A REGULATOR LOOKS AT THE MUTUAL FUND INDUSTRY

Address

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Regulatory Activities

The hard core of the Commission's staff that administers the Investment Company Act of 1940 - the blueprint of prohibitions and requirements for your industry - consists of only twelve attorneys and analysts. You might be prompted to exclaim - "so much regulation by so few!" You could also add "and so effective in protecting public investors in investment company shares."

These Commission experts on investment company administration confer constantly with members of the industry about the many regulatory problems that arise under the Act. They assist the representatives of investment companies in understanding and complying with the statutory standards, interpretations and administrative requirements of the Commission. The types of questions that continually recur in enforcing the Act include the following: Who are investment companies? Do the companies have the requisite number of independent directors? Are names of companies deceptive or misleading? Are the pricing policies of investment companies non-discriminatory? Has there been an illegal transfer of management or underwriting contracts? Are transactions between investment companies and affiliates fair? The determination of these matters is made by the Commission after thorough discussions with its staff and often after consultation with representatives of the companies concerned.

The performance of these regulatory functions does not, of course, encompass the full gamut of the Commission's jurisdiction over investment companies. To the work of the twelve specialists must be added the activities of the staff who administer the disclosure requirements of the Securities Act of 1933 and enforce the provisions of the Securities Exchange Act of 1934 applicable to broker-dealers and salesmen handling investment company shares. 168 registration statements, offering to the public, in the aggregate, about 2.8 billion dollars of investment company securities, were filed with the Commission in the fiscal year 1957. Supplemental sales literature is processed for compliance with the standards established in the Commission's Statement of Policy. Annual and periodic reports are analyzed. Examination of investment company operations are at times made by inspectors in the Commission's field offices.

Effect of Regulation

The effect of the pervasive regulatory complex that the Commission administers over the investment company industry has been healthy and beneficial to investors, to the industry and to the American economy.

The ultimate policy and purposes of the Investment Company Act are - in the language of the statute - "to mitigate, and so far as is feasible, to eliminate the conditions enumerated . . . which adversely affect the national public interest and the interests of investors." The conditions enumerated include inadequate information available to security holders, inequitable and unsound capital structures, and failure by management and affiliates to observe proper fiduciary standards. These abuses, which existed in the industry during the incredible era of the twenties and thirties have, in large measure, now been eliminated. The regulatory control over the operations of investment companies entrusted to the Securities and Exchange Commission, together with the general honesty of the industry, have jointly contributed to investor confidence in investment company securities. The great pools of liquid and readily negotiable assets held by investment companies of all types - which now aggregate nearly 15 billion dollars - may continue to tempt exploitation by unscrupulous persons. However, the opportunity of self-dealing, overreaching, and misappropriation of assets has been effectively mitigated.

The benefits resulting from federal regulation of the industry have three aspects:

First, protection has been given to the investing public by providing prospective investors and shareholders with adequate and reliable information about the management, finances and investment policies of investment companies. Investors may have considerable assurance that their company is not being managed by anyone who has been guilty of securities fraud; that at least 40% of the board of directors is independent of any financial connection with the company; and that the company is not being managed to promote the special interests of its officers, directors, investment advisers, principal underwriters, brokers or affiliates. The holders of investment company shares are generally guaranteed voting rights. Adequate assets coverage for senior securities is maintained. Even though neither the Act nor the Commission's regulation of the industry purports to protect the investment value of investment company shares or to supervise management performance, the regulatory controls exercised by the Commission have unquestionably assisted in restoring investor confidence in investment companies.

Second, investment companies, and particularly mutual funds, have prospered and grown during their regulatory experience. The industry has become an impressively dynamic force among financial institutions. Second only to private pension funds, investment companies have grown more rapidly than any other financial intermediary. Net assets of open-end companies have doubled in less than three years, aggregating 9 billion dollars at the end of 1956. A net increase of 50 open-end companies have become registered with the Commission during the last three years.

Third, the general welfare of the American economy has been fostered by the resurgence of investment companies to public investor favor. The impact of investment companies in the capital markets through channelling individual savings into corporate securities has been significant. In the first half of 1957, investment companies purchased on balance about one half a billion dollars of common and preferred stocks. This sum constituted almost 50% of the net purchases by all financial intermediaries, and is equivalent to almost 25% of all the new equity money raised by American corporations during that period. The ultimate significance of these statistics is not clear because reliable information regarding the sources of the funds used to purchase investment company shares is not available. This subject may be developed by the Commission in the course of its proposed study on the effect of size of investment companies on the securities markets.

Particular Regulatory Problems

1) Variable Annuities

One of the principal problems in the administration of the Investment Company Act is to determine what companies are subject to the Act. The celebrated case which the Commission brought last year against two companies in the District of Columbia to restrain the sale of "variable annuity" contracts without compliance with the Securities Act illustrates the great importance of this regulatory function.

A variable annuity is difficult to define because of the number of variations which the contracts may assume. Their characteristics can be determined by comparing them with conventional insurance and annuity policies, on the one hand, and with mutual fund shares, on the other. The variable annuity contracts involved in this lawsuit use the terminology of insurance. They provide for "premium" payments, "cash surrender values," and "annuity" payments. Significantly missing in their nomenclature, however, is any reference to "face amount," any promise to pay a "fixed sum" at maturity, or any fixed dollar amount of "annuity" payment. The contract holder makes certain payments which are described in the contract, and, in return, the company promises to invest the money it receives, after the deduction of sales and other expenses, in a portfolio comprised principally of equity securities. The contract holder is given an undivided interest in the portfolio, which naturally fluctuates in direct relationship to its investment experience.

In the variable annuity case the Commission contended that a variable annuity is basically an equity security similar to a share in a mutual fund. The principal consequences flowing from this theory would be: 1) the registration of the issuer of variable annuities as an investment company; 2) the registration of the contracts as securities under the Securities Act; 3) registration of their salesmen as broker-dealers; 4) the subjection of their selling practices to the various protective

provisions of the securities laws.

The federal District Court recently held that the hybrid policy-contract had the characteristics of both insurance and securities. The Judge stated that the logic of the law would serve "to bring the variable annuity contract within the purpose and intendment of the Securities Act, and the defendants within the terms and plan of the Investment Company Act." However, he denied the injunction on the ground that the McCarran Act, which was adopted by the Congress in order to prevent the Federal Government from preempting the business of regulating insurance, made the securities statutes inapplicable. The Judge concluded that it was the function of the Congress to brand this "attractive new creature /that/ has been discovered on the financial range" as either "insurance" or "investment." Notices of appeal from this decision have been filed by both the Commission and the National Association of Securities Dealers, which intervened as plaintiffs in the case.

In instituting this lawsuit, the Commission was not motivated by, or concerned with, any evaluation of the concept of variable annuities. Whether variable annuities are good or bad is not for the Commission to determine. Its interest is solely to establish whether or not, as a matter of law, variable annuity contracts and their issuers are subject to the jurisdiction of the securities acts. The resolution of this question, either by the courts or by the Congress, has great significance to public investors, the financial community, insurance companies, and the national economy.

2) Adequate Disclosure and Selling Practices

Problems confronting the Commission in the enforcement of adequate disclosure standards and regulation of selling practices fall into three categories.

First, in registration statements and prospectuses filed by investment companies under the Securities Act of 1933, registrants are sometimes tempted to obscure certain aspects of the funds' performance. The effort to make the shares seem as attractive as possible often results in a presentation of information which hides some unpleasant realities. Some of the melancholy truths that are frequently omitted or concealed in registration statements, as originally filed with the Commission, are: the fact that the value of mutual fund shares may go down as well as up; that a substantial commission or load is charged the purchaser; that dividend income may be low in relation to net asset value although past appreciation may have been substantial; and that the cost of the professional management which the fund provides is borne by the shareholders.

In order to provide public investors with increased factual information about investment company operations, the Commission has nearly completed a revision of certain forms for registration of investment company securities under the Securities Act. A new table has been

devised which will show in greater detail than presently required the per share experience of the fund related to its costs of administration.

The second category relates to standards of disclosure in supplemental sales literature used by investment companies. The Commission has almost completed a revision to its Statement of Policy. The amendments affect the use, form and contents of charts and tables. The most important revisions are: 1) relaxation of the present ten-year restriction on the time period which charts may cover; 2) approval of charts showing on an annual basis reinvestment of dividend income as well as the acceptance of capital gains distributions in additional shares; 3) requirement that the difference between the initial investment cost and initial net asset value be shown more specifically; 4) requirement that reference be made on the charts and tables to the amount of sales commission as described in the prospectus; and 5) changes in captions to charts and tables to emphasize their illustrative nature.

The description and arrangement of all of the data contained in the approved charts and tables, as amended, have been prepared with meticulous care by the Commission after consultation with various representatives of the industry. Our joint objective has been to make it difficult for careless or unscrupulous salesmen to draw unwarranted conclusions about investment company performance from charts or tables. False, exaggerated and misleading impressions of what the investor may expect by investing in mutual funds have sometimes been created through the use of charts, drawn by ingenious draftsmen. The Commission believes that the form of charts to be permitted in the revised Statement of Policy, when accompanied by the information shown in tabular form and the required prospectus, should not be deceptive to the ordinary investor.

The third area regarding adequate disclosure standards and selling practices involves the oral representations made by salesmen. Some investors of mutual fund shares have complained to the Commission that salesmen have falsely represented that they could always receive back in full the amount of the money paid to purchase shares. They were falsely told that no sales commission would be charged. Some mutual fund salesmen have represented to investors that the investment was guaranteed to grow and would produce increased income.

None of these misapprehensions would, of course, occur if purchasers clearly understood what is required to be plainly stated in prospectuses. Salesmen can assist in eliminating dissatisfied stockholders and foster increased respect for and confidence in mutual fund companies by accurately explaining to investors just what they are buying. A large number of inexperienced persons who are not knowledgeable in securities has recently been attracted to mutual fund selling on a part-time basis. The result is that the Commission and the industry are confronted with an increasingly difficult problem in

maintaining high standards of selling practices. Of an estimated 57,000 representatives registered with the National Association of Securities Dealers, perhaps 25,000 sell mutual funds.

3) Names of Investment Companies

With increasing frequency, the Commission has been faced with difficult problems posed by the adoption of specialized names for investment companies. Justification for the use of such names is urged on the ground that new funds cannot successfully compete with established funds unless their names have some quality of romantic appeal. The highly competitive nature of the industry has stimulated the search for distinctive names that tend to arouse sales interest.

The Act authorizes the Commission to prevent investment companies from adopting deceptive or misleading names, or names which imply that the company or its securities have been recommended or approved by the United States or an agency or officer thereof.

Two of the most troublesome regulatory problems of the Commission regarding names are: First, names may suggest that the company invests in a particular industry or that it follows a particular investment policy. A name may be misleading and deceptive unless the investment policy of the company offers reasonable assurance that the implications of the name will be realized. Where the name of a mutual fund suggests that its portfolio will be invested principally in companies in a particular industry - such as uranium or electronics - the company must be faithful to this representation by investing primarily in the securities of that particular industry, and it must so bind itself in its statement of fundamental investment policy. Sponsors of funds at times object to these limitations on their management. The most effective way for investment companies to avoid hampering restrictions on their portfolio activities is to avoid names that tend to create in the purchaser's mind the inference that its investments will be confined to a particular industry.

The second problem involves names that may imply that the investment company has particular investment characteristics which serve the financial needs of specified classes of persons - such as doctors, teachers or government personnel. Such names as Doctors' Fund, Teachers' Fund, or Government Personnel Fund might be considered misleading because they indicate that the fund offers unique or special investment benefits for doctors, teachers or government personnel that are otherwise unobtainable. However, the investment needs of doctors, teachers or government employees, which are heterogeneous groups, vary with each individual. No one fund could probably serve the investment needs of all the persons in these groups.

The Commission has consistently held that any seriously deceptive implications that may exist in the use of its name are not cured by disclaimers or hedges in a registrant's prospectus.

4) Sale of Investment Advisory and Principal Underwriting Contracts

A critical problem for the Commission as well as for the sponsors, management, investment advisers and underwriters of investment companies involves the sale of investment advisory and underwriting contracts. One effect of the rapid growth of investment companies in recent years has been to increase the value of these contracts, which are frequently held or controlled by the sponsors of investment companies. Many sponsors desire to cash in on the position of trust that exists between an investment adviser or underwriter and the investment company be selling these contracts at a price which capitalizes their future earning prospects.

In the legislative history to the Investment Company Act as well as in the Act itself, the Congress expressed its concern with trafficking in these contracts. The Act provides that management and principal underwriting contracts are not assignable. An attempted transfer terminates the contracts with the result that the shareholders must approve new contracts. Furthermore, the transfer of a controlling block of stock in a corporate management or underwriting company constitutes an attempted transfer of the underlying contracts, which causes the contracts to terminate.

Control of these contracts affords opportunities for the exploitation of investment companies. In its administrative determinations, the Commission has consistently held that these contracts should not be transferable as ordinary commodities nor made the subject of trading in the market place. The Commission believes that the Act prohibits an investment adviser or principal underwriter from selling his contracts at a profit to himself.

The legal theory underlying these provisions is that such arrangements are personal. Investment advisers and the principal underwriters are so closely related to the essential operations of the fund that they are, in effect, members of management, and, therefore, occupy positions of trust to the fund and its shareholders. Being fiduciaries, investment advisers and principal underwriters have obligations similar to trustees, officers and directors, who are prohibited from taking advantage of their position of trust and responsibility for their own benefit by selling their positions for profit.

If investment advisers or underwriters were free to transfer the benefits of their contracts to others, the control of investment companies could be put on the auction block and sold to the highest bidder. In bargaining for the sale of these contracts investment advisers and underwriters are in a position that conflicts with the interests of the shareholders of the fund. Their personal interest in obtaining the highest possible price for the contracts would tend to make management ignore the welfare of investors. A possible reduction in fees or improvement in services in the interests of investors would not be consonant

with realizing the most advantageous price for the contracts. Purchasers of the contracts would be motivated to pursue hazardous or doubtful policies in order to recoup as quickly as possible the substantial prices they paid for control of the fund.

The resolution of the principles applicable to sales of management and advisory contracts is now under consideration in the federal courts. Since these contracts involve such large sums of money, an authoritative interpretation of the statute in the higher courts will have great significance to the industry.

5) Operations of Investment Companies

The rapid growth of the investment company industry and the formation, in recent years, of many new funds, some of whose practices were below the accepted standard of the industry, has compelled the Commission to institute a program of regular inspections of active management companies. While the Commission has always investigated particular cases where it had some reason to believe that the law was being violated, until this past year no attempt has been made to inspect investment companies on a systematic basis. So far, the conduct of this broad program has been handicapped by lack of funds and experienced personnel, but the Commission intends to expand its inspection activities as rapidly as conditions permit.

The sole purpose of these inspections is to assure the Commission that the industry is operating in accordance with the high fiduciary standards imposed by the Act, and that harmful practices have not been developing in the industry. The inspections should be particularly helpful to new funds in advising them how to comply with the requirements of the law. When this inspection program is in full operation, it should afford public investors in investment company shares additional protection and will probably be regarded by the industry as both useful and healthy in maintaining the investor confidence.

Conclusion

In its period of maturity, the industry must assume the responsibility for curbing the tendency towards zealous exaggeration and hyperbole in its selling techniques. Mutual funds can, at times, be oversold. Salesmen can succeed too well. For many investors mutual fund investments should not be the one and only savings program. To prevent inevitable disillusionment, salesmen must warn investors - especially the unsophisticated - that securities values sink as well as rise.

Investor confidence is nurtured by faith in the soundness of the American system of free enterprise. It will continue to flourish in an atmosphere of honest and objective selling. By exercising a policy of moderate firmness in enforcing the disclosure and regulatory standards prescribed in the securities acts, the Commission assists in maintaining a healthy climate for both the public investors and the managements of mutual funds.

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