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DEREGULATION HAS ITS PRICE

ADDRESS BY

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Our national economy and financial markets are in a state of turmoil. As an economist, it is difficult for me to refrain from discussing such problems as inflation, high interest rates, lack of investment in productive facilities, slowing technological advancement and low productivity. As a member of the Securities and Exchange Commission, however, I am well aware that our statutory mandate does not extend directly to the resolution of these problems and that perhaps the most meaningful contribution the Commission can make in this regard is to facilitate improvements in securities markets and to reduce regulatory burdens and impediments to capital formation to the extent consistent with the protection of investors.

In my opinion, we have made considerable progress toward the goal of reducing regulatory burdens in our administration of the Investment Company Act. Much, however, remains to be done because, as I am sure you would agree, investment companies are still subject to the most comprehensive and burdensome scheme of regulation that exists among financial institutions. Accordingly, I would like to focus my remarks today on some changes which are occurring and which I believe should occur in that regulatory scheme.

Some of you may recall that as the minority staff director of the Senate Committee on Banking, Housing and Urban

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Affairs, I worked closely with leaders in your industry to minimize regulatory burdens inherent in legislative recommendations which were based on the Commission's 1966 Report on Public Policy Implications of Investment Company Growth. One of the major areas of concern when the bill was first reported by the Committee in 1968 was the additional intrusion of the Commission in investment company operations. I personally agreed with a statement contained in the Minority Views that, "placing Federal decisionmaking over the whole relationship, superceding and supplanting present decisions of directors and shareholders, is not the proper solution to problems that may result from the somewhat unique investment company management structure." Unfortunately, the suggested alternative that 60 percent of the directors of investment companies be unaffiliated with the management company, and that they be specifically charged with the responsibility of representing shareholder interests, was rejected by a majority of the Committee.

Now, twelve years later, as a member of the Commission, I fully support the studies being undertaken by our Division of Investment Management and the general trend of Commission decisions to permit greater freedom of action by investment company directors and to reduce Federal government agency involvement in investment company activities, as exemplified by the unit investment trust start-up rules, the major changes in advertising regulations, and various rules under Section 17 which permit certain transactions between an investment company and its affiliates.

I believe the approach we are taking offers important advantages. By adopting rules which permit the exercise of business judgment without seeking prior Commission approval, we can reduce the costs and burdens of regulation. It also builds on the important role which disinterested directors play in the regulatory system established by Congress to deal with the unique nature and structure of investment companies. While there may be other regulatory approaches that are worthy of consideration, such as the establishment of an industry organization to provide self regulation, it seems to me that in view of the important duties which disinterested directors already have under the Investment Company Act, they are in a good position to assume the investor protection responsibilities necessary to make it possible for the Commission to reduce its regulatory requirements.

Our effort to enhance the functions and independence of investment company boards of directors is also consistent with the well documented trend toward greater independence of boards of directors from management and greater board involvement in corporate decision-making. In most larger corporations, independent directors are now a majority of the board and there is an increasing awareness that decisions with respect to subjects where there may be specific conflicts of interest between management and shareholders, such as audits, management compensation, and the nomination of directors, should be made by independent directors.

In my judgment, successful deregulation of the investment company industry, without major structural change, is dependent to a considerable extent on the willingness of disinterested directors to accept and faithfully fulfill an independent watchdog role. Thus, I am troubled by signs of resistance in the industry to some of the Commission's proposals granting conditional authority to fund directors to approve otherwise prohibited or restricted activities. Some of the rules providing greater freedom of action have been criticized for not resolving all uncertainties, for retaining too many restrictions, and for opening up liabilities. Constructive criticism of our proposals is indispensable to proper rule-making, and I encourage it, but in some cases, comments appear to reflect an unwarranted concern with possible difficulties and a reluctance to accept the full measure of responsibility that goes with reduced regulation. For example, I do not believe it is constructive to object to requirements that directors make findings that certain types of transactions are "fair and reasonable" or "in the best interests" of the fund.

Until recently, comments of this type represented a relatively small proportion of the total. But the underlying resistance they suggest came out in full force when the Commission proposed Rule 12b-1 which, if adopted, would permit mutual funds to use their assets to finance distribution. The implications of the unanimous opposition to that rule proposal by those who favor permitting such a

use of fund assets are disturbing. As most of you know, the Commission has been very reluctant to move away from its long-standing view that it is generally improper, in the absence of an appropriate rule, for funds to use their assets to promote the sale of their shares. Because we have received some comments suggesting that the Commission is being unduly influenced by the staff in this matter, I would like to make it quite clear that the Commission as a whole has been considerably more reluctant than the staff to have a permissive rule on this subject. Those of you who may have attended the Commission's open meetings on this topic know that I personally have strong reservations about the wisdom of permitting the financing of distribution out of fund assets even under the conditions of the proposed rule, and will be unable to vote for it unless I can conclude that its possible benefits to shareholders exceed the risks involved.

Since the staff has a recommendation on the distribution rule before the Commission, which I expect will be acted upon within the next two or three weeks, I want to make it quite clear that I have not prejudged the issue and I am keeping an open mind until we as a Commission are able to consider fully what action to take. I do, however, want to discuss the distribution proposal in a limited way because the reaction to proposed Rule 12b-1 indicates an unwillingness to accept the Commission's approach to deregulation. The proposed rule embodies the fundamental concept that whenever possible, and subject to safeguards necessary for the protection

of investors, investment companies and their managers should have responsibility for management decisions. However, to a substantial degree, it goes further than prior proposals in that it permits business judgment to be exercised with respect to a subject about which there is a great deal of controversy.

Traditionally the Commission has been reluctant, for several reasons, to permit the use of fund assets for distribution. First, the investment adviser of the fund has a conflict of interest in recommending that a fund spend money for distribution. I realize that there are many conflicts of interest in the relationship between a fund and its adviser, but in this area the conflict is compounded by a number of factors. For example, it has not been shown that mutual funds are likely to derive any significant benefits from financing distribution. Thus, there is a very distinct possibility that, if the Commission adopts a permissive rule, funds could be called upon to spend considerable amounts of money without receiving anything in return. A related question is whether permitting the use of fund assets for distribution would be fair to existing shareholders who may have paid a sales load or may have bought shares in a no-load fund with the understanding that they would not have to pay for sales. You may not believe these to be serious problems, but the Commission must consider them carefully because of its responsibility to protect investors.

Another area of mutual fund regulation in which I have long been interested is Section 22(d) of the Investment

Company Act which generally requires the sale of redeemable investment company securities at a current public offering price described in the prospectus. Over the years the Commission has by rule and by order provided for some exemptions from the provisions of 22(d) for the reduction or elimination of the sales load in a number of circumstances such as quantity purchases and reinvestment plans.

In 1969, the Senate Committee on Banking, Housing and Urban Affairs considered the advisability of repealing Section 22(d) in conjunction with the amendments proposed by the Commission in 1967. At that time, the Committee concluded that the consequences of such a step had not been sufficiently studied and asked the Commission to study the matter. In November 1972, the Commission transmitted a report of its study to the Committee. The report had no recommendations, but stated that "its findings certainly suggest there is no compelling public interest in continued retail price maintenance in this field and that the repeal of Section 22(d) would on balance be desirable." Again, following hearings in early 1973, the Commission concluded in a letter to the Senate Committee in August 1974 that, "price competition at the retail level is a desirable goal." However, we added, it appeared to us that the immediate abolition of Section 22(d) would serve the interests of neither the public nor the industry, and expressed our intention to exercise our available administrative authority to encourage the industry to move toward competition."

Now, six years later, there is increased competition in the investment company industry. This has not occurred because it was required by the Commission, but because it was permitted by increasingly liberal exemptive orders from an anti-competitive retail price maintenance provision and a desire by investment companies to make their product more competitive with other investment alternatives. In other words, once again we find that free market competitive forces are the most powerful motivators of constructive change.

I believe it may now be appropriate for the Commission to further enhance the ability of mutual funds to structure their offerings to provide for reductions in sales charges without the necessity of relying on exemptive orders. This could be accomplished simply by interpreting Section 22(d) as it literally reads. Section 22(d) has generally been construed to restrict sales to a single uniform offering price described in the prospectus, but neither the plain language of the section nor the legislative history compel such a result. In fact, the section reads, "No registered investment company shall sell any redeemable security issued by it to any person, except either to or through a principal underwriter for distribution or at a current offering price described in the prospectus" If shares are currently being offered to the public, the section prohibits sales to any person other than the issuer, a dealer, or a principal underwriter "except at a current public offering price described in the prospectus."

There is nothing in this language to indicate that a single uniform public price is required. On its face, it permits any number of current public offering prices as long as those prices are described, as required, in the prospectus. If Congress had intended a single uniform public offering price it would have chosen the definite article "the" rather than the indefinite article "a" to convey that meaning. This interpretation is reinforced by the fact that a Senate Committee print of the proposed legislation requiring that sales be made at "the current public offering price" was changed to read "a current public offering price" in response to industry suggestions.

Moreover, a literal interpretation of Section 22(d) would appear to be desirable from a policy standpoint, because it would not mandate changes in investment company distribution systems, but would facilitate competition. It would permit an investment company if it so desired, to maintain a single uniform charge for its securities by describing only one price in its prospectus. On the other hand, any investment company desiring to provide for various reductions in sales loads could do so by describing the alternatives in the prospectus, without relying on an exemptive rule or requesting Commission approval. Unfair discrimination could be avoided by requiring that any reduced sales charges be made available to all similarly situated investors.

Even if Section 22(d) is interpreted in the foregoing manner, it may be appropriate for the Congress to

consider whether that provision continues to serve a valid purpose. The foundation on which Section 22(d) rests is concern for possible disruption in the dealer network which might result from unchecked competition. However, it is becoming increasingly apparent that repeal of Section 22(d) would have a much less disruptive effect on the investment company industry than would have been the case a few years ago. Most of the present action is in no-load money market funds. In addition, the effect of 22(d) has been somewhat undermined by increasing competition from highly publicized no-load equity funds.

There are other issues that also have been with us for some time which will be receiving renewed consideration during the months ahead. Recently, we had reason to consider the scope of the safe-harbor provided by Section 28(e) of the Exchange Act which, as you know, provides generally that a money manager does not breach fiduciary duties under state or Federal law solely by reason of his paying brokerage commissions in excess of the amount another broker-dealer would have charged if the manager determines in good faith that the commission is reasonable in relation to the value of brokerage and research services received. This provision was added to the Exchange Act as part of the Securities Act Amendments of 1975 in response to the concerns expressed by money managers and research-oriented brokerage firms that with the elimination of fixed commission rates a money manager would be subject to suits alleging a breach of fiduciary

duty if he paid commission rates in excess of the lowest rates available in effecting securities transactions for his clients.

Despite the view expressed in the Conference Committee Report that the language of Section 28(e) could not act as a shield behind which the give-ups and reciprocal practices prevalent in the 1960's could be reinstated, our Report of Investigation in the Matter of Investment Information, Inc. ("III"), published pursuant to Section 21(a) of the Exchange Act, reveals that certain investment advisers, banks and broker-dealers may be using the provision in that fashion. The report indicates that III solicited money managers to place their clients' brokerage with a broker who had agreed to pay III 50 percent of the commissions received from participating money managers. III, in turn, remitted 33 to 40 percent of the commissions by paying for goods and services which had been independently acquired by the money managers.

Consistent with our 1976 interpretive release, the Commission expressed the view that some of the services received by participating money managers, such as periodicals, newspapers, quotation equipment and general computer services, were not protected by Section 28(e), because they were not "research services" or were readily and customarily available and offered to the general public on a commercial basis.

The primary focus of the report, however, was not on whether the services in question constituted "brokerage and research services" but on whether the brokers involved

provided the services. A fair reading of Section 28(e) and its legislative history requires that research services paid for with brokerage commissions from accounts under management be provided by the particular broker which executed the transactions for those accounts.

This requirement poses a dilemma which has significant public policy implications. We took the position in our 1976 interpretive release and again in the III 21(a) report that research services need not be produced "in house" in order to obtain the protection afforded by Section 28(e). Thus, a broker might, under appropriate circumstances, contract with a third party to provide research services to money managers. A contrary position would have severe anti-competitive effects on smaller or specialized brokers who do not have the "in house" capability to provide the research services to compete effectively with larger more diversified firms and therefore would appear not to be in the public interest.

The difficulty with this interpretive position is one of line drawing. If it is assumed that the services in question constitute research services within the meaning of Section 28(e)(3), some might question whether there is any substantive difference between a situation where the broker has a prearranged contract with a third party to provide the services to the broker's money manager clients and one in which the broker merely pays the costs incurred directly by the money manager in securing the services. Nevertheless, I

believe we all can agree that the latter situation poses greater potential for abuse.

These questions merit further consideration by the Commission. I have never been too happy with the safe-harbor provided by Section 28(e) except as a means to ease the transition into an era of competitive brokerage commissions. If the Section leads to abuse, that cannot be remedied by the Commission, we may have to turn to Congress to either repeal it or provide us with a standard which is more workable.

Similar concerns are raised by the National Association of Securities Dealer's ("NASD") proposed amendments to its Anti-Reciprocal Rule circulated in a Notice to Members dated March 6 of this year. The present rule was adopted in 1973 in response to the position taken by the Commission in its 1972 "Statement on the Future Structure of the Securities Markets" that the practice of allocating brokerage business by a mutual fund to a particular broker-dealer in return for that broker-dealer's sale of the fund's shares must be terminated. This position was premised on several problems related to the reciprocal use of portfolio brokerage, including: (1) undue influence on retail sellers of mutual funds to base recommendations of funds on the amount of brokerage commissions received rather than on the customer's needs; (2) selection of firms to execute fund transactions that are not necessarily in a position to obtain the best price; (3) anti-competitive impacts on small funds which cannot allocate as much brokerage for sales as larger ones, and who therefore cannot compete

effectively for dealer favor on that basis; (4) possible unfairness of imposing selling costs on existing shareholders who may derive little or no benefit from the sale of new shares; and (5) the inability to properly disclose sales costs which take the form of reciprocal brokerage payments.

The NASD's proposal is essentially identical to one previously submitted by the Association as part of its testimony at our hearings on this general subject held in 1974. Among other things, it would specifically permit an NASD member to sell fund shares or act as an underwriter for a fund which follows a policy, described in its prospectus, of considering the sales of its shares as a factor in the selection of broker-dealers to execute its portfolio transactions, when such broker-dealers are qualified to provide best execution. This is in contrast to the present standard under which sales of fund shares can be neither a qualifying nor disqualifying factor in the selection of a broker-dealer to execute portfolio transactions.

If the proposal is approved by the NASD Board and the membership, it must be approved by the Commission prior to becoming effective. In making a determination on such a proposed amendment, the Commission would have to consider whether under present conditions the rule actually deters the same broker from providing fund distribution and portfolio execution and, if so, whether the resulting impact is outweighed by the risk that approval of the proposed amendment would lead to the abuses the present rule was designed to eliminate.

This is obviously a time of challenge and opportunity for investment companies. You have shown an ability to react to changing economic conditions and provide new products that are in demand, by the introduction of municipal bond funds and money market funds. These financial instruments and reactions to them have brought additional challenges.

Efforts by the Commission to reduce regulation and provide greater decision-making freedom to investment companies and their managers have also brought benefits and challenges. Our actions demonstrate that we are willing to rethink the whole concept of investment company regulation and find innovative alternatives to the paternalistic approach which has existed over the last forty years.

I urge you not to be too critical of the fact that the Commission proposals do not grant unfettered freedom but to accept the added responsibilities that go with deregulation and channel your energies into assisting us in our efforts. I recognize that you have submitted some innovative ideas such as the formula on which the proposed yield quotation is based. My hope is that you will continue to respond positively to the challenge and the opportunity to help mold an improved regulatory structure.