# INVESTMENT COMPANIES AND THE RESTRICTED SECURITIES PROBLEM

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This evening I would like to discuss some of the regulatory problems involved in the purchase of restricted securities by investment companies. As you know, investment companies are a major element in the institutional mosaic. Today we are experiencing increasing institutionalization of our securities industry. The word institutionalization may be a lexicographer's nightmare, but it conveniently describes the increase in ownership of equity securities by investment companies, pension funds, insurance companies, foundations and bank-administered trust funds.

Institutions now own more equity securities than ever before: In 1954, institutions owned approximately $66 billion, or one-fourth of the then outstanding equities. In 1968, institutions owned approximately $260 billion in equities, more than one-third of the total outstanding.

The increase in equity ownership by institutions has been, for the most part, a rather recent phenomenon. At the end of 1957, insurance companies owned $8.5 billion in equities; their ownership of equities had grown to $25.5 billion in June 1968. Mutual funds owned approximately $8 billion in equity securities at the end of 1957; by June 1968, they held approximately $46 billion in equities.

It became clear that the growth of financial institutions would have a far-reaching impact on our securities markets and our economy generally; accordingly, in 1968 Congress authorized the Commission to conduct a study to find answers to problems posed by institutionalization.

Our Institutional Investor Study, now operating at full steam, will provide information to enable the Commission to determine whether a legislative program should be recommended to Congress, and what administrative action, if any, should be taken by the Commission under existing law. Hopefully, our Study will complete its work sometime in the next year or so.

It is not my purpose tonight to examine all the problems raised by institutionalization -- I'll gladly leave that burden to the Study. Rather, I would like to speak to one small -- but important -- aspect of institutionalization. I will examine the increasing purchase of restricted securities by investment companies and discuss some of the regulatory problems brought to a focus by this trend.

The Private Offering Exemption

As you know, restricted securities are simply securities which cannot be offered to the public for sale without first being registered under the Securities Act of 1933. Restricted securities are also referred to as "letter stock" because of the practice frequently followed by the seller of requiring the buyer to furnish a letter representing that the buyer has purchased the securities for investment purposes and not for resale to the public. This letter, commonly called an "investment letter," is intended to substantiate a claim that the transaction is exempt from the registration requirements of the Securities Act of 1933 as a transaction not involving a public offering. The letter provides a record of the buyer's investment intent. Whenever I refer to an investment letter, I feel constrained to point out that the investment letter per se is not a guarantee that a private offering exemption is available for the transaction in question. Clearly, such a letter is only one fact to be considered in determining whether a public offering is involved. The question of the existence of a private offering exemption is, for the most part, beyond the pale of this discussion; however, in this regard I commend to your attention Chapter VI of Commissioner Wheat's Disclosure Study. Although the Commission has not completed its review of the Study, in my opinion, it is an excellent analysis. Not the least of its virtues is a lucid discussion in Chapter VI of the problems faced by practitioners and the Commission in dealing with the private offering exemption.

There is one further aspect of the private offering exemption which I want to discuss, and that is whether and how an investment company which has purchased restricted securities may sell such securities to the public.

It is my view that ordinarily an investment company purchasing restricted securities does so with a view toward further distribution of these securities. I say this because under most circumstances the open-end investment company must stand ready to sell its portfolio shares, including restricted securities, in order to meet redemptions; and both the open-end and the closed-end companies must stand ready to dispose of any portfolio securities, including restricted securities, when prudent investment management dictates that a portfolio security be sold. If it can be established that the investment company purchased its shares with a view to their further distribution then, of course, the investment company would be an underwriter within the meaning of Section 2(11) of the Securities Act, and as an underwriter the investment company could not sell the securities to the public without registration under that Act. Further, if the investment company is deemed an underwriter, it may incur liability under the Securities Act for any false or misleading statements made during a distribution.

Performance

Since investment companies may be faced with some difficulty when it comes time to dispose of restricted securities, why do they buy restricted securities in the first place? A related question is: Why the relatively recent increased interest in restricted securities by investment companies?

The answer to both questions is simply the great and unprecedented emphasis on performance. Several indicators point to the increased accent on performance by all institutions. At one end of the institutional spectrum managers of industrial concerns are hiring outside financial advisers to improve the performance of their pension funds, and universities are dividing their endowment portfolios among competing financial advisers to maximize investment results. At the other end of the institutional spectrum insurance companies, bank pension trusts, and investment companies are engaged in a vigorous competition for the investor's dollar, and we know that, in many instances, victory will go to that institution which the investor believes offers the most hope of capital growth.

Probably the best indicators that performance has become a consecrated concept are the turnover rates of open-end investment companies and life insurance companies.

The turnover rate during the first quarter of 1969 for life insurance companies was 18.2% -- for open-end investment companies an incredible 47.9%. This compares with 10.8% for life insurance companies and 37.4% for open-end investment companies during the same quarter of 1968.

It is worth noting that for the quarter ending September 1968, at least 14 open-end investment companies had a turnover of 100%. In other words, if those companies continued a turnover rate of over 100% for an entire year, they would completely change their portfolios in a one-year period.

I should make clear that, absent fraudulent and manipulative practices, the quest for performance has never been viewed as unethical or opprobrious. The performance fad may well serve a beneficial purpose for a certain segment of investors. Please note that this is not a blanket endorsement of a "go-go" approach for institutions. Far from it. I would certainly have reservations if pension funds -- or any other institution entrusted with retirement savings -- engaged in short-term trading or short sales, or borrowing to obtain leverage, or the purchase of puts and calls to bolster their performance. In fact, as I noted in a speech to the Mississippi Valley Group of the Investment Bankers

Association as far back as October 1967, I had serious personal misgivings about the then current speculative activity of some of the funds in order to meet their performance objectives. Here again, however, I will leave this topic to the findings of the Institutional Study with only the observation that I will be greatly surprised if they don't confirm with considerable documentation my concerns in this area.

Getting on, therefore, to the subject at hand; restricted securities provide an attractive vehicle for an investment company whose objective is performance. Of course, a private placement of restricted securities provides a legitimate access to capital for an issuer who seeks to avoid the cost and delays involved in the registration process. For the purchaser, the attraction stems from the fact that it generally acquires restricted securities at a discount from the market price for the issuer's unrestricted shares of the same class. Furthermore -- and this is where the basic attraction lies for an investment company -- the purchaser frequently gains access to a growth situation where there is a limited float of the issuer's securities or before the opportunity to purchase the issuer's securities is available to the public.

Valuation

When an investment company does purchase restricted securities, it is faced with the problem of proper valuation of such securities.

In considering the problem of determining the value of restricted securities, the threshold question is when such securities should first be valued as part of the assets of the investment company. To state the problem another way, the question is: When should the transaction be reflected on the books of the investment company?

It is my understanding that the purchase of restricted securities generally falls into three phases: The first is the "handshake" phase in which an understanding, generally oral, is reached and a price agreed upon. The second is the "contract" phase in which conditions for a closing are set forth in a formal document. Finally, there is the "closing" phase in which all the conditions of the contract are met and the transaction completed.

Apparently there is some sentiment in favor of reflecting the transaction on the books of the fund at each of the three phases I have referred to. Which phase should be employed would, I suppose, depend upon a variety of matters. But speaking generally, I would think the transaction should not be reflected prior to the "contract" phase because of the factual and legal uncertainties which exist at the "handshake" phase.

We then pass from the question of the date on which restricted securities should be first valued as part of the portfolio to the method of determining their fair value.

The Investment Company Act requires that an investment company must value at market those securities in its portfolio for which there is a readily available market quotation. Other securities and assets must be valued at their fair value as determined in good faith by the board of directors; thus, restricted securities must be valued by the board of directors because there is no readily available market quotation for restricted securities. I might add parenthetically that most of us connected in one way or another with the securities industry know there is a private market -- limited to a large extent -- for restricted securities. This consists of pension trusts, insurance companies and investment companies. But I think it is obvious that, as yet, there are no readily available market quotations for restricted securities. I emphasize the word "market" since that connotes a place where public transactions take place and, of course, there can be no public transaction in restricted securities -- the transaction must be "private."

While the dictates of the Investment Company Act regarding the valuation of restricted securities are clear, i.e., the valuation must be fixed in good faith by the investment company's board of directors -- there is a wide disparity in the methods investment companies have adopted to value restricted securities in their portfolios.

For example, a number of investment companies value restricted securities at a discount from the market quotation for unrestricted securities of the same class; this discount is sometimes kept at a constant percentage based on the purchase discount. It has been suggested that this method of valuation may be justified only if the discount continues to reflect, in the good faith judgment of the board of directors, the true value of the restricted securities.

A second method used by investment company managers to value restricted securities involves valuing such securities initially at the acquisition price, usually a discount from the market value of similar unrestricted securities, and amortizing any discount. The amortization period may vary. In one instance, the amortization period ended on the date by which the issuer had agreed to file a registration statement pursuant to an agreement under which the shares were purchased. It has been urged that there is one advantage to amortizing a discount; amortization avoids a sudden change in value which could occur when a restricted security is carried at a constant discount and the discount is eliminated when the securities become unrestricted.

Some investment companies have valued restricted securities at the market price for similar unrestricted shares. If the restricted shares were purchased at a discount from the price for similar unrestricted shares, I have difficulty finding any rationale for an immediate markup of the restricted securities to the market price for unrestricted shares. I concede that there is the remote possibility that the investment company's research staff may have uncovered a company whose unrestricted shares are traded at a price far below fair value, and as a result fair value of the restricted securities may be at or near the market for unrestricted shares. I hasten to add, however, that this possibility is so remote as to be virtually nonexistent.

Still other investment companies value restricted securities at cost. Cost is, of course, satisfactory at the time of acquisition since this was the price paid for the securities in a presumably arm's length transaction, but a constant valuation of cost would not reflect any change, if it occurred, in the inherent value of the security.

Without passing judgment on the specifics of any of the methods of valuation I have mentioned, it seems clear that arriving at a method of valuation is a complex problem. Regardless of the method of valuation used, proper valuation is critical, since any distortion in the valuation of a restricted security held by an investment company will distort the price at which the shares of the investment company are sold or redeemed.

Redemption

In addition to problems of valuation, which relate to both open-end and closed-end investment companies, restricted securities present a redemption problem unique to the open-end company or mutual fund.

The Investment Company Act provides that the holder of redeemable shares issued by an open-end company is entitled to receive approximately his proportionate share of the issuer's current net assets, absent specified unusual conditions, within seven days after the tender of the redeemable security to the investment company, or to its agent designated for that purpose.

In view of the redemption privileges available to shareholders, mutual funds must continually maintain a degree of liquidity in their portfolios, and they must be in a position to value continually their portfolios to determine a shareholder's proportionate share of the fund's net assets. If a fund holds a material precentage of its assets in illiquid interests, a serious question may arise concerning its ability to meet its redemption obligations. A recent case illustrates this point.

I am sure most of you are familiar with the Mates Fund matter. This case has received a good deal of coverage by the financial press, but it merits mention to highlight some of the problems a fund may encounter when it purchases restricted securities. During the first half of 1968, the Mates Fund was widely heralded as the number one performer among mutual funds. This publicity resulted in a deluge of purchase orders for the Fund's shares, and the deluge of orders, in turn, caused the Fund to experience some books and records difficulties. As a result, the Fund voluntarily suspended sales in June 1968. While sales were suspended, the Fund purchased restricted securities and engaged in substantial borrowing which was secured by a lien on the Fund's portfolio.

Our staff has been concerned with the Mates situation ever since a routine inspection in June 1968. The staff's concern culminated in charges in an order for proceedings adopted by the Commission last month. The order charged, among other things, that Frederic Mates, the president of the Fund, caused the Fund to acquire substantial amounts of restricted securities and to borrow more than $7 million from banks secured by a lien on the Fund's entire portfolio, contrary to representations to Fund shareholders that the Fund would not acquire securities that were restricted and that Mr. Mates would not cause the Fund to impair its shareholders' right of redemption. The order also charged that the restricted securities were improperly valued, and that Mr. Mates and others misrepresented to shareholders of the Fund and clients and prospective clients of Mates Financial Services, a registered investment adviser, that the resulting net asset increase was due to his investment advice.

Mr. Mates and the other respondents, without admitting the allegations in the order, consented to findings of violations as set forth in the order. In due course, the Commission will issue its definitive findings and opinion, which will describe and discuss the activities involved and the respects in which they violated the federal securities laws.

I am sure you are also aware that the Commission permitted Mates Fund to suspend redemptions in December 1968. Last month, the Commission entered an order rescinding this permission as of July 22, 1969. Thus, Fund shareholders will have been deprived of the right to redeem for over six months. The Fund had applied to the Commission for permission to suspend redemptions because the Commission had suspended trading in the securities of Omega Equities Corporation, a company whose securities represented approximately 16% of the Fund's portfolio. The Fund's holdings of Omega were restricted securities, and Omega was only one of six restricted securities in the Fund's portfolio when it requested the suspension of redemptions. Because of the suspension of Omega, the directors of the Mates

Fund found it impossible to value the Fund's Omega holdings and, consequently, they were unable to place a net asset value on the Fund's shares. Furthermore, I'm sure everyone realizes that the situation might have become calamitous for Fund shareholders if redemptions had continued during the period Omega was suspended. Indeed, since it would have been extremely difficult for the Fund to sell any of its Omega holdings -- because trading in these shares had been suspended -- the sale of the other restricted securities under "emergency" conditions to meet redemption requests would probably have resulted in the Fund receiving a good deal less than the carrying value of those securities.

Clearly, the Mates situation was not ordinary; rather, it was an unfortunately graphic illustration of the dangers inherent in the purchase of restricted securities by a mutual fund. But even under ordinary circumstances restricted securities in a mutual fund's portfolio may restrict the company's ability to meet requests for redemption. This is so, for as I stated earlier, restricted securities may not be publicly sold -- nor can they be passed out to shareholders as a redemption in kind -- and although they may be sold privately, there may not be sufficient time to obtain the best price, since payment on redemption must be made in seven days. Furthermore, as I mentioned earlier, any distortion in the valuation of restricted securities in a fund's portfolio will result in a distortion of the redemption price.

Possible Solutions to the Valuation and Redemption Problems

There have been a number of suggestions advanced to solve the problems I have mentioned. Perhaps the solution most often mentioned is a legislative ban on the purchase of restricted securities by mutual funds. The principal objection advanced to this course of action is that it would deprive fund shareholders of the attractive growth situations discovered by diligent research.

It has also been suggested that it may be possible to limit purchases of restricted securities by funds. I should add that, presently, it is the position of the Commission's staff that illiquid investments of any kind in a fund portfolio should be limited, at the time of acquisition, to 15% of the fund's assets.

Proponents of a percentage limitation on fund purchases of restricted securities also suggest that it would be desirable to broaden the current reporting requirements for funds that invest in restricted securities.

Here again, I will not pass judgment on the specifics of these proposals. Our staff is studying these problems and will shortly report to the Commission. We will consider all alternatives consistent with our basic responsibilities to the investing public. We are determined to arrive at soundly based solutions to deal with the complex and troublesome problems I have discussed this evening.