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1973 – A CHALLENGE TO INNOVATE

An Address By

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Securities and Exchange Commission

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It is a pleasure for me to be here today to speak to the members of the Investment Company Institute. I want to talk with you about future developments that are likely to have an effect upon your industry and the challenge they present for us all. We at the Commission can appreciate that this past year has not been easy for you. Small investors have been staying out of the markets, competing products and financial services have developed a significant following and are likely to be even stronger competition in the future -- and the fund industry is still in the throes of an unprecedented period of net redemptions.

I do not mean to suggest that your very survival is at stake. The fund industry is too strong and too important to our securities markets and economy for there to be any doubt that you will be in business for many years to come. But survival should not be our emphasis. Change is upon us and we must all work for adjustment that will better enable you to serve investors and provide a sound foundation for renewed industry growth in the future.

A major area of concern, of course, is the viability of the mutual fund distribution system. Some change is almost certain in this area. Advertising restrictions will be relaxed to the fullest extent possible, consistent with the requirements of the Securities Act of 1933; there may also be some revisions in the current restrictions against providing quantity discounts to groups purchasing mutual fund shares. We will continue to do what we can to simplify paperwork requirements in connection with mutual fund sales, and an NASD rule package designed to assure reasonable sales loads to investors will probably become operative.

In the context of these changes that will impact the fund distribution system, and others that may result from our study, your key concern nonetheless is with the Commission's decision on the fundamental issue of repeal of Section 22(d) -- the uniform offering price provision of the Investment Company Act. I can tell you now that we have not yet formulated our position.

We have recently completed the mutual fund distribution hearings; they involved 15 days of oral presentations, more than 70 appearances and over 100 written submissions. The Commission was gratified by your response. The written submissions, both in quantity and quality, were impressive. They reflected a great deal of thought and provided some new ideas and insights into the fund distribution system. You are to be congratulated for your open and candid approach to the issues and for your cooperation.

As regards a timetable, I personally would like to see the Commission's recommendations spelled out by this summer and the completion of any discussion and necessary changes in the distribution area this year. I would also like to see us reach the point where by the end of this year we will be able to put aside our concerns with the distribution system -- for the first time in more than a decade -- and allow time for stabilization and adjustment, so that we can all turn to meet other challenges that lie ahead.

The challenges, of course, are many. One of the lessons of the hearings is that, like ladies fashions, the fund concept is taking many new forms.

Just 10 years ago fund managers, for the most part, were only that. Perhaps some were also investment counselors or broker-dealers whose fund activities were a natural adjunct to their other business. In contrast, many fund management companies today are part of a much larger, broadly diversified, complex of financial holding companies, insurance companies or even major conglomerates, often publicly held. This trend to diversification is also apparent at the level of the investment adviser itself. Thus, in addition to advising mutual funds, advisers today also provide a host of other money management products, including traditional private counseling, so called mini-accounts, investment advisory subscription services, unit trust bond funds and closed-end income or venture capital companies, real estate syndications and other tax sheltered programs and variable annuities, and, of course -- soon to come -- variable life insurance.

In a sense this trend to diversification is the fund industry's chicken and egg problem. Its hard to say whether competition has forced the industry to diversify or whether diversification created competition.

But in any event, we have both competition and diversification, and both cause problems for the regulators. The Investment Company Act is directed to areas where a demonstrated need for investor protection existed in 1940. However, one must question the worth of existing regulation when the diversification of the past 33 years has introduced activities with the same potential for abuse but which are totally unregulated. That is not to say that all money management vehicles should be subject to equal regulation under an Investment Company Act type statute, but rather that we are aware that, unlike investment companies, a number of money management vehicles and services have been developed and are being sold without sufficient regulatory protection. For this reason, our staff is re-examining the existing statutory pattern -- perhaps "patch-work" would be a better term -- of protection for the investor.

The thrust of the analysis is what, if any, additional responses or adjustments in the regulatory structure ought to be made. There are a number of obvious gaps, and we will be considering the level and type of protection appropriate and necessary for each vehicle. Our interest is not confined solely to unregulated vehicles. For example, we are turning our attention to the closed-end investment company. While closed-end companies dominated the industry during the 1930's, by 1950 and until very recently they were not a significant factor. Now, after three decades of relative quiescence, syndicated offerings of closed-end investment companies have suddenly blossomed into the principal competitor for the mutual fund. Over \$1.2 billion of closed-end funds were sold in 1972, another \$1.2 billion hit the market in the first four months of 1973, and at last count, another \$552 million were registered with the Commission and waiting to go effective. By comparison, there were \$1.5 billion in net redemptions of mutual fund shares in calendar 1972.

The great majority of these closed-end funds are intended to provide maximum current income, generally through investment in the bond market, and are sponsored by banks and insurance companies. Like the real estate investment trusts, which raised almost \$6 billion from public offerings from 1969 through 1972, closed-end bond funds are sold to investor anxious to participate in the returns resulting from the high level of interest rates in recent years. These funds are apparently sold on the inference that a yield of better than 7% will be available in the future and also with the promise that some appreciation can be achieved from skillful management of portfolio trading. Certainly, this potential return appears attractive in light of the recent performance of the equity market and of many mutual funds, and the availability of REIT's and bond funds may have contributed both directly and indirectly to the apparent disappearance of the small investor from the stock market during the past several years.

In addition to offering the appeal of a higher current return, the bond fund salesman has a selling tool not available to his open-end competitor -- the existence of a closing date, which compels the prospect to make a quick decision. Furthermore, although maximum sales loads charged by closed-end funds may not be quite as high as the maximum rates charged by mutual funds, the sales incentives may be much greater because there is often no distributor's retention nor quantity discount. Finally, the NASD's proposed rule, which will prevent use of portfolio brokerage to promote the sale of fund shares, does not cover closed-end companies -- although we expect this omission to be corrected as soon as possible.

We are also curious about the performance of these funds in the after-market. The shares of most closed-end companies investing in common stocks trade in the secondary market at a discount from net asset value. Managers of the new closed-end bond funds appear, however, to have discovered the secret of perpetual motion. By offering shareholders the opportunity for reinvestment of dividends, monthly distributions of a fund may effectively provide a partial floor for the secondary market.

In a few cases, shares of such funds are even selling at slight premiums over net asset value.

I wonder how long the enthusiasm for bond funds can continue, particularly if the investor fails to recognize either the impact of the initial sales charge and the management fee on the ultimate return or the fact that the values of bond portfolios, unlike savings accounts, are highly volatile. Furthermore, to maximize profit, many bond fund managers have quite properly employed leverage and rapid portfolio turnover. These practices have become more difficult in the current market, where the supply of new long-term issues has been limited and the spread between yields on short and long-term interest rates has narrowed.

From past experience, we are concerned that the last chapter in the tale of these funds not be one of unfulfilled expectations for investors and unremitting public disfavor for the vehicles and their sponsors. For this reason, I have asked our staff to review the underwriting and selling techniques employed in distributing these funds, as well as their subsequent operation, including the portfolio management practices and expenses involved, and the accounting and valuation procedures followed.

Apart from the particular phenomenon of closed- end funds, the increasing activity of banks in the public money management arena is receiving more of our attention. Some banks have registered their adviser subsidiaries under the Advisers Act. However, at best this gives us an uneven regulatory handle over this largest group of investment managers. The Commission staff has expressed some concern that federal banking regulation, with its natural emphasis on bank solvency, is not comparable to that experienced by registered investment advisers. The Commission itself has not yet determined whether it might be necessary or advisable to sponsor legislation which would require registration of bank trust department money management activities under the Advisers Act but this is a possibility that should be considered.

Even more basic than regulation, however, is the question of disclosure by all institutional money managers of their portfolio holdings and transactions, first suggested in the Commission's Institutional Investor Study of 1971. Since that Study, the securities markets have become even more "institutionalized". A number of observers have described the current institutional investor as focusing mainly on short-term performance, which results in extraordinarily high portfolio turnover ratios, and concentrating investment in glamour stocks selling at high price-earnings ratios -- the "religion stocks". These characteristics, it is argued, account partially for the "air pockets" that have hit a number of NYSE-listed securities, sometimes reducing the market value of a stock dramatically in a single day. We are reminded of the old adage that someone has to get hurt when everyone tries to run for the door at the same time. In addition, we understand this situation has led the small investor to take shelter in other investment media outside the securities markets. As I have said on other occasions, the absence of the individual investor already appears to be having a strong, visibly adverse effect on the liquidity of our capital markets. Some observers have even advocated restricting institutional ownership or trading of securities.

On other occasions I have discussed my opposition to artificial barriers in the market place, but in order to restore the individual investor's confidence in the stock market, the Commission is considering requesting Congress to enact an Institutional Disclosure Act to give the Commission rule-making power to require reports of holdings and transactions from all types of institutional managers. My feeling at this point is that all managers of more than \$100 million in discretionary money, including registered investment advisers, banks, insurance companies, and all varieties of internal pools, should file quarterly public reports with the Commission indicating institutional holdings and block transactions (10,000 shares or 1% of the outstanding shares) in so-called reporting companies.

I believe that, in view of the importance today of the institutional investor, disclosure of this data may be as important to the individual as disclosure of corporate results. Hopefully, institutional investors will recognize the value of this program for them, since they depend heavily on a liquid and viable market place for their investments.

Another money management vehicle of interest to you all, I am sure, is the mini-account -- the non-pooled investment management arrangement designed to provide professional investment advice to smaller individual investors. As you know, these services offer direct security ownership rather than an indirect investment through a mutual fund, while also providing access to professional investment advice and continuous management. At the same time, however, they present questions about the applicability of the Investment Company Act, the Securities Act of 1933 and other federal securities laws. As a first step toward resolving these questions and clarifying our policy in this area, the Commission last October appointed an Advisory Committee to focus on the area.

Recognizing that more data was needed than that available personally to its members, the Committee asked us to send a questionnaire to firms providing mini-account services. Our Division of Investment Management Regulation received replies from 71 firms offering such arrangements. It is interesting to note that 70 percent of the respondents have had their service in operation for five years or less and that they already manage close to 24,000 accounts with assets under management of nearly \$1 billion. Further, while a mini-account was defined as having an upper limit of \$200,000, almost 70 percent of the 24,000 accounts were in the \$5,000 to \$50,000 range. None of these 71 arrangements was registered under either the Investment Company Act or Securities Act.

In its January 1973 report, the Committee recommended that: small account investment management services should not be treated as investment companies if they do not involve pooling and the client has all the attributes of direct ownership of securities, such as ownership and control of specified whole shares of securities, with

confirmations after every transaction; and also that the offer of small account investment management services with the indicated attributes should not be treated as a public offer of securities which would have to be registered under the Securities Act.

The Committee also made recommendations for other rules to define individualized treatment, improve disclosure to clients and prospective clients and lessen conflicts of interest and other potential abuses.

These recommendations appear logical but they are far-reaching and call for the Commission and staff to substantially re-think prior legal positions. We are now giving them our very careful consideration and I expect that in the near future we will announce our general conclusions about the direction we will follow in this relatively new, but already significant, area of money management. We are aware, of course, that the ICI urged before the Committee that a regulatory gap not be created by inappropriate exemptions from registration under the federal securities laws. Whatever our decision, I am sure that mini-account services will only be encouraged in a manner consistent with the protection of investors.

In recent years, the mutual fund industry has faced competition from other types of investment vehicles whose appeal has not always been as an opportunity to profit, but rather the tax shelter they provide. Indeed, many such programs, unlike mutual funds, offer investors little or no realistic chance of recovering even the original investment. To a significant degree, tax shelters are another form of money management, competing directly with investment companies for the same savings dollar, and presenting problems reminiscent of those common to the early investment company industry. For example, they often feature incredibly complex structures, built-in conflicts of interest, opportunities for self-dealing, and problems arising from externalized management.

In one particular tax shelter area -- oil and gas programs -- we have already proposed remedial legislation. You may recall that the original recommendation in 1970 was simply that oil programs be regulated under the Investment Company Act. Because

of the close resemblance of certain features of many oil programs with mutual funds, such as externalized management, the utilization of management arrangements involving self-dealing, "redemption" or repurchase features, installment plans and low minimum investment, this seemed a natural recommendation. Our current legislative program calls for a separate statute which would require registration of oil programs and provide special regulation of their activities.

While the Commission was drafting its oil and gas bill, the NASD issued in May 1972 for public comment proposed rules of fair practice which deal not only with oil programs, but also with other tax-sheltered programs, including those in real estate and cattle. The NASD's rule proposals would extend regulation well beyond the areas of traditional NASD responsibility.

Other tax-sheltered investment programs such as those in real estate, cattle, and citrus groves, of course, present many of the same investor protection problems as oil and gas programs. Further, although real estate investment trusts are not tax-sheltered vehicles in the strict sense of the term, they too present investor protection problems similar to those in limited partnership syndications. Perhaps in these areas, as well as oil and gas, federal legislation will be needed to provide adequate investor protection. We certainly expect to give this entire area careful review in connection with our consideration of the substance of the NASD's rule proposals, and the legal and policy questions they raise. There is, of course, the possibility that the tax reform legislation currently before Congress, which reduces significantly the advantages of these vehicles, may make the need for regulation less acute.

Let me conclude by discussing variable life insurance, a subject of concern to a number of you. In January of this year, after extensive hearings the Commission determined that the public sale of variable life contracts should comply with the Securities Act and the Securities Exchange Act. The Commission also adopted rules

exempting insurance company separate accounts funding variable life insurance contracts from the Investment Company Act and their advisers from the Investment Advisers Act.

In taking this action the Commission indicated in its release announcing the adoption of the rules that one of the reasons it reached this determination was to give state insurance regulators an opportunity to develop a comprehensive regulatory structure to provide the necessary protections that would otherwise be available under the Investment Company and Advisers Acts. The Commission went on in that release to note that these protections include uniform valuation of portfolio securities, furnishing to contract-holders annual reports containing information similar in nature to the information that would be provided by a registered investment company, protection against unauthorized or improper changes in investment policies and against excessive management, administrative and sales charges, and restrictions on transactions with affiliates.

In adopting the exemptive rules the Commission also stated ht it would closely monitor the development of state law in this area to assure its adequacy in providing protections and, if in the future substantial deficiencies appear, the Commission would consider whether to modify or rescind these rules. To follow through on this we have instructed our staff to begin monitoring the development of state insurance laws regulating variable life insurance and have taken steps to establish necessary liason with the National Association of Insurance Commissioners in order to provide technical assistance in developing more comprehensive regulation of variable life insurance.

For both the Commission and the industry these new money management vehicles mean new challenges. Your challenge will be to recognize opportunities to build greater public awareness and better understanding of the products and services you have to offer in the most efficient way and to develop products which will give investors what they need and want. Our challenge is to provide a regulatory environment appropriate to meet the needs of these diversified vehicles and of the public which invests in them.

During our 22(d) hearings, time and again we heard that only 3 out of 10 persons know about mutual funds. We believe the regulatory environment should give you the opportunity to reach as many of those 10 persons as you would care to and to give them a better idea of what mutual funds are, and what they are not; to differentiate mutual funds from each other and from competing products and services by clearly indicating differences in investment goals, risks and results so that investors may select that one which best meets their needs.

In the final sessions of the hearings several witnesses told us that integrated selling of a wide variety of different financial products through multi-service financial entities was the only way to remain viable in the developing competitive environment. Profits, they told us, will lie in increasing market effectiveness while offering services at less cost to the consumer. Perhaps here too we can do more, through the interpretation of our existing rules and through our application processes, to facilitate flexible pricing of fund shares when they are sold in combination with other financial products.

We face these challenges together. Regulation must provide an open, competitive environment in which the investing public has access to a variety of investment alternatives and the opportunity to accept or reject them on a well-informed, rational basis.