equity market became increasingly institutional. In 1965, individual investors held 83.8% of U.S. equity securities outstanding, while institutional investors held 16.2%. By 1975, the amount of equity securities outstanding accounted for by institutional investors increased to 41.4%. In the U.S., institutional investors also tend to be far more active traders than individual investors who tend to hold shares for the longer term. In 1987, the year of the global stock market crash, the relative share of stock outstanding held by U.S. institutional investors reached 50% for the first time. Since then, the percentage of U.S. equities outstanding accounted for by institutional investors has fluctuated very little, remaining at about 50% over the past decade (See Annex Table 3).

The U.S. has encouraged the free flow of capital throughout most of its economic history. In fact, the early economic development of the U.S. was greatly aided by foreign investment. From Colonial days on, American investors have purchased securities in foreign markets. By the 1860's foreign securities were being floated in the U.S. capital market and, by 1906, it is estimated that Americans held about \$600 million in foreign securities. While the first U.S. mutual fund was established as a distinct form of financial enterprise in Boston in 1924, its origins can be traced back to late 19th century when English and Scottish investment trusts helped finance the expansion of U.S. railroads and other industries.

B. Securitization of Household Financial Assets. Over the past decade, the market value of the households sector's liquid financial assets grew from US\$4.5 trillion to US\$8.7 trillion. Over this time span, a pronounced change occurred in the relative importance of different classes of assets held by households. There was a pronounced shift away from bank deposits (including certificates of deposits) toward securitized assets. Prior to 1986, households consistently held more than 50% of their liquid financial assets in bank deposits. From the mid-1980s onward, there was a pronounced shift to marketable debt and equity securities. From 1987 to 1994, the share of household sector's liquid financial assets held in the form of bank deposits declined from 48.3% to 31.7%. Equity securities holdings became a more important share of household's liquid financial assets over this period, increasing from 26.4% in 1987 to 33.6% in 1994. While the value of bond holdings increased from US\$720 billion to US\$1.6 trillion between 1987 and 1994, the relative share of the household sector's financial assets accounted for by bonds remained largely unchanged (Table 3).

Table 3

Household Sector's Liquid Financial Assets

C. Current Economic Environment. Over the past decade, lower inflation has been accompanied by a decline in both short and long term interest rates. This, along with moderate growth in GDP and improved corporate earnings, has created an investment climate favorable to the expansion of the U.S. capital market. The decline in the U.S. inflation rate reflects a trend toward dis-inflation in the industrialized countries in recent years. With inflation at 2.3% in 1994, the industrialized nations experienced the lowest level of inflation in 30 years with the exception of 1986, which was heavily influenced by sharply falling oil prices.² In the 1990s, the U.S. inflation rate has declined each year -- from 5.4% in 1990 to 2.6% in 1994. In the past 30 years, the U.S. achieved a lower inflation rate only in 1986 (1.9%) and 1965 (1.7%). Although interest rates increased in 1994, both short and long-term interest rates have declined over the past decade. Although stock prices were flat in 1994, U.S. stock prices appreciated by more than 400% over the past decade). These trends have had a powerful influence on investors' expectations. It has produced an investment climate that is conducive to holding financial assets for the long-term (Table 4 and Annex Table 4).

Table 4

U.S. Interest Rates: 1984-1994

III. Structure of the U.S. Capital Markets

Today, the U.S. securities markets are the most developed in the world, both in absolute terms and relative to GDP. At year-end 1993, U.S. equity market capitalization amounted to US\$ 6.1 trillion compared to about US\$ 3.0 trillion in Japan, US\$ 1.1 trillion in the United

² Bank for International Settlements Annual Report: 1994 Basle, Switzerland, at page 9.

Kingdom, and US\$ 460 million in France and in Germany, respectively. At US\$ 7.3 trillion, the U.S. domestic market for Federal government and private corporate bonds was more than twice as large as Japan's (US\$ 3.4 trillion) which has the world's second largest debt securities market. The U.S. capital market is also the largest among the industrialized countries when compared to nominal GDP.

A. Securities Outstanding Relative to GDP. In recent years, the U.S. capital market has grown not only in absolute terms but also relative to the size of the U.S. economy (i.e., nominal GDP). As discussed earlier, the recent expansion of the U.S. domestic securities market has been fueled by the continued institutionalization of the savings and investment process. From 1985 to 1994, the market for debt securities expanded from US\$ 3.8 trillion to US\$9.2 trillion, while the U.S. equities market capitalization (stock exchanges, NASDAQ, and over-the-counter markets) grew from US\$2.4 trillion to US\$6.0 trillion. As a percent of nominal GDP, the aggregate value of debt securities outstanding in the U.S. increased from 95.0 % of GDP in 1985 to 137.4 % of GDP in 1994. Over this period, all segments of the U.S. debt securities markets -- corporate bonds, U.S. Government securities, and municipal securities -- displayed substantial growth. From 1985 to 1994, corporate equities outstanding as a percent of nominal GDP increased from 59.5% to 90.0% (Table 5).

Table 5

Securities Outstanding as a Percent of Nominal GDP: 1984 - 1994

The dynamic nature of the U.S. corporate securities market stems from several factors including the fact that it serves the world's largest economy where the private sector traditionally has served as the engine of economic growth. Moreover, the institutional framework and

regulatory system is conducive to securities market development with a wide array of financial instruments which serve as an alternative to bank credit as a source of long-term funding for private issuers of securities. While the separation of investment and commercial banking has generally prevailed in the underwriting and distribution of corporate securities, the regulatory framework promotes a high degree of competition in the provision of financial services with relatively easy entry into the securities business for both domestic and foreign firms. In essence, all market participants, both foreign and domestic, must comply with the same rules and regulations. While the U.S. no longer dominates the world's corporate securities market, it is still the largest market for private corporate bonds and has the broadest array of financial products available to corporate issuers and investors.

B. Corporate Equity and Bond Markets. The market for corporate securities in the U.S. is quite large and dynamic. Both the equity and corporate bond markets are the most developed in the world. In the U.S., it is not unusual to find corporate bonds with maturities of 25 to 30 years, or even longer. Corporate bonds are held mainly by institutional investors. They are especially attractive to insurance companies with a long-term time horizon. In the U.S., corporate bonds normally have the same general characteristics as government bonds. They have a fixed face value, pay interest semiannually according to a fixed coupon rate, and mature on a specified date. However, there are many variations of corporate bonds. Corporate bonds, for example, are frequently issued in the form of convertible bonds, or bonds with warrants attached that can be converted into shares of common stock of the issuer under specified circumstances at a future date.

Corporate stocks and bonds are normally distributed by underwriting syndicates. The first step in the process of issuing corporate securities involves the selection of an investment

banking firm by the issuer. The investment banking firm will make the arrangements for the underwriting and distribution of the securities in the U.S. public market or arrange for a private placement with institutional investors. For public offerings of corporate debt or equity, an agreement among underwriters is normally created prior to the filing of a registration statement with the SEC. Representatives of the underwriters can then negotiate with the issuer the terms of the offering. Normally, the final underwriting agreement is prepared immediately prior to the effectiveness of the registration statement. Bonds offerings are normally underwritten on a firm commitment basis whereby the underwriters assume the market risk. Best efforts offerings are frequently used for new issues of common stock of relatively small companies. Under a best efforts arrangement, the investment bankers agree to use their best efforts to distribute the securities with the corporate issuer assuming the market risk. No securities may be sold to the public until a registration statement filed with the SEC becomes effective. After a registered public offering has been made, issuers must also file periodic disclosure reports with the SEC. For corporate debt offerings in the U.S., shelf registrations are frequently used by seasoned issuers (i.e., issuers that have previously issued securities). With a shelf registration, the issuer may begin offering a portion of the securities at time when market conditions appear to be favorable.

The Securities Act of 1933 requires that securities that are distributed to the public, including investment company shares, must be registered with the SEC unless they are otherwise exempt from the Act (i.e., U.S. Government Securities). The principal exemption to registration available to corporate issuers is the private placement method of distribution, including the 144A offering method. The registration statement includes information on the issuer, its officers and directors, its capitalization, the purpose of the financing, the terms of the offering, income

statements and balance sheets for the issuer, and certain legal agreements. A waiting period is observed between registration and sale during which time the SEC reviews the registration statement.

The gross value of new corporate debt and equity security offering (both public offerings and private placements) grew from US\$128.6 billion in 1984 to a record US\$1,245 billion in 1993. Reflecting somewhat unfavorable market conditions (i.e., higher interest rates and flat stock prices) the volume of gross corporate securities offerings declined to US\$844 in 1994. The public market (i.e, issues registered with the SEC) is much larger than the market for private placements (See Table 6 and Annex Tables 5, 6 & 7). And the public market is growing at a much more rapid pace, driven in large part by the growth in the market for asset backed securities that barely existed a decade ago. In 1994, for the eighth consecutive year, the value of U.S. corporate debt underwriting issued in the primary market achieved a new record. From 1984 to 1993, the value of straight corporate bonds, convertible bonds, and asset backed securities increased each year from US\$69.4 billion to US\$921.1 billion before declining by about one-third in 1994. Much of the increase in the corporate sector over the past decade was due to the growth in asset backed securities that was only a very small segment of the corporate debt market a decade ago. During the 1983 to 1994 period, the value of underwritten equity offerings of common and preferred also increased dramatically, from US\$13.2 billion to \$US130.7 billion. The value of U.S. corporate equity underwriting declined to US\$77.1 billion in 1994. In terms of market value outstanding, the equities market is three times as large as the debt market in corporate securities.

Table 6

New Corporate Security Offerings: 1984-1994

Corporate stocks trade primarily on the stock exchanges and through the NASDAQ. There is also an organized over-the-counter (O-T-C) market for smaller less active issues. Corporate bonds typically list on a stock exchange but most trading occurs O-T-C which consists of a network of several dozen large dealer firms that make wholesale markets in large numbers of corporate bond issues. The National Association of Securities Dealers maintains a computerized system by which dealers may enter their bids and offers for issues in which they make a market but there is a paucity of information about the volume of corporate bond trading in the O-T-C market

C. Private Placements and Rule 144 A Offerings. Private placements which are not required to register with the SEC are normally purchased by a small number of institutional investors. They are often specially structured offerings designed to meet the needs of particular institutional investors. In general, secondary market trading in private placements is not permitted for a two year period after the securities are issued. Because the private placement market is not liquid, some institutional investors face regulatory limitations on the amount that can be invested in this market. Factors to be considered in determining whether an issue is a public offering or a private placement include the number of purchasers, the financial sophistication of the purchasers and the absence of public solicitation activities such as advertising.

In response to the growing importance of institutional investors in the private placement market and increased global competition in securities, the SEC enacted Rule 144A on April 19,

1990.³ It was intended to provide an easy avenue for a U.S. or foreign issuer to launch an international offering in both the U.S. and the Eurobond market with relative ease. Foreign issuers, including those from developing countries, can also gain access to a relatively large number of U.S. institutional investors. Rule 144A liberalized the private placement market by providing a "safe harbor" from registration for resale of securities to qualified institutional buyers ("QIBs"). QIBs are no longer required to hold such securities for a two year period before they can be sold. It allows for a secondary market in unregistered securities among QIBs was created with the adoption of the Rule. QIBs must own and manage at least US\$100 million in securities. Banks and savings and loans associations must meet an additional net worth test in order to qualify. In order to take into account the effects of deposit insurance, banks and savings and loans must have a net worth of at least US\$25 million. Broker-dealers are considered qualified if they own or manage US\$10 million in securities, or if they act as riskless principals for QIBs. Investment bankers will not likely underwrite an issue rated lower than A because the firm will be subject to 100% capital charge under the SEC's net capital rule. In effect, the security will be treated like a non-liquid asset. Securities rated at least A by two rating agencies receive a capital charge ("haircut") of only 10% under the net capital rule.

The adoption of Rule 144A made the U.S. private placement market more competitive with the U.S. dollar currency sector of the Eurobond market. In a Rule 144A offering, an investment banker purchases the securities at a fixed price in order to resale the securities at a higher fixed price to qualified institutional buyers. The Rule 144A offering method, which

³ On that date the SEC also approved the National Association of Securities Dealers PORTAL system which is a screened based system designed to facilitate secondary market trading in securities issued pursuant to Rule 144A.

resembles a firm commitment underwriting, has been used extensively by foreign issuers, including issuers from the developing Latin American nations. From 1990 to 1994, private placements of debt securities in the U.S. market by foreign issuers (including 144A offerings) grew from US\$18.7 billion to US\$34.2 billion, while over this same period equity offerings increased from US\$3.8 billion to US\$8.4 billion. Rule 144A private placements of debt securities (including offerings by foreign issuers) increased from US\$3.5 billion in 1990 (the first year of the Rule) to US\$57.3 billion in 1994. Over this five year period, Rule 144A equity offerings grew from US\$1.4 billion in 1990 to US\$8.4 billion in 1994 (Table 7).

Table 7

Rule 144A Offerings: 1990-1994

D. U.S. Government Securities Market. The U.S. Government securities market is the largest and most liquid market for debt securities in the world. It is largely an institutional market. It consists of the market for U.S. Government securities issued by the U.S. Treasury Department on behalf of the federal government and the issues of government agencies and corporations. In this market, treasury securities are issued in the form of short-term treasury bills, medium term notes, and bonds with longer maturities. The U.S. Government securities market has been able to meet the heavy borrowing requirements of the federal government and also serve the needs of the Federal Reserve in conducting open market operations. Consequently, the U.S. model for the issuance of federal government securities has been employed with increased frequency around the world. The pricing efficiency of the U.S. government securities market is critical to other financial markets as well. It provides a continuous benchmark. This benchmark is used, not only in the U.S., but world-wide, for

pricing U.S. dollar-denominated debt instruments across the maturity spectrum. The market in U.S. Government securities is a global market with continuous trading 24-hours a day.

The Secretary of the Treasury is authorized to issue treasury securities on behalf of the federal government. These securities are exempt from registration with the U.S. Securities And Exchange Commission ("SEC"). The U.S. Treasury, through the 12 Federal Reserve district banks and their respective branches, sell government securities to the public through a competitive auction process. The Federal Reserve Bank of New York, acting on behalf of the Federal Open Market committee, uses the day to day purchases and sale of government securities as an instrument of monetary policy. The auction rules are issued by the U.S. Treasury which is also responsible for compliance and enforcement.⁴ The secondary market in U.S. Government securities is considered the most liquid fixed income in the world. There are about 1,700 brokers and dealers trading in the secondary market for U.S. Government securities but 38 primary dealers account for the major share of trading volume. The secondary market is largely a whole sale market involving institutional investors such as banks, thrift institutions, pension funds, insurance companies, mutual funds and state and local governments. The brokers and dealers in U.S. Government securities are primarily commercial banks and securities firms. There are also a large number of specialized secondary market dealers in U.S. Government Securities.

Growing federal deficits fueled the expansion of the U.S. Government securities market. As a result, the U.S. Department of Treasury is the single most important issuer of debt

⁴ For a comprehensive discussion of markets in U.S. Government securities, see: Joint Report on the Government Securities Market, Department of the Treasury, Securities and Exchange Commission, and the Board of Governors of the Federal Reserve System, U.S. Government Printing Office, Washington, D.C., January 1992.

securities in the world. With large federal deficits each year, the outstanding federal debt grew from US\$2.2 trillion in 1985 to US\$5.6 trillion in 1994. As a percent of nominal GDP, outstanding federal government debt securities increased from 50.0% in 1984 to 83.7% in 1994. In each of the past ten years, the value of treasury securities outstanding has been growing at a faster rate than nominal GDP. Likewise, corporate debt outstanding has also expanded more rapidly than GDP in each of the past ten years. Taking account of municipal bonds issued by state and local governments, total government debt in the U.S. -- federal, state and local -- is now larger than nominal GDP.

The current regulatory structure for brokers and dealers in U.S. Government securities is relatively new.⁵ Major gaps in the regulation of brokers and dealers in U.S. government securities existed prior to the passage of the Government Securities Act of 1986 (GSA).⁶ Although broker-dealers and banks were subject to regulation under the Securities Exchange Act of 1934 and the banking laws, respectively, there were a large number of dealers in U.S. Government securities, including several primary dealers, that were neither broker-dealers as

⁵ In the early 1980s, U.S. institutional investors experienced problems in their dealings with unregulated government securities dealers. The failure of several unregulated government securities dealers between 1975 and 1985 resulted in losses to investors that had engaged in repurchase agreement transactions with the unregulated dealers. In addition to the demise of several savings and loan institutions, a number of other savings and loan institutions, municipalities, and school boards incurred substantial financial losses. It is estimated that between 1982 and 1986, U.S. investors lost about US\$ 900 million due to the failure of unregulated government securities dealers. All of the firms that failed were outside the federal regulatory structure.

⁶ The Government Securities Act of 1986, Report of the Committee on Banking, Housing, and Urban Affairs, United States Senate, to accompany S. 1416, 99 Congress, 2nd Session, Senate Report 99-426, Washington, D.C., September 3, 1986; Government Securities Act of 1985, House of Representatives Report, 99-258, 99th Congress, 1st Session, Washington, D.C., September 9, 1985; and The Government Securities Act of 1986: A Historical Perspective, Thomas J. Lykos, Jr., Practising Law Institute (J. Eugene Marans and Robert C. Pozen, Co-Chairman), New York, 1987, pp. 223-298.

defined in the Securities Exchange Act of 1934, or banks, as defined under U.S. banking law. Consequently, they were largely unregulated at the federal level because they were not required to register with any regulatory agency as a result of their activities.⁷ As a result, the Government Securities Act (GSA) was enacted in 1986. The GSA, enabled the U.S. Treasury to issue regulations for the protection of investors including capital standards, record-keeping, reporting, and auditing of government securities brokers and dealers.⁸

E. State and Local Government Bonds. State and municipal securities are issued by state and local governments and their agencies. Municipal bonds are generally issued to finance capital improvements such as roads, bridges, hospitals and educational facilities. Since, 1983, municipal securities have been issued only in registered form. Short-term instruments are also issued by state and local governments to finance operating budgets since municipal governments often rely on tax revenue that is seasonal. However, most municipal securities are long-term in nature.

Investors are primarily interested in municipal securities for their tax advantages. Interest income on municipal bonds is generally exempt from federal income taxes and from local taxes

⁷ Prior to the passage of the GSA, the lack of regulation resulted from the classification of "government securities" as exempt securities defined in Section 3(a)(12) of the Securities Exchange Act of 1934. Although the vast majority of government securities dealers were subject to some form of regulation, brokers and dealers that executed transactions exclusively in U.S. Government securities were not subject to supervision by any regulatory agency.

⁸ In drafting regulations, the U.S. Treasury was required by the GSA to consult with the SEC and the Federal Reserve Board. Enforcement authority for these rules rests with the SEC and the self-regulatory organizations or with the appropriate financial institution regulatory agency. See: U.S. Government Securities: More Transaction Information and Investor Protection Measures Are Needed, U.S. General Accounting Office Report to Congressional Committees, Washington, D.C., September 1990 and Study of the Effectiveness of the Implementation of the Government Securities Act of 1986, Prepared by the Department of the Treasury, Securities and Exchange Commission, Board of Governors of the Federal Reserve System, Washington, D.C., October 1990.

for the localities issuing the securities. Consequently, municipal bonds are favored by investors with high marginal tax brackets.⁹ In recent years, households, commercial banks, and insurance companies have been the principal holders of municipal bonds. Household participation in the municipal securities market has increased over the past decade, taking into account indirect holdings in the form of mutual funds and bank personal trust accounts. Bond funds and tax-exempt unit investment trusts are widely held by retail investors. Since the passage of the Tax Reform Act of 1986, commercial banks' interest in municipal securities has diminished. The Act prohibited financial institutions from deducting the amount of interest attributable to purchasing or carrying municipal securities. The purchases of municipal securities by property and casualty insurance companies are a function of their underwriting profits and investment income. Life insurance companies and pension funds hold few municipal securities since they do not benefit appreciably from the tax benefits of municipal securities. The value of municipal bonds displayed considerable growth over the past decade, increasing from US\$95.1 billion in 1984 to US\$161.9 billion in 1994 (See Annex Tables 8 & 9).

There are two basic types of municipal bonds: general obligation bonds and revenue bonds.¹⁰ At US\$195.6, revenue bonds accounted for two-thirds of the total value of municipal

⁹ The basis for tax exemption can be traced back to a landmark 1895 Supreme Court decision ruling that the interest on municipal securities was not subject to federal income taxation since this would burden state governments and interfere with their power to borrow money. More recently, however, the tax exempt status of municipal securities has been weakened by more recent court decisions. While the Tax Reform Act of 1986 continued the basic tax exemption for interest on municipal securities, it contained a number of provisions limiting the types of municipal securities that are eligible for federal tax exemption. See: Fundamentals of Municipal Bonds (Fourth Edition), Public Securities Association, Washington, D.C., 1990.

¹⁰ General obligation bonds are secured by the issuer's general taxing power. They are issued primarily by states, counties, cities, and school districts. Some general obligation bonds are secured not only by the issuer's general taxing power, but also by additional revenues from certain fees, grants or special charges. Revenue bonds are issued to finance projects that

bonds issued in 1993 compared to about four-fifths in 1983. This drop in the relative share of revenue bonds was due at least in part to the passage of the Tax Reform Act of 1986 that changed the tax status of certain type of revenue bonds. Today, the vast majority of municipal bonds are negotiated bond offerings rather than by competitive bid where the issuer receives a sealed bids from bond dealers. The dealer, or the syndicate that offers the lowest interest cost will be selected to underwrite the bonds. Negotiated offerings, on the other hand, involve the issuer choosing the dealer or syndicate ahead of time who are able to work with the issuer in structuring the offering to ensure the lowest possible cost of financing.¹¹

Issuers of municipal securities are required to file an official statement (i.e., prospectus). The official statement is not subject to any government review, but a copy must be filed with the Municipal Securities Rule-making Board (MSRB) and a copy must be distributed to potential investors. Municipal bonds must have legal opinions rendered by bond attorneys from recognized firms in municipal law. In rendering a legal opinion, the bond counsel determines if the issuer is legally able to issue the bonds, has prepared the bond sale properly and the security safeguards provided bondholders are actually supported in law and regulations. The legal opinions and document reviews are important to the bondholders in the event that they have to secure their rights in court.

In a public offering, the issue is generally underwritten by investment banks or the municipal bond departments of commercial banks. The firm conducting the underwriting

generate a cash flow (i.e, airports, toll-roads, universities, hospitals etc.). They are not backed by the taxing ability of the issuer.

¹¹ Overview of the Public Securities Market, Part 4, Public Securities Association, Washington, D.C., 1994.

becomes responsible for the distribution of the issue and accepts the risk that investors' demand may not be sufficient to buy the entire issue at the offering price. Public offerings can be made by either competitive bidding or direct negotiations with underwriters. If competitive bidding is used, the issue is awarded to the lowest bidder. Credit ratings are considered essential for large issues, but smaller issues are frequently unrated. Bond insurance is available whereby an insurance company will pay the principal or interest in the event that the issuer does not meet its obligations to bondholders. The secondary market for municipal securities is large; however, most issues trade only infrequently. Municipal bond dealers are usually associated with a large securities firm or commercial bank but there are specialized firms that participate in the market for municipal securities. Bond brokers play a key role in secondary market trading, acting as agents for the dealers.

Historically, the municipal securities market had been relatively free from federal regulation. When Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934, it specifically exempted municipal securities from major provisions of these two key pieces of legislation. In the 1970s, financial distress of some municipalities, most notably New York City, raised concerns about the adequacy of regulation. In 1975, the Securities Act Amendment contained provisions to broaden federal regulation in the municipal market by bringing brokers and dealers in the municipal market (including banks that underwrite and trade municipal securities) within the regulatory scheme of the Securities Exchange Act of 1934. As a result of this legislation, the Municipal Securities Rulemaking Board (MSRB) was established in 1975 as an independent, self-regulatory agency and the primary rule-making body

for the municipal securities industry.¹²

IV. Institutional Investors in the U.S. Regulatory System

U.S. institutional investors' assets grew from US\$91 billion to US\$10.3 trillion between 1950 and 1994. Assets managed by investment companies and pension funds have grown more rapidly than other types of institutional investors. This section examines the role of the four largest U.S. institutional investor groups (i.e., investment companies, pension funds, insurance companies, and bank trust departments) in the capital market and the regulatory environment in which they must operate.

A. Portfolio Investments. Institutional investors portfolio investments are the dominant force in the U.S. capital market today and their influence is felt increasingly around the world. Their market impact is especially large with respect to the stock market since they tend to be active traders. In recent years, institutional investors (i.e., public pension plans) have tended to get more involved in corporate affairs to ensure that management is acting in the best interest of shareholders. While institutional investors bond holdings are quite large, bonds do not generally trade as frequently as stocks even though institutional investors are more active traders than individual investors. Of US\$4.8 trillion in private pension fund assets, about 40% is invested in the stock market and 33% in Government and corporate bonds. In recent years, all segments of the mutual fund industry -- equity funds, bond funds and money market funds have

¹² The MSRB's regulatory authority covers dealers, dealer banks and brokers in municipal securities, but not issuers. It is financed by the municipal securities industry. Rules adopted by the MSRB must be approved by the SEC. The MSRB has no enforcement or inspection authority. This is the responsibility of the SEC, the National Association of Securities Dealers, and certain bank regulatory agencies.

experienced rapid growth. Of US\$ 2.2 billion in mutual fund industry assets at year-end 1994, US\$866.5 billion was accounted for by 1,944 equity funds and US\$684.0 billion in assets was held by 2,450 bond and income funds. In addition, there were 644 mutual funds with investments of US\$500.4 billion in taxable money market funds. At year-end 1994, there were also 319 mutual funds with assets of US\$110.6 in tax-exempt money market funds (see Annex Tables 10,11,& 12).

Institutional investors' holdings of U.S. equity securities increased from US\$60 billion in 1960 to US\$3,136 billion in 1994. As a percent of total equity securities outstanding, the market share held by institutional investors increased from 14.2% in 1960 to 30% in 1970 and 41.4% in 1975. Since then, institutional holding relative to total equity securities outstanding has increased at a much slower pace reaching a peak of about 52% in 1989 and again in 1994. At year-end 1994, private pension funds held 17.3% of equity securities outstanding compared to 12.2% for mutual funds and 8.6% for public (state and local government) pension funds. Foreign institutional investors accounted for 5.6% while U.S. broker-dealers held less than one percent of total stock outstanding in their own trading and investment accounts (Table 9 and Annex Table 3).

Table 9

Share of Total Equity Securities Outstanding
Held by Institutional Investors: 1980-1994

U.S. Institutional investors have also been active participants in emerging securities markets. In 1994, it is estimated that U.S. pension funds invested US\$40 billion overseas and that US\$6.6 billion was invested in emerging securities markets. As a result, U.S. pension

funds had an estimated US\$300 billion invested internationally with US\$28 billion held in the form of emerging market securities. Also, U.S. closed-end funds and mutual funds continue to have large investments in emerging markets with new funds focusing on the smaller and younger emerging markets.¹³

B. U.S. Regulatory System. Institutional investors are subject to varying forms of regulation by different regulatory bodies depending upon the type of financial institution that performs the investment management function or similar services. While investment companies are regulated by the U.S. SEC, other types of pooled investments are exempt from the definition of investment company and therefore are not required to register with the Commission. This would include individual and collective trust funds administered by commercial banks, private pension plans which are often administered by banks or insurance companies, and insurance company separate accounts. Each are regulated by different regulators even though they are functionally similar to investment companies. Another important facet of the regulatory scheme is the role of ratings by qualified credit rating agencies. The SEC, Federal and state bank regulators, and the National Association of Insurance Commissioners all provide for the use of ratings in administering their respective regulatory schemes. In most states, for example, ratings are used as criteria for investment eligibility for securities held by fiduciaries and state regulated entities such as insurance companies, public retirement funds and state chartered banks.¹⁴

In order to understand the regulatory standards applied to investment companies and other

¹³ Emerging Markets Fact Book: 1995, International Finance Corporation, Washington, D.C., at page 10.

¹⁴ O'Neill, Leo, "Rating Agencies and Securities Market Development," Standard and Poors Rating Group, 1991.

entities registered with the SEC, it is important to understand that the cornerstone of the U.S. securities regulatory framework is the disclosure of information to investors and the maintenance of strong prudential standards. The SEC does not engage in merit regulation (i.e., make decisions concerning the quality and quantity of issues brought to the market). It is not permitted to do so under its regulatory mandate. Consequently, investment companies may include in their portfolios more speculative types of investments such as high-yield ("so-called junk bonds) corporate bonds provided that this is disclosed to investors at the time the investment company's shares are registered. Consequently, U.S. investors are expected to make their own informed decisions concerning the relative risks and rewards of a particular investment. It should be noted, however, that the investment objectives of the fund must be clearly disclosed to investors and they cannot be changed without shareholder approval. Also, the SEC assigns certain regulatory responsibilities to the stock exchanges, the National Association of Securities Dealers, and other self-regulatory organizations. As discussed below, other U.S. Government agencies and state regulators are involved in the regulation of institutional investors' money management activities. This includes the U.S. Department of Labor, Federal and state bank regulatory agencies, and state insurance commissions (Table 10).

Table 10

Profile of U.S. Regulatory System
for Institutional Investors

C. Securities Regulatory Models. Although several regulatory models are employed around the world, the most common approach today is a variation of the basic U.S. model. It allows relatively free markets, competition in the financial sector, and strong government

oversight of the securities markets accompanied by the delegation of certain regulatory responsibilities to self-regulatory organizations. In the U.S., for example, the stock exchanges and the National Association of Securities Dealers (NASD) inspect and examine broker-dealers. The NASD also reviews the sales literature and advertisements of mutual funds. This model has replaced the more traditional practitioner based self-regulatory model that was often employed in developed markets and in some emerging securities markets until recently. The traditional approach (the old British model) to the regulation of securities markets was based on the principal that only minimal formal government oversight of the stock exchange and market practitioners was necessary. A third model (often employed in emerging markets) is a regulatory regime whereby the government exercises extensive management and control over the securities market. In some countries, government management and control over the market is accomplished with the help of self-regulatory organizations whereby private parties may be given monopolistic privileges to engage in what otherwise would be considered anti-competitive activities. Finally, a fourth regulatory model that has been employed in many countries is one of direct government supervision or control over the market with a minimal reliance on self-regulation. Most countries employ hybrid models. Many countries are in transition to the U.S. style regulatory model that relies heavily on market forces with strong government regulatory oversight.¹⁵

D. Investment Companies

¹⁵ Chuppe, Terry M., Haworth, Hugh H., Watkins, Marvin G, "Global Finance: Causes, Consequence and Prospects for the Future," Global Finance Journal, Volume 1, Number 1, Fall 1989; Atkin, Michael, Chuppe, Terry, "Regulation of Securities Markets: Some Recent Trends and Their Implications for Emerging Markets," WPS 869, January 1992; and "Regulation of the Asian Bond Market," Chapter 3, The Emerging Asian Bond Market, World Bank, June 1995.

1. Role of Investment Companies. An investment company is essentially an issuer of securities that is primarily engaged in the business of investing in securities.¹⁶ Investment companies offer investors both professional money management and diversification of risk. In the U.S., there are two basic types of managed investment companies: open-end funds (i.e., mutual funds) and closed-end funds. The U.S. capital market has a wide array of investment companies with a variety of investment objectives. Mutual funds are called "open-end" funds because they continually offer new shares to the investing public. Closed-end funds, on the other hand, offer only a fixed number of shares. The number of shares offered by a closed-end fund is determined at the time of the initial public offering. Unit investment trusts are another distinct form of investment company. They are essentially an un-managed portfolio of redeemable units of a fixed portfolio of securities.

In 1940, the year the Investment Company Act was enacted, the dominant form of investment company was the closed-end fund. Unit investment trusts were also very popular at that time. In 1940, open-end funds were relatively new. Since then, open-end funds have grown dramatically. By the 1960s, open-end funds became the dominant form of investment company and accounted for more than four-fifths of investment company industry assets. Today, open end funds, or mutual funds, account for more than 95% of the US\$2.3 trillion in investment company industry's assets.

a. Mutual Funds. With the formation of the Massachusetts Investors Trust, the first U.S. mutual fund was established in Boston in 1924. Following a period of expansion, the stock

¹⁶ As discussed later in this paper, there are several important types of pooled investment funds that are not considered to be investment companies under the Investment Company Act.

market crash of 1929 brought to a near halt the distribution of investment company shares to the public. A renewed expansion occurred between 1932 and 1936; fund assets grew from US\$75 million to US\$500 million over this period. With the recession of 1937-1938, a decline in the assets of investment companies occurred and relative stagnation in asset growth continued for an additional three-year period.¹⁷ Since then, the U.S. investment company industry has experienced continuous growth. Today, investment companies are an important vehicle used to mobilize the savings of small individual investors. Also, other institutional investors such as pension funds and bank trusts often gain access to the capital market by investing funds through investment companies. When the U.S. Investment Company Act was passed in 1940, there were 296,000 shareholder accounts under management with assets of about US\$448 million. In 1945, with the new regulatory regime firmly in place, the industry's assets grew to US\$1.0 billion. In 1951, the number of shareholder accounts reached one million. By the early 1970s, there were 400 funds with assets of US\$50 billion. Today, there are more than 5,300 funds with assets in excess of US\$2.1 trillion. Much of this growth has occurred over the past decade (Table 1 and Annex Table 11-14).

In recent years, there have been many innovations in the investment company industry. With the introduction of money market funds in the early 1970s, the U.S. financial landscape was fundamentally changed. Until then, mutual funds invested primarily in equity securities. The introduction of money market funds allowed small savers to obtain market rates of interest through money market funds that were able to invest in a diversified portfolio of treasury bills

¹⁷ A Study of Mutual Funds, Prepared for the Securities and Exchange Commission by the Wharton School of Finance and Commerce, Report of the Committee on Interstate and Foreign Commerce, 87th Congress, 2nd. Session, August 28, 1962, at page 4.

and short-term private money market instruments. The money market funds attracted many new investors to the financial markets. The growth of money market funds is also credited with helping spawn other innovations in the fund industry that followed shortly thereafter. In 1979, tax exempt money market funds were first introduced. In the early 1980s, further innovations took place with the introduction of U.S. Government bond funds and funds investing in securitized housing finance followed later in the decade by the rapid growth of funds investing in a specific sector, country funds, and international securities. The Investment Company Institute, the trade association for U.S. investment companies, has identified 18 different specialty fund categories.¹⁸

Mutual funds offer a number of important advantages to investors: (i) professional money management, (ii) portfolio diversification, and (iii) economies of scale. Mutual funds (commonly referred to as open-end funds) are the largest segment of the investment company industry. Mutual fund invests the money of its shareholders in a wide array of liquid financial instruments including equity securities, government and corporate bonds and money market instruments. The later include short-term (usually less than one year) instruments such as Treasury bills, commercial paper, and bank certificates of deposit. Mutual funds must invest in liquid securities in order to meet investors' demand for redemptions. U.S. regulations require that at least 85% of fund assets must be invested in liquid securities. Although liquidity is not specifically defined in the regulations, the ability to liquidate a security position in seven business days is normally considered appropriate. Many U.S. mutual funds invest in foreign securities including those of emerging securities markets.

¹⁸ Mutual Fund 1995 Fact Book, Investment Company Institute, Washington, D.C., 1995, pp. 15-23.

Mutual funds are normally classified according to their investment objectives. Because the SEC does not engage in merit regulation, mutual funds may invest in all types of securities including high yield corporate bonds or speculative stocks provided however that the investments meet the objectives of the fund stated in the registration statement. In general, mutual funds may be classified according to the relative safety or stability of capital or current income. Many funds seek growth in capital. The objective of some mutual funds is to seek rapid capital appreciation, which implies a higher degree of risk. Money market funds, on the other hand, invest in short-term Government securities, or money market instruments which entail relatively little risk. Many investors would view a money market fund as a deposit substitute since they offer little risk and immediate liquidity. Typically, there is a rapid flow of funds into and out of money market funds. Balanced funds, seek both growth and income while specialized sector funds may invest in a specific industry or region of the world (i.e., Latin America, or a specific country).

Specialized funds invest only in a particular instrument such as tax free municipal bonds or in speculative investments such as high yield corporate bonds (i.e., so-called junk bonds). In addition to the specialized funds, many funds invest in a highly diversified portfolio of stocks, bonds, and money market instruments. They are free to alter the composition of their portfolio in response to changing market conditions. Another approach available to investors is to select an indexed fund which does not attempt to out-perform the market but rather simply structure their portfolios to track a particular index such as the Standard and Poor's 500.

Mutual funds are sold by securities firms (i.e., broker-dealers), banks, sales staff employed by the funds managers, or directly by the fund itself to investors. The latter offers an advantage to investors in that this method of distribution does not have a sales charge (so-called

no load fund) or a relatively low sales charge. Regardless of the distribution method, mutual funds charge a management fee to investors. Mutual funds offer a variety of services to their shareholders. Most funds offer investors the right to buy shares at regular intervals with dividends re-invested automatically. Many funds offer a so-called family of funds whereby investors may move their money among funds with varying objectives with little or no cost in adjusting their balances among funds within the group. In the 1990s, mutual funds have increasingly been organized into investment company complexes which are large groups of mutual funds associated with common investment advisers or underwriters. One advantage to investors is that they typically obtain the privilege of moving monies among the funds.

With the expansion in the number and diversity of mutual funds, there has also been a dramatic growth in U.S. institutional investors' demand for mutual funds as an investment vehicle. When the U.S. Investment Company Act was passed in 1940, there were few, if any, institutional investors investing their funds through investment companies. By 1970, institutional investors' investments in investment companies amounted to eleven percent of investment company assets whereas by 1994 they accounted for 47.5% of the total assets of the mutual fund industry. So, today about half the monies invested in mutual funds represents funds supplied by other institutional investors, usually on behalf of managed accounts.

b. Closed-end Funds. As the name implies, closed-end funds are investment companies that offer only a limited number of shares to the public. The number of shares is set at the time of the initial registration with the SEC. Closed-end funds shares are not redeemable at the option of the investor in the fund. The owners of closed-end fund shares can be sold in the secondary market. Many closed-end funds are listed on the New York and other stock exchanges. Today, closed funds are a far less important than they were in earlier years. At the

present time, closed-end funds account for less than five percent of the investment company industries' assets (see Table 1). At the time the investment Company Act was enacted in 1940, closed-end funds were the dominant form of investment company.

c. Unit Investment Trusts. A shareholder in a unit investment trust simply has an undivided interest in a package of securities that are held by a trustee, or custodian. Unit trusts do not have a board of directors and the portfolio in the trust is un-managed. It remains fixed throughout the life of the trust. Often the trust sole asset is the share of a single open-end investment company. In this instance, the trust issues certificates that represent the indirect interest of its investment in the shares of the underlying mutual fund.¹⁹

2. Regulation of Investment Companies. In the U.S., the regulation of investment companies commenced with the passage of the Investment Company Act of 1940 and its companion law, the Investment Advisors Act of 1940. These laws were enacted following a four year study of investment company practices by the SEC. The legislation was passed by Congress without a dissenting vote. Furthermore, the Investment Company Act of 1940 operated for 30 years without a significant amendment.²⁰ The Act was finally amended in 1970 to enhance the effectiveness of the board of directors of investment companies by strengthening their independence. Under the Investment Company Act, two types of management companies are recognized: open-end and closed-end. Provisions to the Act were also added restricting

¹⁹ Loss, Louis and Seligman, Joel, Fundamentals of Securities Regulation, Third Edition, Little Brown and company, New York, at page 36.

²⁰ In 1958 the U.S. SEC commissioned the Wharton School of Finance and Commerce (University of Pennsylvania) to conduct a study of the mutual fund industry. Following completion of the study in 1962, the U.S. SEC sent its own report to Congress in 1966 that eventually led to the Investment Company Act Amendments of 1970.

investment company sales charges and fund expenses. Investment companies are also subject to other laws administered by the SEC in the form of disclosure and reporting requirements covered by the Securities Act of 1933 and the Securities and Exchange Act of 1934. Several exemptions are provided in the Investment Company Act for institutional investors that are regulated under other systems of regulations such as pension funds, bank common trust funds, and insurance companies. Private investment companies with not more than 100 shareholders are exempt from the Act. Other types of pooled savings managed by financial institutions are also exempt from the Act.²¹

In 1970, the U.S. Congress amended the investment Company Act to provide the exemptions from the act currently available for bank collective trust funds and insurance company retirement accounts holding retirement plan assets. These amendments to the Act in effect codifies the then existing position of the SEC with respect to the treatment of collective trust funds and created a level playing field between banks an insurance companies that managed employee benefit plans through pooled investment accounts. The U.S. Congress also amended Section 3(a)(20) of the Securities Act of 1933 in order to "exempt certain interests in collective trusts funds and insurance company separate accounts for tax-qualified plans from registration under the Securities Act."²²

²¹ For an exhaustive examination of investment company regulation, see: Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, Washington, D.C., May 1992; Rosen, Robert C., Pollack, Irving M., and Simon, Wayne, International Securities Regulation, Binder 5, the United States, Oceana Publications, Inc., 1995. Also, see: "The Regulation of Investment Companies in the United States", by the Division of Investment Management, U.S. Securities and Exchange Commission, Paper prepared for the Third Annual International Institute for Securities Market Development, Washington D.C., April 1993; and Fundamentals of Securities Regulation, op. cit.

²² Protecting Investors: A Half Century of Investment Company Regulation, op. cit., page 131.

Investment companies have provided a relatively safe and efficient method for individual investors to participate in the U.S. capital market. Few firms have failed in the 50 plus years following the passage of the Investment Company Act of 1940. The investment company industry itself has contributed greatly to this success. It has maintained high standards through self-policing. In the U.S. regulatory scheme for investment companies, the first line of defense is the board of directors of the investment company itself. To understand the U.S. regulatory regime, it is important to keep in mind that the SEC does not determine the quality of securities that an investment company can purchase for its portfolio. Investment companies are free to invest in any type of security provided that they comply with the SEC's disclosure requirements and invest in the types of securities that are stated in the prospectus at the time of initial registration. In order to change the investment objectives, the investment company must first obtain the approval of its shareholders.

a. Private Investment Companies. Under Section 3(c)(1) of the Investment Company Act, private investments companies are specifically exempt from the definition of investment company. Consequently, private investment companies need not register with the SEC. Under the Act, the private investment company exception applies to "any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities."²³ This exemption has been relied upon by many small investment clubs that would find it too costly to register and comply with the Act. It has also been used by large investment pools with sophisticated investors that rely on the exception to avoid substantive

²³ Protecting Investors: A Half Century of Investment Company Regulation, op. cit., at page 103.

can enforce compliance by the foreign companies with all of the provisions of the Investment Company Act. In general, a foreign investment company may not make a public offering of securities in the U.S. unless the SEC finds, among other things, that it is both legally and practically feasible to effectively enforce the Act with respect to the foreign investment company. The standard is difficult to satisfy. Since the Investment Company Act was enacted in 1940, only 19 foreign funds, mostly Canadian, have ever received orders permitting registration. Moreover, the SEC has not granted such an order since 1973.²⁵

E. Pension Funds

1. Role of Pension Funds. In the U.S., the largest institutional investor group are pension funds. Today, pension fund assets amount to about US\$4.7 trillion compared to only US\$17 billion in 1950. Of this amount, about US\$3.5 represents private pension plans with the remaining US\$1.2 billion accounted for by state and local pension plans. In the U.S., two types of private pension plans are recognized under ERISA -- Insured and Trusted plans. Insured pension plans are simply offered through insurance company separate accounts. It does not imply that certain returns are guaranteed to the participants. All other private pension plans must be offered through a trust instrument. Normally, trusted pension plans are offered by bank trust departments or mutual funds. However, trusted plans may be offered by other financial institutions as well. At year-end 1994, trusted private pension plans totaled US\$2,610 billion while insured plans amounted to US\$907 billion (Table 8).

²⁵ See: "The Regulation of Investment Companies in the United States," Paper by the Division of Market Regulation at the International Institute for Securities Market Development, Washington, D.C., April 26 -May 7, 1993.

Table 8

Private and State and Local Government Pension Plans

The tax laws have contributed to the rapid growth of pension funds. Tax exempt contributions to the plans support the payment of employee benefits at retirement. In the U.S., there are two basic types of pension plans: (1) defined contribution plans and (2) defined benefit plans. In a defined contribution plan, the benefits to the individuals covered by the pension scheme are limited to the returns from investments chosen by the plan participant. In a defined benefit plan, benefits are based upon a payout schedule which must be met by the employer. In the U.S., defined benefit plans are insured by the Pension Benefit Guarantee Corporation.

Today, more than fifty million Americans are covered through pension plans provided by their employers. The assets of employee benefit plans are often invested by their employers in bank collective trust funds or through insurance company separate accounts whereby the bank or the insurance company pool the assets of two or more plans to manage the assets more efficiently and to diversify risk.²⁶ Although such pooled investment vehicles are functionally similar to investment companies, they are generally exempt from the provisions of the federal securities laws.²⁷ Private pension plans and their sponsors are regulated by the Federal Government under the Employee Retirement Income Security Act of 1974 (ERISA) while public

²⁶ The U.S. securities laws which were enacted in the 1930s contain an exception from coverage for certain pooled investment vehicles, including pension funds. At that time, however, the type of pension plans offered were predominately "defined benefit plans" offered by large sophisticated employers.

²⁷ "Pooled Investment Vehicles for employee Benefit Plan assets," Chapter 2, Protecting Investors: A Half Century of Investment Company Regulation, op. cit., at page 119.

pension plans (other than those operated by the Federal government for its employees) are regulated by state and local governments. The public pension plans operated by state and local governments include plans for state government employees, municipal employees, school districts and other local government entities. Unlike the Federal government pension scheme, the state and local government pension plans are funded.²⁸ They do not operate on a pay-as-you-go basis. The public pension plans operated by state and local governments are primarily defined benefit plans which may be supplemented with defined contribution schemes similar to 401(k) plans available to the private sector. At year-end 1993, pension funds held about 40% of their assets in corporate stock and about 33% in bonds.²⁹ The remainder was held in the form of cash and other assets.

Over the past 20 years, the composition of the pension fund industry has changed with a notable shift toward coverage by "defined contribution plans." This trend has been especially pronounced with respect to plans offered by small and medium sized companies. In the defined contribution plan, "an employer promises that it will set aside a specific contribution for an individual account for each employee's benefit and that each employee will receive a benefit equal to the amounts contributed to his or her account plus or minus the account's investment

²⁸ Although the basic retirement scheme for Federal employees operates on a pay-as-you-go basis, supplemental benefits are available in the form of a "Thrift Savings Plan" whereby tax deductible employee contributions (and for certain employees Government matching contributions) are invested in one of three funds operated by the Federal Retirement Thrift Investment Board. An employee may elect to allocate money contributed to the Thrift Savings Plan to a (1) stock index fund, (2) corporate bond fund, or (3) fund investing exclusively in Government securities. As is the case with private sector 401 (k) plans, the income and capital gains earned on money invested in the Thrift Savings Plan are tax deferred until retirement, unless withdrawn early (rather than rolled-over into an individual retirement account) upon leaving Government service.

²⁹ Estimates are based upon data from the Employee Benefit Research Institute and Investment Company Institute. See: The Brancato Report.

gains or loss."³⁰ Under these plans, it is often the responsibility of the employee to direct the investment of their own individual account. Thus, the investment risk falls on the individual employee rather than the sponsor. Moreover, the defined contribution plans are not covered by the insurance scheme maintained by the Pension Benefit Guarantee Corporation.

2. Regulation of Pension Plans. As noted earlier, private pension plans are not regulated by the SEC. Although pooled investment vehicles offered in the form of private pension plans are functionally similar to investment companies, they are specifically exempt from registration and regulation under the securities laws.³¹ Instead, employee benefit plans are regulated by the Employee Retirement Income Securities Act of 1974 (ERISA) which is administered by the U.S. Department of Labor. Consequently, ERISA is the primary law governing the regulation of pension plans and their sponsors. The sponsors of pension plans are subject to a variety of fiduciary duties regarding the choice of plan investments.

Under ERISA, pension plan fiduciaries are responsible to discharge their duties solely in the interest of the participants and beneficiaries. ERISA requires that "a fiduciary shall discharge his duties with respect to a plan with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such

³⁰ *Ibid.*, at page 120.

³¹ Under the Securities Act of 1933, Section 3(a)(2) generally exempts from registration with the SEC the securities issued by collective investment trusts and separate accounts. Under the Securities and Exchange Act of 1934, Section 3(a)(12) exempts securities issued by these vehicles from the registration requirements of the "1934 Act"; and Section 3(c)(11) of the Investment Company Act of 1940 excludes such pooled investment vehicles from regulation under the "1940 Act".

matters would use in the conduct of an enterprise of a like character and with like aims."³² Consequently, a plan fiduciary must act solely in the interest of the plan participants and such duties must be discharged for the exclusive purpose of providing benefits and with reasonable administrative expenses. Plan investments must be diversified "so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so."³³ ERISA does not provide quantity restrictions or engage in merit regulation with respect to a specific investment instrument. This is left to the judgement of plan fiduciaries who, as discussed above, are subject to the requirements of the "prudent man" rule. Finally, the fiduciary must act in accordance with the documents and instruments governing the plan so long as they are consistent with the requirements of ERISA.

In the U.S., ERISA does not require that pensions be made available to workers upon retirement. In the event that such promises are made to workers, it is ERISA's responsibility to make sure that they are kept. ERISA's assurances are accomplished by applying four basic principals. First, workers must become eligible for benefits after a reasonable period of time. Second, adequate funds must be set aside to provide the benefits promised under the retirement plan. Third, persons managing the plan must meet certain standards of conduct. Finally, sufficient information must be made available to determine if the law's requirements are being met.³⁴

³² Section 404(a)(1)(B) of the Employee Retirement Income Security Act of 1974. See: Pension and Welfare Benefit Programs, 29 CFR Part 2550, Rules and Regulations for Fiduciary Responsibility; Investment of Plan Assets Under the "Prudence: Rule, U.S. Department of Labor, Federal Register, Vol. 44, No. 124, June 26, 1979.

³³ Ibid., pp-1-2.

³⁴ The Prudence Rule and Pension Plan Investments Under ERESA, U.S. Department of Labor Circular, at page 1.

Under ERISA, it should be recognized that the disclosure regulations tend to focus more on the disclosure to participants about the plan itself rather than detailed disclosures about the underlying investments. This may have been more appropriate prior to the growth of participant-directed defined contribution plans. In this instance, the investment decisions and related risk falls more on the employee than the company sponsor. Consequently, disclosure standards more comparable to that found under the Investment Company Act may be more appropriate. Furthermore, the fiduciaries of a participant-directed defined contribution plan apparently are not obligated to assure that participants choose suitable investments from the options made available to them under the plan but merely have a duty to choose prudently and monitor the investment options.³⁵ Under ERISA, plan participants are provided a basic disclosure document that describes the plans benefits and investment objectives. There is also a requirement that each pension fund submit an annual report to the U.S. Department of Labor which includes a detailed balance sheet and investments schedule. Pension funds are required to report this information at market value. The information contained in the annual report, which is rather technical in nature, is also available to plan participants. Unlike mutual funds, there is no requirement that fund assets be valued on a daily basis. In this regard, pension plans invest for the long-term retirement needs of plan participants. Mutual funds, on the other hand, must be able to meet the short-term liquidity needs of investors. Consequently, mutual funds must also be able to determine the funds' net asset value at the end of each business day.

F. Bank Personal Trusts.

1. Role of Bank Personal Trusts. U.S. banks pool money from trusts and other

³⁵ Protecting Investors: A Half Century of Investment Company Regulation, op. cit., at page 120.

fiduciary accounts and invest the money in financial assets. The pool of money may be from the accounts of individuals, or through collective trust funds. Often the money is invested directly in the stock market, money market instrument, or the bond market. Historically, banks have managed common trust funds, or similar funds maintained by a bank exclusively for the collective investment and reinvestment of monies contributed to the account by the bank in its capacity as trustee, executor, administrator, or guardian. Banks, under regulations administered by the Federal Reserve Board, are able to "invest the assets of pension, profit-sharing, and stock bonus plans collectively, provided that each such plan was exempt from federal income taxes and the collective investment was specifically authorized by the trust instrument underlying the plan."³⁶ Many employee plans are too small to allow for portfolio diversification. This problem has been alleviated by an IRS ruling which provided that " a qualified plan may pool its funds with the funds of other qualified plans in a group trust without losing its "qualified" status under Section 21 of the Code."³⁷ These regulations have facilitated the growth of pooled investments managed by bank trust departments.

There are three basic types of trust department accounts available to investors: (1) personal trust accounts, (2) agency accounts, and (3) retirement plan accounts. In a personal trust account, the bank holds title to the trust assets for the benefit of its client. In an agency account, the bank trust department holds custody of the assets but the customer retains title to their assets. Concerning the management of the accounts, the bank trust department must follow the instructions of the customer, or the account sponsor in the case of a trust account. For an

³⁶ Protecting Investors: A Half Century of Investment company Regulation, op.cit., pp. 125-126.

³⁷ Ibid., at page 126.

agency account, the customer provides direction with respect to investment decisions for the account within the framework provided by the account agreement. For a trust account, the account sponsor will direct the account as provided in the trust agreement which provides the basis for the operation of the account. As noted earlier, a recent trend has been for many institutional investors, including bank trust departments, to invest monies under their management in mutual funds rather than to go directly to the capital market. This is a reflection of the diversity of funds available with a wide range of investment objectives and the high degree of safety (i.e., an absence of fraud or fund failures) that is available through mutual fund investments.

In retirement plan accounts, banks compete with other institutional investors for the management of pension fund assets. In the U.S., all pension plans must be offered through a trust instrument or through an insurance company separate account. In a retirement plan account, a trust department offers through a trust instrument pension plan account services similar to those offered by mutual funds and insurance companies. Such services may be offered to individuals or to corporate plan sponsors through bank collective trust funds. As provided for in the trust instrument, the trust department must follow the instructions of the account sponsor. In recent years, there has been a trend toward self-directed plans such as 401 (k) plans and individual retirement accounts where the individual plan participant is largely responsible for investment decisions.

2. Regulation of Personal Trusts. As institutional investors, banks may be regulated by a Federal bank regulatory agency or the individual states depending upon whether they have a national or a state charter. Historically, the investments of bank trust departments have been governed by state law even in the case of national banks which are regulated at the Federal level

by the Comptroller of the Currency. As a general matter, bank trust departments must follow the directions of the account sponsors which are contained in the trust agreement or, through instructions from the customer in the case of an agency account. In nearly all states, the "prudent man rule" applies to the investments of bank trust departments. Under this concept, a bank trust department would be required "to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."³⁸ Banks are also subject to a variety of Federal and state regulations related to conflicts of interest. Furthermore, bank managed pension accounts are subject to the requirements of ERISA.

In recent years, common trust funds, or similar funds maintained by a bank exclusively for the collective investment and reinvestment of monies contributed to the account by the bank in its capacity as trustee, executor, administrator, or guardian have grown in importance. These accounts are exempt from the definition of investment company. ERISA, however, places strict responsibilities on banks as fiduciaries for pension plans whose assets are invested in collective funds. Under ERISA, a plan fiduciary is defined to include "any person who exercises discretion with respect to the management of the plan or its assets, renders investment advice to a plan for a fee (direct or indirect), or has discretion with respect to the administration of the plan."³⁹

³⁸ Pozen, Robert C., "U.S. Institutional Investors and Asian Debt Securities," Paper by the General Counsel and Managing Director of Fidelity Investments, Boston, August 5, 1992, at page 6.

³⁹ Protecting Investors: A Half Century of Investments Company Regulation, op.cit., at page 155.

G. Insurance Companies

1. Role of Insurance Companies. Acting as principal for their own account, insurance companies invest in a wide array of financial instruments and real estate in order to produce sufficient income to meet their obligations in the form of promised insurance benefits. Insurance is sold either through agents representing the insurance company directly, or through independent agents representing many insurance companies. Agents are required to provide a written contract (i.e., an insurance policy) to their clients that sets forth the terms and conditions of the insurance contract. In the U.S., there are many types of insurance companies. They are regulated by the individual 50 states. The U.S. does not have a national insurance commission, or similar regulatory organization. Insurance companies may be owned by private investors, or they may be mutually owned by those whom it insures. If the insurance company is privately owned, the objective is to maximize profits subject to any regulatory constraints that might exist. If the company is mutually owned, the objective is to break even by generating sufficient revenues to cover expenses. As institutional investors, the most important insurance companies are life insurance and property and casualty companies.

a. Insurance Company Risk. Insurance companies receive a premium in return for providing insurance coverage for a particular risk. The risks of insurance are assessed through underwriting procedures. One of the greater risks is so-called adverse selection whereby those individuals or business enterprises with a high probability of loss (i.e., the greater risk) are more likely to seek coverage. There is also risk associated with the possibility of fraudulent insurance claims. Insurers to the maximum extent possible try to cover for the risk of adverse selection by setting premiums and adjusting the terms of coverage according to their judgement of the risk in writing the insurance policy. It is not unusual for insurance companies to deny insurance

coverage where the risk is perceived to be too high. In general, insurance companies also are able to cancel, deny renewal, or change the terms of the insurance coverage, or the insurance premium under specified circumstances. Insurance companies control for risk by monitoring actual loss experience, classifying risks accurately and setting risk based rates, offering incentives to reduce the potential claims of the insured and exercising care in offering catastrophic coverage. Risk may also be controlled through the use of reinsurance to transfer some of the risk to another insurance company, use coinsurance so that the insured entity bears a percentage of the loss, or use deductibles to cover normal losses, or to reduce the probability of moral hazard or adverse selection. Insurers must maintain sufficient capital and liquid assets to promptly meet the claims of customers. This is accomplished by means of a self-sustaining reserve fund based upon an actuarial assessment of past and potential losses.⁴⁰ The insurance premiums are assessed so that a proper level of reserves are available to meet potential claims at all times. In order to have sufficient liquidity to meet the potential claims of policy holders, a substantial portion of reserve funds will be held in the form of liquid money and capital market instruments.

Insurance company separate accounts are an important investment vehicle that are used to compete with bank trust departments for the management of private pension plan assets. Under the separate account arrangement, insurance companies segregate the premiums paid by employers from the insurance companies' general revenues and invest the funds in a broader less conservative range of money and capital market instruments, including corporate equity

⁴⁰ For an excellent discussion of the principals of insurance, see: Reforming Federal Deposit Insurance, Study by the Congressional Budget Office, Congress of the United States, Washington, D.C., September 1990, pp. 23-46.

securities, than would normally be permitted under state law with respect to the insurance company itself. Separate accounts are also used for variable annuities offered by insurance companies. Variable insurance contracts include both investment and insurance features. A portion of the premium is used for the purchase of units in an account that is invested in a portfolio of securities. The value of the units reflect the performance of the underlying securities in the portfolio. In a variable annuity, the units may be converted into a series of annuity payments when the purchaser reaches a certain age while in a variable life contract payment is due to the beneficiary named in the contract in the event of the insured persons death.⁴¹

2. Regulation of Insurance Companies. In the U.S., Insurance companies are regulated by the individual states. Although the U.S. Supreme Court ruled in 1994 that the Federal Government had the authority to regulate insurance companies whose business was conducted across state lines, a Federal law was enacted in 1945 granting authority to the states to regulate the insurance business. There is, however, a National Association of Insurance Commissioners (NAIC) that works toward the harmonization of state laws governing the insurance business. NAIC is a voluntary association of state insurance regulators. At the present time, 47 of the 50 state insurance regulatory bodies are members of the NAIC. With respect to the portfolio investments of insurance companies, the NAIC has developed accreditation standards which must be met for a state to be accredited including regulations "to prevent or correct undue concentration by investment type and issue and unreasonable mismatching of maturities of assets

⁴¹ See: "The Regulation of Investment Companies in the United States", Prepared by the Division of Investment Management for the Third Annual International Institute for Securities Market Development Training Conference Sponsored by the U.S. Securities and Exchange Commission, Washington, D.C., April 26 - May 7, 1995, at page 2.

and liabilities,"⁴² These are guidelines intended to promote harmonization among the state securities commissions. NAIC's accreditation program is intended to provide baseline standards for solvency regulation. At present, 47 state insurance regulatory departments are accredited. The NAIC accreditation program mandates the following: (1) adequate statutory and administrative authority to regulate an insurers' corporate and financial affairs; (2) sufficient resources to carry out their regulatory responsibilities; and (3) organizational and personnel practices that will result in an effective regulatory program. NAIC's accreditation program involves a rigorous examination of state insurance departments by an independent review team. There is a full on-site re-examination and re-accreditation every five years.⁴³

NAIC was first organized in 1971. It provides a national forum to resolve insurance company issues in order to develop a coherent national policy on the regulation of insurance companies. In the U.S., this is particularly important since insurance companies are regulated at the state level and they typically operate in more than one state and many insurance companies operate on a national or regional basis. NAIC operates primarily through a committee system whereby important insurance regulatory issues may be resolved. In this way, complex regulatory issues can be directed to a group of experts before they are voted upon by the entire membership. Each initiative must be considered by one of five standing committees as well as the executive committee prior to plenary action by the full membership. NAIC committees consists of state insurance commissioners who pool their resources to study a particular regulatory issue. Consequently, NAIC plays a prominent role in developing model insurance

⁴² Pozen, *op. cit.*, at page 8.

⁴³ See: National Association of Insurance Commissioners: A Tradition of Consumer Protection, 1994, at page 7.

laws, developing regulatory guidelines, and in coordinating and harmonizing regulations. States may either adapt regulations or model laws or modify them to meet local conditions.⁴⁴ One of the advantages of state regulation of insurance products is that it promotes diversity and experimentation. Nevertheless, there has been a pronounced trend toward greater uniformity which can reduce regulatory costs at the national level.

While some insurance companies bought substantial amounts of junk bonds for their own account in the 1980s, more recently state laws have curbed this activity by requiring that insurance companies invest only in higher quality bonds. The state insurance commissions do not rate the bonds themselves but rather rely upon ratings available through the national securities credit rating agencies. Consequently, the quality of the bond could normally be determined by means of a rating given by one of the four national rating agencies. In general, insurance companies will not invest in bonds rated lower than investment grade (which would exclude so-called "junk bonds"). Pension funds offered through insurance company separate accounts are also subject to the same fiduciary standards as banks under ERISA.

H. Other Intermediaries and Institutions.

Securities firms (i.e., broker-dealers) are important to the capital market in performing their functions as brokers and dealers. U.S. securities firms also provide money management services and are engaged in the underwriting and distribution of mutual fund shares. The asset management fees of New York Stock Exchange member firms, for example, increased from US\$175 million to US\$3.8 billion between 1980 and 1994, while the income derived from the sale of mutual fund shares as a retailer or underwriter increased from US\$105 million to US\$3.2

⁴⁴ *Ibid.*, pp. 1-2.

billion over this period. In their capacity as dealers, or market makers, large inventory positions are held in the full range of capital market instruments. Commercial banks also act as dealers in U.S. government and municipal securities. In this capacity, commercial banks hold huge inventories of U.S. Government and municipal securities in inventory for their own account. Savings and loans, state and local governments, credit unions, and other institutions also make portfolio investments for their own accounts in the money market and through longer-term debt securities, usually Government bonds, Treasury bills, and repurchase agreements. In the U.S., broker-dealers are regulated primarily by the SEC while banks and other types of deposit taking institutions are regulated by Federal or state banking regulatory authorities depending on whether they have a Federal or state charter, or are covered by deposit insurance.

I. Competitive Considerations

In 1962, the courts ruled that insurance company separate accounts could be required to register with the SEC under the Investment Company Act. In order to address the concerns of insurance companies that they be allowed to compete on an equal footing with banks and other financial institutions providing investment management services, the SEC in the early 1960s adopted rules to provide exemptions from registration for insurance company separate accounts and group annuity contracts held in a separate account that were similar to those available to bank products.⁴⁵

⁴⁵ In adopting Rule 3c-3 under the Investment Company Act, the SEC noted its intention to grant relief similar to that already available to pooled investment vehicles for employee benefit plans maintained by banks: "Although the insurance companies may not be acting as trustees, the arrangements for utilization by employers of such special accounts maintained by insurance companies would be similar to arrangements exempted from the definition of investment company pursuant to Section 3(c)(13) of the Act, and maintained by bank trustees for the investment of funds which the employers have set aside to meet their obligations under qualified pension plans. See: Investment Company Act Release Number 3605 (January 7, 1963).

Competition among banks, mutual funds, and insurance companies offering similar products but subject to differing regulatory requirements raises important public policy issues. Banks, insurance companies and mutual funds compete for market share in a variety of ways. They may emphasize differences in investment performance, security of assets underlying the investment, recordkeeping services or special services to participants such as daily valuation of the account. In the U.S., competition among banks, mutual funds and insurance companies have been intensified by the trend toward self-directed "defined contribution" plans, including the explosive growth in 401(k) plans in recent years.⁴⁶ A recent survey of the 100 largest bank and trust corporations found that services provided to self-directed 401(k) accounts were similar to those provided by mutual funds including daily valuation and an array of investment options. Yet, there are significant differences in disclosure and reporting requirements for investments companies, banks, and insurance companies.⁴⁷ With the growth of "defined contribution" pension scheme which are not insured by the Federal Pension Guarantee Corporation, there may be a need for more uniform disclosure to facilitate more informed decisions by individual investors. This would provide for more comparable regulation for similar financial products. It should be noted, however, that similar arguments might be made with respect to other financial services provided by banks which are not subject to regulatory oversight by the SEC.

⁴⁶ The 401(k) plans offer advantages to both employers and employees. For employers, the cost of complying with the requirements of ERISA is lower, employees bear the investment risk, and the employers can more readily predict its future liability. The 401(k) plans offer advantages to employees in that they can make voluntary pre-tax contributions, taxes on income are deferred and employers usually match a percentage of their employees contributions. Also, the 401(k) plans are portable and many plans allow participants to borrow from the plan.

⁴⁷ Ibid., pp. 143-151.

V. Prospects for the Future

In most emerging markets, investors have little to choose from regarding investment management. Unlike the U.S., the investment management industry is not well developed in most emerging markets. Often, large amounts of capital is immobilized in the form of a government sponsored provident funds, while private pension funds are not a significant factor in the market. In the U.S., it is expected that the importance of institutional investment in the form of private pensions and mutual funds will continue to grow in the years ahead. This is likely to occur because of the demographics of the population (i.e., a large segment of the population is age 40 to 50) and the process of securitization is likely to continue in the years ahead. Also, the current economic environment of historically low inflation and relatively stable interest rates is conducive to investment in financial assets.

In the U.S., the growth of institutional investment has been encouraged by government tax policy and a regulatory environment that has been conducive to the growth of the mutual fund industry and private pension plans. In particular, basic safeguards mandated by the Investment Company Act of 1940 have provided for a high degree of public confidence in mutual funds. Without a high level of public confidence, it is highly unlikely that the mutual fund industry would have experienced continuous and rapid growth in every decade since 1940. It is noteworthy that the U.S. securities regulatory model, with suitable modifications to fit local conditions, is now being put in place in many countries around the world.⁴⁸ Likewise, ERISA has contributed to the rapid growth of private pension plans in the U.S. by providing basic

⁴⁸ Since 1994 the Emerging Markets Institute, Inc. has participated in training and technical assistance missions to 25 countries in Asia, Latin America, and the Caribbean on the development and regulation of emerging securities markets.

protection regarding the management and operation of private pension plans. One important benefit to the capital market is that large amounts of funds are available for investment. Yet, the decision making process with respect to such investments are highly decentralized.

The development of private pension plans to supplement Government sponsored national provident funds is being given a high priority in many emerging markets. This trend should result in greater liquidity in emerging markets and enhanced allocative efficiency. One of the problems in most emerging stock markets is that the local investors are normally relatively unsophisticated individual investors, while the institutional investment is primarily foreign in origin. Even in the dynamic Asian emerging markets, policy makers are trying to enhance the role of domestic institutional investors in both the money and capital market. In fact, the lack of an adequate institutional investor base is often cited as a reason bond markets have generally lagged in the development of emerging equity markets.⁴⁹ In contrast, in the industrialized countries institutional investors have facilitated the development of bond markets by enhancing market liquidity through secondary market trading. If Colombia were to implement appropriate policies regarding the development and regulation of institutional investors, this could be expected to facilitate the further development of the money and capital market.

It is perhaps noteworthy to recognize that the first U.S. mutual fund was based upon a model provided in the form of a British investment fund. Today, however, U.S. domestic securities regulations impede competition that might be provided if foreign funds were given greater access to the U.S. capital market. In general, the U.S. capital markets have benefited from Government policy actions that have encouraged competition and innovation in the

⁴⁹ See: The Emerging Asian Bond Market, op. cit.

provision of financial services. This is reflected in the wide array of institutional investors and money management services that are available to U.S. investors. Certainly, such policies could be emulated in Colombia with appropriate modifications to fit local conditions.

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Table 1: Growth of Institutional Assets - 1950-1994
(US\$ Billions)

	1950	1960	1970	1980	1990	1994
Pension Funds	14	58	213	859	3,116	4,750
Bank Trust	-	-	187	342	759	1,250
Insurance Companies	74	43	225	519	1,328	1,780
Mutual Funds	3	17	48	135	1,067	2,161
Closed-End Funds	-	-	-	5	53	120
Foundations	-	-	-	48	143	210
Total	91	118	673	1,908	6,466	10,271

Source: Federal Reserve Flow of Funds Accounts, Investment Company Institute Fact Book, New York Stock Exchange Institutional Investor Fact Book.

Table 2: Securities Outstanding in U.S. Capital Markets: 1950-1994
(US\$ Billions)

	1950	1960	1970	1980	1990	1994
Equities	142.7	425.0	859.8	1,534.7	3,530.2	6,048.8
Corporate Bonds*	41.4	91.8	204.3	508.4	1,696.0	2,416.9
Government Securities	218.4	242.8	341.6	1,008.3	3,911.7	5,641.6
Municipal Bonds	42.7	71.0	145.5	365.4	1,039.9	1,202.7
Total	445.2	830.6	1,551.2	3,416.8	10,177.8	15,310.0
*MEMO: Asset Backed Debt	-	-	-	0.5	178.9	253.4

Source: New York Stock Exchange Fact Book and Securities Industry Association Fact Book.

Table 3: Household Sector's Liquid Financial Assets

Market Value in Billions of U.S. Dollars							
	1980	1985	1990	1991	1992	1993	1994
Equities	934	1,210	1,717	2,469	2,810	3,088	2,913
Bank Deposits & CDs	1,511	2,260	2,778	2,726	2,739	2,729	2,753
Mutual Fund Shares	46	192	452	592	734	973	969
Municipal Bonds	76	257	449	483	449	433	403
Money Market Funds	62	195	375	383	341	331	352
U.S. Gov't Securities	212	350	648	600	699	702	1,084
Corporate Bonds	31	31	95	105	107	142	198
Total*	2,871	4,495	6,512	7,358	7,878	8,397	8,671

Sources: Securities Industry Association Fact Book and Federal Reserve Flow of Funds Accounts.

Table 4: Selected U.S. Interest Rates

	Federal Funds	3-Month U.S. Treasury Bills	6-Month U.S. Treasury Bills	10-Year U.S. Government Bonds	30-Year U.S. Government Bonds	Corporate	
						Aaa	Baa
1984	10.2	9.6	9.8	12.4	12.4	12.7	14.2
1985	8.1	7.5	7.7	10.6	10.8	11.4	12.7
1986	6.8	6.0	6.0	7.7	7.8	9.0	10.4
1987	6.7	5.8	6.1	8.4	8.6	9.4	10.6
1988	7.6	6.7	6.9	8.8	9.0	9.7	10.8
1989	9.2	8.1	8.0	8.5	8.4	9.3	10.2
1990	8.1	7.5	7.5	8.6	8.6	9.3	10.4
1991	5.7	5.4	5.5	7.9	8.1	8.8	9.8
1992	3.5	3.4	3.5	7.0	7.7	8.1	9.0
1993	3.0	3.0	3.1	5.9	6.6	7.2	7.9
1994	4.2	4.3	4.6	7.1	7.4	8.0	8.6

Source: Federal Reserve Bulletin.

Table 5: Securities Outstanding as a Percent of Nominal GDP

Year	Corporate & Foreign Bonds	U.S. Gov't Securities	Municipal Bonds	All Debt Securities	Corporate Equities
1984	19.5	50.0	14.9	84.5	49.9
1985	21.7	54.9	18.4	95.0	59.5
1986	25.7	61.1	18.5	105.3	65.4
1987	27.8	64.4	19.2	111.4	61.5
1988	29.0	65.3	19.2	113.4	63.3
1989	29.8	66.5	19.1	115.5	73.6
1990	30.2	70.5	19.1	119.8	63.9
1991	31.9	75.8	19.8	127.4	85.0
1992	32.8	79.4	19.8	132.0	86.8
1993	34.2	81.7	19.7	135.5	96.0
1994	35.9	83.7	17.9	137.4	90.0

Sources: Securities Industry Association Fact Book and Economic Report of the President.

Table 6: Corporate Securities Offerings : 1984 - 1994

	(Billions of U.S. Dollars)			(Number of Issues)		
	Total	Public	Private	Total	Public	Private
1984	128.5	82.6	45.9	2,643	1,289	1,354
1985	217.7	138.0	79.7	4,118	1,933	2,185
1986	404.3	284.8	119.5	5,621	3,116	2,505
1987	406.7	272.3	134.4	5,140	2,547	2,593
1988	465.1	274.5	190.6	5,365	2,010	3,355
1989	505.5	305.5	200.0	4,880	1,953	2,927
1990	445.5	314.4	131.1	4,300	1,830	2,470
1991	702.3	584.2	118.1	6,470	3,550	2,920
1992	973.8	846.1	127.7	7,884	4,659	3,225
1993	1,244.6	1,051.8	192.9	10,725	6,468	4,257
1994	843.5	702.5	141.0	8,831	5,692	3,139

Source: Securities Industry Association Fact Book.

Table 7: Rule 144A Private Placement

Year	US\$ Billions		# of Issues	
	Debt	Equity	Debt	Equity
1990	3.5	1.4	28	17
1991	17.0	3.3	332	51
1992	34.5	5.5	639	56
1993	82.2	9.0	1,355	74
1994	57.3	8.4	932	118

Sources: Securities Industry Association Fact Book

Table 8: Private and State and Local Government Pension Assets: 1950-1994
(US\$ Billions)

Year	Total Pension Plans				State & Local Pension Plans
		Total	Insured	Trusted	
1950	17	12	5	7	5
1960	75	55	17	38	20
1970	210	150	38	112	60
1980	859	622	158	504	198
1990	3,116	2,379	636	1,743	737
1991	3,783	2,923	678	2,245	860
1992	4,113	3,158	732	2,426	955
1993	4,520	3,400	831	2,569	1,119
1994	4,750	3,517	907	2,610	1,231

Source: Federal Reserve Flow of Funds Accounts, Life Insurance Fact Book, and New York Stock Exchange Institutional Investors Fact Book.

**Table 9: Share of Total Equities Outstanding
(In Percent)**

	1980	1985	1990	1991	1992	1993	1994
Households	60.9	51.3	48.6	50.8	51.4	49.9	48.2
<i>Institutions:</i>	39.1	48.7	51.4	49.2	48.6	50.1	51.8
Private Pension Funds	14.6	19.7	18.6	18.3	17.6	17.4	17.3
Mutual Funds	2.8	4.8	6.6	7.2	8.3	10.8	12.2
Public Pension Funds	2.9	5.1	8.4	7.9	8.2	8.2	8.6
Foreign	4.2	5.3	6.3	5.6	5.5	5.5	5.6
Life Insurance Cos.	3.0	3.1	2.8	2.4	2.2	2.4	2.6
Bank Personal Trusts	8.8	7.3	5.4	4.8	4.0	2.9	2.6
Other Insurance Cos.	2.1	2.4	2.3	1.9	1.8	1.7	1.7
Closed-End Funds	0.3	0.2	0.5	0.4	0.4	0.5	0.5
Broker/Dealers	0.2	0.6	0.3	0.3	0.3	0.4	0.3
Savings Institutions	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Commercial Banks	0.0	0.0	0.1	0.1	0.1	0.1	0.1

Source: Securities Industry Association Fact Book and Federal Reserve Flow of Funds Accounts

**Table 10: Profile of U.S. Regulatory System
for Institutional Investors**

	Investment Companies	Private Pensions	Insurance Companies	Bank Trusts
Principal Regulator	SEC NASD	Department of Labor	State Insurance Departments	State or Federal Bank Regulators
Legal Foundation	Investment Company Act of 1940	ERISA of 1974	State Insurance Laws & ERISA	State Trust Laws & ERISA
Main Regulatory Standard	Full Disclosure	Prudent Man Rule	Prudent Man Rule	Prudent Man Rule

Annex Table 1: Equity and Debt Securities Outstanding in the U.S.
(US\$ Billions)

	All Securities	U.S. Government	Municipal Bonds	Corporate Bonds	Corporate Equities
1960	830.6	242.8	71.0	91.8	425.0
1965	1,232.1	274.4	100.4	123.1	734.2
1970	1,551.2	341.6	145.5	204.3	859.8
1975	1,932.2	550.1	223.0	337.4	821.7
1980	3,416.8	1,008.3	365.4	508.4	1,534.7
1985	6,204.2	2,216.5	744.6	883.1	2,360.0
1986	7,266.4	2,610.4	787.0	1,105.6	2,763.4
1987	7,835.2	2,923.4	862.5	1,270.4	2,778.9
1988	8,651.2	3,198.3	921.4	1,432.6	3,098.9
1989	9,876.3	3,494.1	991.2	1,581.3	3,809.7
1990	10,177.8	3,911.7	1,039.9	1,696.0	3,530.2
1991	12,164.4	4,335.7	1,108.6	1,856.5	4,863.6
1992	13,421.2	4,795.5	1,139.7	2,023.1	5,462.9
1993	14,894.1	5,212.8	1,217.8	2,277.0	6,186.5
1994	15,310.0	5,641.6	1,202.7	2,416.9	6,048.8

Sources: Federal Reserve Flow of Funds Accounts, and Securities Industry Association Fact Book

Annex Table 2: Net Issuance of Securities in the U.S.
(New Issues Less Retirements in US\$ Billions)

	All Securities	U.S. Government	Municipal Bonds	Corporate Bonds	Corporate Equities
1960	14.0	-1.7	5.3	7.3	3.1
1965	17.5	3.8	7.2	6.5	0.0
1970	63.4	21.9	12.0	23.2	6.3
1975	161.4	95.1	15.0	43.5	7.8
1980	195.6	121.0	23.9	36.3	14.4
1985	584.1	326.2	179.5	143.4	-65.0
1986	592.5	394.5	41.4	222.5	-65.9
1987	499.4	316.4	75.5	164.7	-57.2
1988	380.6	274.9	46.3	162.2	-102.8
1989	387.8	295.8	69.8	120.2	-98.0
1990	532.2	414.4	48.7	114.7	-45.6
1991	717.2	424.0	68.7	160.5	64.0
1992	735.4	459.8	31.1	160.4	84.1
1993	868.4	417.3	78.1	252.9	120.1
1994	587.7	428.8	-15.1	142.4	31.6

Sources: Federal Reserve Flow of Funds Accounts and Securities Industry Association Fact Book

Annex Table 3: Holdings of U.S. Equities Outstanding: 1960-1994
(US\$ Billions)

	Total	Households		Institutions	
		Value	% of Total	Value	% of Total
1960	425	364	85.8	60	14.2
1965	734	615	83.8	119	16.2
1970	860	598	69.6	262	30.4
1975	822	481	58.6	340	41.4
1980	1,535	934	60.9	601	39.1
1981	1,423	840	59.0	583	41.0
1982	1,611	905	56.2	706	43.8
1983	1,920	1,028	53.5	892	46.5
1984	1,851	951	51.4	900	48.6
1985	2,360	1,210	51.3	1,150	48.7
1986	2,763	1,399	50.6	1,365	49.4
1987	2,779	1,383	49.8	1,396	50.2
1988	3,099	1,514	48.8	1,585	51.2
1989	3,810	1,828	48.0	1,981	52.0
1990	3,530	1,717	48.6	1,814	51.4
1991	4,864	2,469	50.8	2,395	49.2
1992	5,463	2,810	51.4	2,653	48.6
1993	6,186	3,088	49.9	3,099	50.1
1994	6,049	2,913	48.2	3,136	51.8

Sources: Federal Reserve Flow of Funds Accounts and Securities Industry Fact Book.

Note: Household sector includes nonprofit organizations.

Annex Table 4: Stock Market Performance Indices: 1970-1994
(At Year-End)

Year	Down Jones Industrial Average	S & P 500	NYSE Composite	NASDAQ Composite
1970	838.92	92.15	50.23	-
1975	852.41	90.19	47.64	77.62
1980	963.99	135.76	77.86	202.34
1985	1546.67	211.28	121.58	324.93
1986	1895.95	242.17	138.58	348.83
1987	1938.83	247.08	138.23	330.47
1988	2168.57	277.72	156.26	381.38
1989	2753.20	353.40	195.04	454.82
1990	2633.66	330.22	180.49	373.84
1991	3168.83	417.09	229.44	586.34
1992	3301.11	435.71	240.21	676.95
1993	3754.09	466.45	259.08	776.80
1994	3834.44	459.27	250.94	751.96

Source: Securities Industry Association Fact Book.

**Annex Table 5: Value of U.S. Corporate Securities Underwritings
(US\$ Billions)**

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Straight Corporate Debt	76.4	149.8	117.8	120.3	134.1	106.9	200.5	309.7	432.5	367.4
Convertible Debt	7.5	10.1	9.9	3.1	5.5	4.8	7.5	7.0	9.3	4.7
Asset Backed Debt	20.8	67.8	91.7	113.8	135.3	178.9	300.3	427.8	479.3	253.4
TOTAL DEBT	104.7	227.7	219.4	237.2	274.9	290.6	508.3	744.5	921.1	625.5
Preferred Stock	8.6	13.9	11.4	7.6	7.7	4.6	19.9	29.2	28.4	15.5
Common Stock	24.7	43.2	41.5	29.7	22.9	19.2	56.0	72.4	102.3	61.6
TOTAL EQUITY	33.3	57.1	52.9	37.3	30.6	23.8	75.9	101.6	130.7	77.1
TOTAL CORPORATE UNDERWRITINGS	138.0	284.8	272.3	274.5	305.5	314.4	584.2	846.1	1,051.8	702.2

Source: Securities Industry Association Fact Book.

**Annex Table 6: U.S. Corporate Securities Underwritings
(Number of Issues)**

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Straight Corporate Debt	692	1,104	876	742	775	721	1,617	2,104	3,231	3,441
Convertible Debt	139	207	148	36	63	34	49	65	90	35
Asset Backed Debt	219	391	501	682	533	585	865	1,134	1,287	1,049
TOTAL DEBT	1,050	1,702	1,525	1,460	1,371	1,340	2,531	3,303	4,608	4,525
Preferred Stock	131	186	159	125	108	88	152	278	370	114
Common Stock	752	1,228	863	425	474	402	867	1,078	1,490	1,053
TOTAL EQUITY	883	1,414	1,022	550	582	490	1,019	1,356	1,860	1,167
TOTAL CORPORATE UNDERWRITINGS	1,933	3,116	2,547	2,010	1,953	1,830	3,550	4,659	6,468	5,692

Source: Securities Industry Association Fact Book.

Annex Table 7: Number and Value of U.S. Private Placements

	(Billions of U.S. Dollars)			(Number Of Issues)		
	Total	Debt	Equity	Total	Debt	Equity
1984	45.9	42.3	3.6	1,354	1,244	110
1985	79.7	70.4	9.3	2,185	1,810	375
1986	119.5	107.1	12.4	2,505	2,280	225
1987	134.4	119.9	14.5	2,593	2,397	196
1988	190.6	172.7	17.9	3,355	3,081	274
1989	200.0	168.5	31.5	2,927	2,619	308
1990	131.1	113.6	17.5	2,470	2,267	203
1991	118.1	107.3	10.8	2,920	2,643	277
1992	127.7	112.8	14.9	3,225	2,934	291
1993	192.9	174.2	18.7	4,257	3,933	324
1994	141.0	117.1	23.9	3,139	2,751	388

Source: Securities Industry Association Fact Book.

Annex Table 8: Value of U.S. Long-Term Municipal Bond Underwritings*
(US\$ Billions)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Competitive Bid	5.9	10.2	10.0	7.1	7.6	9.2	7.6	11.0	12.6	20.0	15.0
Negotiated	69.5	150.8	92.6	64.4	78.1	75.8	78.4	102.1	13.9	175.6	89.2
TOTAL REVENUE	75.4	161.0	102.6	71.5	85.7	85.0	86.0	113.1	151.6	195.6	104.2
Competitive Bid	12.6	17.6	23.1	16.3	19.2	20.7	22.7	29.8	32.5	35.6	34.5
Negotiated	7.1	22.8	22.6	14.2	12.7	17.2	17.5	28.1	49.0	56.7	23.2
Total General Obligation	19.7	40.4	45.7	30.5	31.9	37.9	40.2	57.9	81.5	92.3	57.7
TOTAL	95.1	201.4	148.3	102.0	117.6	122.9	126.2	171.0	233.1	287.9	161.9

* Excludes taxable municipal bonds and all maturities under 13 months; data prior to 1986 excludes issues of under \$5 million.

Sources: Securities Industry Association Fact Book.

Annex Table 9: Number of U.S. Long-Term Municipal Bond Underwritings*
(Number of Issues)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Competitive Bid	362	749	665	738	771	710	834	1,004	1,045	831
Negotiated	3,871	2,764	2,588	3,233	3,825	3,431	4,140	5,228	5,588	4,577
TOTAL REVENUE	4,233	3,513	3,253	3,971	4,596	4,141	4,974	6,232	6,633	5,408
Competitive Bid	747	2,854	2,434	2,746	2,793	2,801	3,225	3,146	3,499	3,171
Negotiated	626	1,058	1,141	1,258	1,519	1,568	2,369	3,013	3,531	2,187
TOTAL GENERAL OBLIGATION	1,373	3,912	3,575	4,004	4,312	4,369	5,594	6,159	7,030	5,358
TOTAL BONDS	5,606	7,425	6,828	7,975	8,908	8,510	10,568	12,391	13,663	10,766

* Excludes taxable municipal bonds and all maturities under 13 months; data prior to 1986 excludes issues of under \$5 million.

Sources: Securities Industry Association Fact Book.

Annex Table 10: Number of Mutual Funds: 1980-1994

Year	Equity Funds	Bond & Income Funds	Taxable Money Market Funds	Tax-exempt Money Market Funds	Total
1980	228	170	96	10	564
1985	579	492	346	111	1,528
1986	701	654	359	126	1,840
1987	846	930	388	153	2,317
1988	1,016	1,094	431	174	2,715
1989	1,080	1,173	463	201	2,917
1990	1,127	1,235	508	235	3,105
1991	1,217	1,389	554	267	3,427
1992	1,356	1,629	586	279	3,850
1993	1,615	2,023	628	292	4,558
1994	1,944	2,450	644	319	5,357

Source: Investment Company Institute Mutual Fund Fact Book

Annex Table 11: Mutual Fund Industry Assets: 1970-1994
(US\$ Billions)

Year	Equity Funds	Bond & Income Funds	Taxable Money Market Funds	Tax-exempt Money Market Funds	Total
1970	45.1	2.5	-	-	7.6
1975	37.5	4.7	3.7	-	45.9
1980	44.4	14.0	74.5	1.9	134.8
1985	116.9	134.8	207.5	36.3	495.5
1986	161.5	262.6	228.3	63.8	716.2
1987	180.7	273.1	254.7	61.4	769.9
1988	194.8	277.5	272.3	65.7	810.3
1989	249.1	304.8	358.7	69.4	982.0
1990	245.8	322.7	414.7	83.6	1,066.8
1991	411.6	441.4	452.6	89.9	1,395.5
1992	522.8	577.3	451.4	94.8	1,646.3
1993	749.0	761.1	461.9	103.4	2,075.4
1994	866.5	684.0	500.4	110.6	2,161.5

Source: Investment Company Institute Mutual Fund Fact Book

**Annex Table 12: Distribution of Mutual Fund Assets in Equity and Bond & Income Funds
Year-End, 1980-1994**

Year	Total Net Assets US\$ Billions	Percent Distribution					
		Net Cash & Equivalent	Corporate Bonds	Corporate Stocks	Municipal Bonds	Long-term U.S.Gov't	Other
1980	58.4	9.1	11.3	72.1	4.9	2.4	0.2
1981	55.2	9.5	13.6	67.1	5.5	3.9	0.4
1982	76.8	7.9	14.1	64.2	8.8	4.9	0.1
1983	113.6	7.3	11.5	65.5	11.8	3.4	0.5
1984	137.1	8.7	11.0	60.7	13.5	5.8	0.3
1985	251.7	8.2	9.9	49.1	15.2	17.3	0.3
1986	424.1	7.3	11.2	37.9	16.7	26.3	0.6
1987	453.8	8.4	9.2	40.1	15.1	26.4	0.8
1988	472.3	9.5	11.5	38.0	18.2	22.0	0.8
1989	553.8	8.1	9.6	44.4	15.3	21.3	1.3
1990	568.5	8.5	7.8	38.6	20.9	22.6	1.6
1991	853.1	7.1	10.2	45.1	17.5	19.1	1.0
1992	1,100.1	6.8	10.5	44.6	17.4	20.4	0.3
1993	1,510.0	6.6	11.3	47.2	16.5	18.1	0.3
1994	1,550.5	7.8	10.1	53.5	13.6	14.3	0.7

Source: Investment Company Institute Mutual Fund Fact Book

Annex Table 13: Mutual Fund Industry Shareholder Accounts: 1980-1994
(US\$ Millions)

Year	Equity Funds*	Bond & Income Funds	Taxable Money Market Funds	Tax-exempt Money Market Funds	Total
1980	5.8	1.5	4.8	-	9.8
1985	11.5	8.3	14.4	0.5	34.7
1986	16.6	13.2	15.6	0.7	46.1
1987	21.4	15.5	16.8	0.8	54.5
1988	20.6	15.6	17.6	0.9	54.7
1989	21.5	15.4	20.2	1.1	58.2
1990	23.0	16.6	21.6	1.4	62.6
1991	26.1	18.9	21.9	1.7	68.6
1992	33.2	23.4	21.8	1.9	80.3
1993	42.5	27.5	21.6	2.0	93.6
1994	59.1	30.5	23.3	2.0	114.9

* Equity funds could not be counted separately from bond and income funds before 1978.

Source: Investment Company Institute Mutual Fund Fact Book

Annex Table 14: U.S. Mutual Fund Sales
(Billions of U.S. Dollars)

	Total		Equity		Bond & Income --	
	Total Sales	Net Sales	Total Sales	Net Sales	Total Sales	Net Sales
1983	40.3	25.6	22.1	13.2	18.2	12.4
1984	45.9	25.8	20.3	9.4	25.5	16.5
1985	114.3	80.6	30.1	11.9	84.2	68.6
1986	215.8	148.8	57.7	30.5	158.1	118.3
1987	190.6	74.4	72.1	31.9	118.6	42.5
1988	95.3	2.8	31.0	(3.8)	64.3	6.6
1989	125.7	34.1	54.5	16.2	71.2	17.9
1990	149.5	51.3	71.2	25.7	78.3	25.5
1991	236.6	120.3	98.6	44.4	138.1	76.0
1992	364.4	198.9	144.7	82.2	219.7	116.7
1993	511.6	280.2	228.8	135.9	282.8	144.3
1994	474.3	144.6	271.1	129.1	203.3	15.4

Source: Investment Company Institute Mutual Fund Fact Book

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