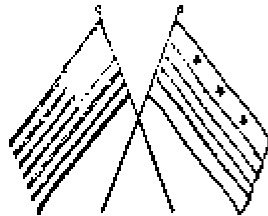

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PERSONAL

July 25, 1962

Honorable Timothy J. Reardon, Jr.
Special Assistant to the President
The White House
Washington, D. C.

Dear Ted:

A number of persons in the investment industry have insisted to me that the recent market decline is symptomatic of rapidly diminishing investor confidence directly related to the protracted securities markets investigation under H. J. Res. 438 now being conducted by the SEC. Although originally aimed at the securities markets, mutual funds and their management companies have received unusual emphasis. Insurance companies and other competitors for small and middle income investors have not been unhappy about this. Mutual funds have out-performed the market for a decade, and have attracted millions of investors.

SEC Chairman Cary has advised Congress that mutual funds have been the subject of an intensive study by the Commission over a period of three years, under a contract with the Wharton School of Finance at the University of Pennsylvania. That study is completed and will be published in the near future. It should be analyzed before additional investigations are undertaken.

Since December of 1959 the SEC has been circulating to investor advisers, investment companies, and distributors of securities a series of special questionnaires designed to elicit precise and up-to-date information on mutual fund operations. Many of these duplicate other investigations and cause unnecessary expense. They lead to constant adverse publicity and add nothing to the SEC's store of information.

There is a widespread feeling among investors and investment companies that continuing investigations shake public confidence in mutual funds. This adds fuel to the market decline and injures the entire economy.

In reviewing the transcript of testimony before the House subcommittee last year on H. J. Res. 438, industry members were much concerned at the line of questioning developed on the amount of fees paid to investment advisers under the Investment Company Act of 1940. There

seemed to be a concern with the fact that the amount of fees paid by mutual funds for professional advice and management is not regulated by the Securitied and Exchange Commission, apparently with the thought that such fees should be regulated as if management companies were public utilities.

This question of management and adviser fees was exhaustively considered by Congress in 1940 when the Act was passed. The original bill recommended by the SEC in 1940 was drafted on the basis of a 5-year study of investment companies. Congressional hearings occupied 21 days during a period of 3 months, and reflected considerable preparation. The final bill was drafted after 5 weeks of intensive work by the SEC and investment company counsel. (Hearings on S. 3580, Senate Banking and Currency Committee, and hearings on H. R. 10065, House Committee on Interstate and Foreign Commerce, 76th Cong. 3d sess. (1940).)

After most careful consideration the present provisions of the 1940 Act were thought by Congress to be the best solution. The Act is presently construed by the SEC as requiring the board of directors of a mutual fund to assure that adviser and management contracts, which must be approved annually by them or by the stockholders, are fair and equitable.

In addition, the independent directors of a mutual fund, that is directors not affiliated with the adviser or management company, are expressly charged with the duty of approving the renewal of such contracts pursuant to Section 15(c) of the Investment Company Act as an alternative to a stockholder's vote.

The SEC staff has long taken the position that the directors of a mutual fund have an obligation to determine whether an adviser or management contract with an outside company is to be preferred over the direct assumption of investment operations by the investment company (mutual fund) itself. The general consensus in the mutual fund industry has been for 20 years that the investors and the public are best served by having the highly technical and complicated management services performed by outside professional companies specializing in this kind of work. Likewise, over the years, it has become commonly accepted by the industry and investors that such professional services are best paid

for on the basis of a contingent fee of one-half of 1 percent of net asset value. This is far less than an investor pays on an individual basis, or banks and other financial institutions normally charge for similar services.

The Investment Company Act of 1940 sets a very high fiduciary standard of conduct for management in the investment company structure. This statute is very elaborately drawn to protect investors in every feasible way consistent with a free enterprise society.

The declaration of policies and purposes of the Investment Company Act, contained in Section 1(b), is in effect a codification of general fiduciary duties imposed upon directors, officers, investment advisers, and other controlling or managerial personnel of investment companies. The legislative objective is declared to be to eliminate various enumerated conditions adversely affecting the national public interest and interest of investors. The statute has worked better and caused less litigation than any the SEC administers.

Such documents as Senate Report No. 1775, 76th Cong., 3d sess. 1, and House Report No. 2639, 76th Cong., 3d sess. 5 (1940), should be reviewed by the White House staff in this connection. It will be seen that the objectives were attained years ago and there is no present need for more stringent regulation.

Under Section 14 of the Investment Company Act the SEC is presently authorized and required to make a continuing study and investigation of the size of investment companies and its effect on investment policy, on investment companies themselves, on security markets and related matters involving the protection of investors and the public interest. The SEC investigations presently under way and referred to above come under this section of the law. Additional protracted investigations add nothing and do much harm.

As stated in a recent article by Nathan Lobell, "mutual funds are emerging as one of the major financial

institutions of our day. Their growth has been phenomenal. Nearly 5 million shareholders own the $17 billion of mutual fund assets, and are given the benefits of investment management once available only to the rich."

This same article points out that "mutual funds have had a 35 times increase in assets in the past 20 years as against a 6½ times increase in the value of shares listed on the New York Stock Exchange. In the past 10 years the estimated number of shareholders of mutual funds has increased more than five times as against less than a two times increase in holders of shares listed on the exchange. During that 10 years, funds have been adding investors at an average rate of 1,000 per day."

SEC Chairman Cary recently testified before the Committee on Appropriations that the number of registered investment companies has increased from 432 in 1957 to 570 in 1960, and stated that he expects there will be 630 such companies in 1961, and 705 by 1962. He further stated "it appears that the estimated aggregate net asset value of registered investment companies has increased from $15 billion at the close of 1957 to about $23.5 billion at the end of 1960. We estimate that these figures will reach $27 billion and $32 billion at the close of 1961 and 1962, respectively." He made a special point of the rapid increases in the estimated number of shareholder accounts in registered investment companies.

He said "at the close of 1957, there were approximately 3.1 million persons owning these securities as compared with 4.6 million accounts at the close of 1960. We anticipate that this number will increase to 4.9 and 5.2 million shareholder accounts at the close of 1961 and 1962, respectively. These figures, I may say, apply only to the open-end mutual funds, whose net assets are about 75 percent of the total I have given. It does not include the very substantial closed-end companies. The total number of shareholders for whose protection the Invesmtnet Company Act was passed is, therefore, substantially more than the estimates I have given."

Mutual funds are presently as closely regulated by the SEC as investor protection and the public interest can possibly require measured by any standard of reason in a free enterprise society.

The important purposes of H. J. Res. 438 have been permitted to be sidetracked by allowing the investigation to be diverted to mutual funds, which are already burdened with current SEC investigations. More importantly, the securities markets investigation should be conducted with a minimum of publicity and terminated at the earliest possible time consistent with accomplishing the purposes Congress had in mind. Finally, it should be remembered that the extraordinary success of mutual funds has been due in large measure to successful management by the professional staffs of the independent management companies. Any change in the present industry pattern and the adverse effect it will have on the mutual fund industry and the millions of shareholders whose life savings are at stake can only be justified by a substantial showing of gross abuse of trust, or gross misconduct of a kind not now regulated under Section 36, and other provisions of the Investment Company Act of 1940. The SEC has tacitly approved this management pattern for two decades. There has not been any suggestion of mismanagement or any showing that the present law is inadequate to regulate the industry.

Financial journals are constantly filled with rumors of adverse legislation in this area soon to be proposed by the SEC. For example, Forbes magazine recently carried an article full of grim forebodings. It would be in the national interest for the White House to bring this matter under control so that investor confidence can be restored at the earliest possible time. This is the only road to a full-employment economy.

Very truly yours,

Carl L. Shipley
Chairman

CLS:tb