DIVISION OF CORPORATION FINANCE

TRAINING PROGRAM LECTURES

Seventeenth Session -- April 18, 1957

Subject : Analysis of a Registration Statement of an Investment Company and Requirements of Commission's Statement of Policy on Sales Literature

Speakers: Mr. Harvey Ollsen, Section Chief
Division of Corporation Finance

Mr. Charles E. Shreve, Acting Chief Counsel
Division of Corporation Finance

MR. OLLSEN: My subject is the examination of a registration statement by an investment company under the Securities Act of 1933.

Companies of this type invest in the securities of other companies and sell their own securities to the public. Most companies that file under the Securities Act are open-end, diversified management companies. An open-end company is a company which issues redeemable securities. That is, a person may at any time turn in his shares and get his proportionate share of the assets of the company. That proportionate share may be more or less than what he paid in because of the fluctuating value of the securities. That is one matter that should be pointed out in the prospectus. Diversified means, as the name indicates, that the portfolio is invested in a diversified list of securities as defined in the Investment Company Act of 1940.

A management company is any company other than a unit investment trust or a face-amount company.

These open-end companies generally make a continuous offering. That is, they sell year after year, register new blocks of stock, keep selling in an attempt to build up the size of the company. The sales load is generally about 8-1/2% of the public offering price, or about 9.3% of the net asset value. The sales load goes to the underwriter. The investment advisory fee which is usually paid quarterly and is equivalent on an annual basis to about 1/2 of 1% of the net assets of the company. However, this usually amounts to about 15 or 20% of the investment income of the company. Both of these ratios are required to be set forth in the prospectus.

The company first must be registered under the Investment Company Act of 1940. Registration is effected by filing a notification on Form N-8A, and a registration statement must be filed on Form N-8B-1 within 3 months thereafter. The registration under the Securities Act is on Form S-5, and this consists substantially of selected information from the Form N-8B-1. If the Form N-8B-1 under the Investment Company Act is not filed when the registration statement under the Securities Act is filed, the registrant should be advised immediately to file the Form N-8B-1 because it is impracticable to examine the Securities Act filing until we have all the data which should be filed under the Investment Company Act.

Copies of the registration statement under the Investment Company Act and under the Securities Act go to the Division of Corporation Finance, and copies also go the the Division of Corporate Regulation. The work of the two Divisions is coordinated and a letter is not sent out by the Division of Corporation Finance until we receive the comments of the Division of Corporate Regulation.

In the examination the first thing you will notice is the name of the company. The name itself may be misleading. In this connection, the first sentence of Section 35(b) of the Investment Company Act prohibits the use of any name of a company or the title of any security which is deceptive or misleading. Some years ago there was a proposed filing by a company called Investors Preferred Fund, Inc. The implication was that the securities of the company or the company was preferred in some respect. After discussions with the company, the name was changed to Investors Preferred Stock Fund, Inc., which was really what it was -- a company investing in preferred stock.

Recently a company filed a registration statement by the name of Atomic Electronic & Chemical Fund, Inc. The company was referred to as A.E.C. Fund -- A.E.C. being the same initials as the Atomic Energy Commission. Some people might have thought that the fund was in some way linked with the Atomic Energy Commission or in some way sponsored by the Government. The Commission objected to the use of the name, and objections were filed formally by other companies with similar names, such as Atomic Development Fund, etc. They felt that this new company might be confused with their companies or the securities of their companies on which they had spent considerable money to get the companies started. After discussions, the name was changed to Nucleonic Chemistry and Electronic Shares, Inc.

Section 14 of the Investment Company Act prohibits a public offering under the Securities Act unless the company has a net worth of $100,000 on firm subscriptions of not more than 25 persons which will assure it of a net worth of $100,000. The examiner should be sure that the company does have this net worth, and if subscriptions have been made by insiders or directors to get the company started, that those subscriptions are bona fide. In other words, in an open-end company after the company has sold its securities, these persons who put up the $100,000 may have the legal right to redeem their stock, and some of them have redeemed it just as soon as the public offering has been commenced. The Commission policy is that they should hold the securities for investment.

The main sales appeal of these investment companies is the past performance of the company and the anticipated future performance. These companies produce no steel or copper, run no railroads or airlines. They are, in effect, merely selling the know-how of the investment management. Their stock in trade is the ability of their management, and they go to great length to indicate that the management possess investment knowledge. In order to do this the prospectus of the company may contain inferences and implications which may tend to distort the past performance of the company and imply substantial future performance.

The prospectus may contain statements of prospective liberal income, preservation and growth of capital, to be attained by expert professional investment management with vast experience in investment research. The examiner should watch the statements of investment policy and objectives such as: (1) a liberal return on your investment, whereas in examining the statement the performance of the fund in the past has only been average or perhaps poor; (2) statements as to objectives for preservation of capital, whereas the portfolios of the company contain speculative securities. In connection with the above, the Commission's Statement of Policy prohibits implications of high return or increase in capital.

For example, a prospectus was filed recently by a company which included reference to experienced, professional investment management; professional investment experts; specialists with wide experience and knowledge, devoting their entire working time to the management of securities. However, in looking over the registration statement and the financial statement and the ten-year record which is required to be put in the prospectus by Item 12 of Form N-8B-1, it was noted that the past performance was poor in comparison with other funds. In view of the mediocre record of the fund a comment was cited to the effect that such references to the management's ability were extravagant in light of the moderate performance of the fund to date. Attention was also directed to Paragraph (k) of the Commission's Statement of Policy which prohibits extravagant claims regarding ability of management. In the amendment the above references were deleted or revised.

In examining the registration statement, the examiner should be careful to check the responses to Items 4 and 5 of Form N-8B-1 and the reflection of those items in the prospectus, as to portfolio turn-over, types of securities invested in, whether or not the company will invest for the purpose of controlling other companies, whether it will concentrate in certain industries, and similar matters. A definite statement should be made as to these. The Act provides that the company may reserve freedom of action, but we have interpreted that to mean that the company cannot reserve complete freedom of action. It has to indicate some limits. For example, it cannot say that the company does not intend to borrow money but it reserves complete freedom of action to borrow money at any time. It may say that the company does not intend to borrow money but reserves freedom of action to borrow sums up to 10% of its assets -- some overall limit.

Some years ago a registration statement was filed by a company called Composite Foreign Funds, Inc. The prospectus indicated that the policy of the fund was to invest in a selected and diversified list of bonds and that the company contemplated the purchase of securities for investment. However, when we looked at the portfolio given in the back of the prospectus, it did not appear very impressive and included a lot of bonds which had high returns. So we checked the statistical services such as Moody's, checked every security in the portfolio, and found that very few of them had an A or even a B rating, and most of them had a very low rating. Therefore the following deficiency was cited:

> "In view of the fact that only about 1/4 of the funds of the company as at the end of the year were invested in bonds carrying ratings by the services indicating them to be securities for investment for income and that at least a substantial portion of the remainder are of an entirely speculative character, it appears that the statement of policy in the prospectus should be expanded to indicate more clearly the company's policy as regards investment for income and investment for appreciation."

The prospectus was amended and disclosed that a substantial part of the fund was invested in speculative bonds and that the management intended to continue this policy.

Where a company has a name which implies that it invests in certain types of securities or in certain industries, or where its statement of policy indicates that it invests in a certain way, we hold it is misleading if the company in fact invests differently. For example, if a company is called Atomic Fund and the portfolio shows substantial investments in railroads, it is clear that it is misleading. In the case of Nucleonics Chemistry and Electronics Fund the statement of objectives implied that the company would make substantial investments in these three fields. But the limited investment restriction and the broad definitions of the constituent industries actually permitted the investment in a broad list similar to the portfolio of the average investment company. For example, they said they would invest in companies which use chemical processes. U.S. Steel Company uses chemical processes. They said they would invest in companies that are connected with the electronic industry. A. T. & T. is connected with the electronic industry. The following comment was cited:

> "If, as it appears, the broad limits and definitions relating to investment policy will permit the fund to invest in a large selection of securities which is substantially a cross-section of industry, such as those selected by the average investment company, and therefore will in fact not be unique in its investment policy as opposed to the policies of other investment companies, information to this effect should be disclosed in the prospectus."

It was also pointed out that if the investment policy was not changed, the name would be inappropriate.

The matter was discussed by members of the Division of Corporation Finance and the Division of Corporate Regulation with representatives of the company. As a consequence, the name was changed. The solution was somewhat complicated because of the three industries. When a company indicates that it invests in one industry, the industry has to be defined and a substantial portion of the funds invested in the securities of that industry. Here we had three industries: nucleonics, chemistry, and electronics. The amended prospectus defined more clearly and in more restrictive terms the three fields represented by nucleonics, electronics and chemistry. It also disclosed, in effect, that investments would be in common stock. All common stock investments would be in companies active in one or more of these fields to at least 25% in each field. At least 75% of investments would be in companies deriving a principal portion of their gross revenues from activities in one or more of these three fields, and at least 15% would be so invested in each of these three fields. That meant that they had to invest at least 15% of their assets in companies which derived a major portion of their gross revenues from one of these three fields, and 25% of their assets in companies which were at least active in each of these three fields.

Another matter that the examiner should watch is the disclosure with respect to the interest of directors, officers and associates. These investment companies generally pay very small or no salaries at all. The investment adviser of the company which handles the portfolio of the company for its fee or 1/2 of 1% generally pays most of the expenses, including salaries. However, the officers and directors of the company often have a substantial interest in underwriting firms, or in the investment advisory firm, or in both. The prospectus will disclose that the company pays no salaries, but the investment advisory firm may be getting half a million dollars a year. The president of the fund may be a substantial stockholder in the investment advisory firm. The examiner should be sure that appropriate disclosure is made in the prospectus of fees and other direct and indirect remunerations to the underwriting firm, the investment advisory firm, and a clear disclosure of any interest of officers, directors, and associates in those firms.

Periodic payment plans are defined in Section 27 of the Investment Company Act. Generally a periodic payment plan is merely a means of selling underlying shares in an open-end investment company. In other words, you may buy certificates for X dollars, and you make payments of $25, $50, or $100 per month over a period of years. The sales load is deducted and what remains is invested in the securities of the open-end investment company. Under the Act the sales load must not exceed 9% of the total payment. However, up to 1/2 of the first 12 months payments may be deducted as the sales load, or 50% of what the investor pays in the first year may go to the underwriter and only 50% is actually invested.

This large front end load should be clearly explained in the prospectus, and it should be clearly indicated that the investor will suffer a substantial loss if the program is terminated in the early years. In this connection, the Commission's Statement of Policy on sales literature of investment companies requires that, with respect to any periodic payment plan, it should be indicated that the investor will incur a loss under the plan if he discontinues the plan when the market value of his accumulated shares is less than his cost; that the investor is investing his funds primarily in securities subject to market fluctuations; and that the method involves continuous investment of such shares at regular intervals regardless of the price level. The investor must take into account his financial ability to continue such plans through periods of low price level, and that such plans do not protect against loss of value from declining market. All of those matters should be disclosed in the prospectus.

Periodic payment plans should not be confused with so-called systematic payment plans which are used by some regular open-end investment companies. For example, an open-end investment company will go out and sell its securities to the public and try to get some one to buy 100 shares. It will suggest to such buyer that he should have a program of putting away or saving his money periodically. They will sell him a systematic payment plan by which he signs a statement of intention that he will buy $200 worth every two months. These plans carry no obligation on the part of the investor actually to make the purchase. They are merely statements of intention. Each time the investor buys the regular sales load of 8-1/2% of the public offering price is deducted.

Closed-end funds file registration statements under the Investment Company Act on Form N-8B-1, the same as open-end companies. Some items in that form are applicable only to each type of company.

In some cases the investment company is organized as closed-end to permit a firm commitment underwriting of the initial block, and then later it is changed to an open-end company. For example, in setting up a new fund, they will set up a closed-end company, getting an underwriting group to underwrite the first block of 1,000,000 shares, sell it to the public, say, for $10 per share. When the $10,000,000 is received, then they switch over to their regular underwriter who is connected with the management, change the company to an open-end company, and make continuous offerings from that point. The more the management can build up these funds, the more it is to their benefit because the management fee is 1/2 of 1% of total assets per year. For a small company that may be trivial. On a $100,000,000 fund it would be half a million dollars per year. In either event, it has the supervision of the portfolio, and although the larger fund may involve more work and more responsibility, it wouldn't be in relation to the fee.

There are also face-amount certificate companies. These companies are defined in Section 2(a)(15) of the Investment Company Act. Section 28 of the Act indicates certain restrictions upon or requirements for such company. A fully paid certificate is one where the investor makes a lump sum payment, say $900. The company at the end of a year will pay him back $1,000. In effect it is a promissory note. Very few of that type are sold. Most of the certificates sold by such companies are the installment type certificates. The investor makes payments monthly, quarterly, semiannually, or annually, and at the end of a period of years he gets back a lump sum. In other words, installment type certificates are somewhat similar to the endowment policies of insurance companies with one very important difference - there is no insurance protection. If the certificate is terminated, the person gets only the cash surrender value. Reserves must be maintained at all times and be computed at not in excess of 3-1/2%. In this connection I might point out that the lower the rate used in computing reserves, the stronger the reserves. If the investor paid in $100 per year and the company put the entire $100 in the reserve, that would be a zero rate of return, a zero rate of computing the reserve. If he paid $100 per year and the company put only $70 in the reserve, this would assume a computation of 5, 6, 7 or 8%.

The Act says that face amount companies must put in the reserve an amount which at no more than 3-1/2% would figure out to the maturity value. In other words, the Act is saying that a face-amount investment company cannot assume that it can invest its funds at a rate greater than 3-1/2%.

The yields on face-certificates are very small. They are generally sold on a forced savings basis for some objective, such as a child's education, or retirement, or something else for the future. By forced savings I mean that there is a plan that you will go through with.

Disclosures with respect to these companies should be made right on the facing page of the prospectus of (1) the yields to maturity on each certificate; (2) the year when the cash surrender value will equal the amount paid in; and (3) the effect of lapses in payments, that is, if the investor fails to make a payment, the maturity date is extended and the yield is reduced.

MR. SHREVE. I shall try to expand a bit on the subject of the Statement of Policy to which Harvey Ollsen alluded in his remarks.

Section 24(b) of the Investment Company Act requires the filing of supplemental sales literature used by registered open-end, unit and face-amount investment companies or their underwriter. In 1950 the Commission reviewed samples of this advertising and supplemental sales literature of investment companies -- both material that was on file and material which was not filed. This examination revealed practices which appeared to violate the anti-fraud standards of the 1933 and 1940 Acts. Accordingly, in 1950 the Commission issued a Statement of Policy to assist issuers, underwriters and dealers to conform to the anti-fraud standards of the Acts. This Statement of Policy was amended in January, 1955, and further amendments are now under consideration by the Commission.

What is the basisof the issuance of such Statement of Policy? It is not a rule-making power. There is no express provision in the statutes for adopting rules on this subject. It is more in the nature of an interpretive power over which a court would have final, ultimate authority.

The validity of the Statement of Policy depends upon its acceptance by the courts. The courts have held that the interpretation by the expert agency should control unless plainly erroneous. In view of this attitude of the courts, it is felt that the Statement of Policy should serve as a useful aid to the industry in the preparation of sales literature.

The Statement of Policy declares that it covers all sales literature, written, radio, or television, as used by an issuer, underwriter or dealer. As has been indicated, the standards which we apply to the Statement of Policy are also applicable to the prospectus and to the registration statement.

The Statement of Policy declares that regular reports to stockholders are not sales literature if they do not contain an express offer of securities. But such reports must conform to the Statement of Policy.

The NASD has undertaken to review the sales literature of its members for conformity with the Statement of Policy.

One of the principles of the Statement of Policy is that if material is in fact misleading, the fact that there is no express prohibition in the Statement of Policy does not prevent it from being fraudulent or deceptive.

Another general rule is that sales literature is misleading if it contains untrue statement of material facts or omits material facts necessary to make the statement complete and not misleading.

The Statement of Policy declares that it is materially misleading to represent or imply a percentage rate of return on investment. It also declares that it is misleading to combine in one amount investment income and other distributions, such as capital gains. This requirement is particularly important in connection with charts and tables.

It is also regarded as misleading to imply a stable, continuous, dependable, liberal, or specific rate of return.

The Statement of Policy states that you may not imply safety of capital, increase in capital, or protection against loss in value. Other discussions, such as accumulation of capital, or estate, protection against loss of purchasing power, diversification, and profit possibilities, must point out the inherent market risks involved. The Statement of Policy warns against referring to Federal or State supervision without explaining there is no supervision of the management of investment companies. It states that you should not imply protection from depreciation, or protection by use of a named custodian or transfer agent, or dividend paying agent.

Any discussion of redemption features should include an explanation of the effect of market values in determining redemption prices. It is regarded as improper to imply similarity of investment company securities with Government bonds, insurance, savings accounts, etc. Similarly, it should not be implied that investment companies are subject to regulations similar to those applied to savings banks and insurance companies.

If comparison is made with a market index or other medium of investment, you should show the basis of selection of the medium and period involved and factors affecting the result such as investment policy, the material differences between the two subjects, and anything else to make the comparison fair.

One should not represent that the investment company is a direct source of new capital to industry. Extravagant claims of management ability should not be made. It is improper to imply that investment companies are similar to cooperatives, or that their shares are generally selected by fiduciaries as an investment medium. Any discussion of dollar cost averaging, that is, investing regular amounts in the same shares at regular intervals over a long period of time which includes market rises, drops, or other types of continuous investment plans, should include a disclosure of the risks involved. In other words, it depends upon the market level at the time the investor chooses to leave the investment scheme, and, of course, depends upon his financial ability to carry on the investment plan during rising and falling markets.

There has been some attempt to demonstrate dollar cost averaging by using a market index. The feeling has been that if you want to demonstrate the dollar cost averaging, you should sell the actual experience of the investment fund involved.

If the sales commission charged upon the sale of the security is not shown, a clear reference should be made to information set forth in the prospectus in regard to such commission.

Where switching from one security to another is encouraged, there should be included a statement of the effect of the sales charge upon the switch.

Any comparison to industry performance should be limited to companies whose portfolios approximate that industry. Any use of published articles by quotation should conform to the Statement of Policy and not take the publication out of context.

There are pending certain amendment proposals. These amendment proposals deal primarily with the use of charts and tables. Such charts and tables commonly refer to an investment of a lump sum -- say $10,000. They must reflect the immediate deduction of the sales charge which, if it were 7-1/2%, would reduce the net amount invested initially to $9,250. Then there is a line that shows the performance by years for a ten-year period of the amount invested and retained in the fund, plus, in some cases, another line showing what would happen if you re-invested all capital gains distributions. Such capital gains distributions are commonly paid out because of the tax consequences of retaining them in the fund but may be reinvested.

Other types of charts show what would be the effect of re-investing distributions of dividend income. In such case it is generally regarded as necessary to show the re-investment of such dividend income as an increase in cost.

The proposed amendments were published last August. There have been public hearings, conferences with representative groups of the industry, various changes in the proposed revision of the Statement of Policy, and I believe certain principal areas of agreement have now been reached.

These agreements include the proposition that charts and tables should be governed by substantially the same rules. Charts and tables may cover the life of the company, or the preceding ten years, or periods exceeding ten years in multiples of 5. The reason for such arbitrary periods is to prevent any selection of a best period which shows the highest rise in the asset value of the fund. Also, certain of these charts and tables may reflect the reinvestment of dividend income.

There is one item of disagreement still outstanding. The industry objects to a proposal by the staff that when any chart or table is used showing the performance of hypothetical investment, such as $10,000, with its usual balooning effect because of the rising market, with the reinvestment of capital gains and dividends, that it be accompanied by a table of per share performance and rates of return based upon average annual asset value. This table, it was felt, would show more clearly what the company did on an annual basis, with funds at its disposal for investment. It would tend to bring down to earth the effect of these other charts and tables of the company.

There are a few forms in the mill, Forms N-8B-1, N-8B-2, N-8B-3, S-4, S-5 and S-6, for revision. The revision of those forms must wait upon the outcome of the remaining problems under the Statement of Policy.

Adjourned.