

**RECENT DEVELOPMENTS CONCERNING MUTUAL FUNDS**

**Address of**

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## RECENT DEVELOPMENTS CONCERNING MUTUAL FUNDS

Two years ago I had the pleasure of appearing before you to discuss the Commission's then new Statement of Policy which set up certain standards as to the form and content of supplemental literature used in the sale of investment companies securities. At that time the mutual funds had total assets of about \$2,758,000,000. Some in the industry felt that the application of the Statement of Policy would so circumscribe selling efforts that the funds would wither and die. Now they have assets of over \$3,600,000,000!

Today I propose to discuss some of the developments during the intervening period in the sales literature of mutual funds, as well as certain other aspects of mutual fund operation which now deserve attention.

If some of my comments seem sharp it is not because I have any lack of confidence in the theoretical soundness of the investment company idea.

Rather, as I said the last time I appeared before you, it is because I firmly believe in the investment company concept, but feel that only under the prudent and conservative guidance of men conscientiously fulfilling their duties as trustees for their shareholders, will investment companies play the role in our economy they merit.

Today, many investors find it impossible, as a practical matter, to find their way through the labyrinth of the modern day financial world. More and more they have been obliged to turn to others for investment advice and for the selection of an investment medium which will suit their individual needs. To fill this need is the avowed purpose of most mutual funds. But I regret it cannot yet be said that they fully meet their responsibilities in this respect.

Sometimes the investor is offered securities which the dealer desires to sell because he will realize the largest commission or greatest incidental advantage, rather than one best suited to the particular investor's needs. When a dealer pushes his own self-interests to the point where he sells an investor something that is not suited to the investor's needs and circumstances, he is defeating the true purpose of the investment company and violating his fiduciary responsibility to his customer.

For example, I know of cases in which salesmen of mutual funds have followed the practice of dividing almost contemporaneous sales to the same customer for the sole purpose of keeping each individual sale below the point at which reduced commission rates would be applicable. And this was done only because in that way they would receive the maximum possible sales commission.

We at the Commission earnestly believe that if investment companies are to live up to their stated high aims and provide the kind of service that they purport to provide, then more careful consideration must be given both to the character of their personnel and their business practices. Two of the most important services which investment companies state they are offering the investor are the careful selection of the type of investment suitable to his needs and circumstances, and, thereafter, the continuing professional management of his funds.

All too often, however, salesmen have little or no training in the nature, purpose and merits of the funds they are trying to sell. They cannot, therefore, select investments best suited to the needs of their customers even if they made the attempt. Both investment companies and their underwriters have an obligation to see that the men engaged to sell their shares are thoroughly qualified to perform the services that they are supposed to perform. Selling securities obviously is quite different from selling tangibles which the buyer can examine and test for himself. With securities the buyer must rely upon the ability and integrity of the salesman. If the salesman is lacking in either of these qualities, he has no business trying to sell mutual funds.

The same principle holds true for management. It should bring to its task the necessary knowledge, experience and integrity required of a trustee engaged in a complex and hazardous undertaking involving the safety of other peoples money. The industry must somehow see to it that mutual fund managements always possess these necessary qualifications:

Turning now to sales literature, some indication of the size of the task involved in the administration of the Commission's Statement of Policy is to be found in the volume of supplemental sales literature filed with us. During the Commission's past five fiscal years an annual average of somewhat in excess of 2,000 pieces of such literature has been filed. For the fiscal year ended on June 30, this year, 2,100 pieces were filed.

The largest amount filed in any one year, fiscal 1951, was just under 2,600 pieces. This appears to have been occasioned by the revision of material to make it conform to the Statement of Policy. Aside from this the Statement of Policy does not seem to have had much effect one way or the other upon the volume of sales literature used, since the amount of material filed each year over the past five years has been about the same. But as new supplemental sales literature is always being proposed and used, the problems with it are continuing ones and we must be prepared to deal with them for the indefinite future.

As you know, the Statement of Policy resulted from a survey of a vast quantity of sales literature voluntarily submitted by investment companies and their sponsors. The survey was made jointly by the Commission and the National Association of Security Dealers. It revealed a great variety of exaggerations, misstatements and even some falsehoods in the sales literature then in use. In fact the literature was so bad that many of the companies in the industry were thoroughly disgusted over the situation.

Nevertheless, we are realistic enough to know that the Statement of Policy was not welcomed unreservedly by the entire industry. Indeed it was rather sharply attacked by some. A few financial writers even described it as an unnecessary limitation upon private initiative. However, it was in the main accepted in good faith and with good grace by most of the industry. The attacks upon it gradually petered out when it became apparent that it had the real effect, not of stifling the use of legitimate sales literature, but rather of elevating it to a higher level of accuracy and effectiveness.

Generally speaking, I am satisfied that the industry has made a sincere effort to bring its sales literature into line with the Statement of Policy. This has been indicated by the frequency with which material is submitted in advance in order that there may be no doubt as to whether it meets the requirements of the Statement when it is released to the public. Of course, we have not achieved perfection. The administration of the Statement of Policy has been and still is largely a process of education, both as to its requirements and as to its objectives. There are still today a considerable number of persons who inadvertently violate its provisions and there are even a few, I regret to say, who have indulged in calculated circumventions.

As an example, the Statement of Policy requires that under certain circumstances the market risks involved in the investment shall be pointed out or explained. Efforts have been made to meet this requirement by inserting a brief phrase that the investment is "subject to normal market risks." Of course, this does not adequately point out or explain the risk involved. Further it is felt that it is misleading since it obviously can be taken to mean that the investment is not subject to abnormal market risks of which there are many.

By and large, however, the sales literature presently used is free of the more flagrant misstatements of several years ago. One now seldom sees in sales literature express or implied promises of a consistent return of 7% or 8% on one's investments in mutual funds. Formerly, such representations were frequently made. Such a return was arrived at only by ignoring the sales load and by treating as a part of the return distributions of profits arising from the sale of portfolio securities even though

these "profits" were bought and paid for by the investor when he purchased his shares and the dividend in reality was a return of the investor's capital, on the receipt of which he was obliged to pay taxes. The Statement of Policy now places very exacting requirements upon statements relating to past and future returns on investments in investment company securities. Those requirements have resulted in much more reliable statements as to the rate of return on investment in such securities.

But all of the bad practices have not been wholly eliminated. We know that some salesmen still point to the prospects of capital gains distributions in the future as an inducement to buy shares, without disclosing the fact that the investor will be paying for these distributions in advance. This situation is further aggravated by the excessive delays between the declaration, the fixing of record dates, and the payment of dividends, which prolong the period during which salesmen are tempted to use this misleading sales argument. In fact there is reason to believe that sometimes these dates are fixed with this sole purpose in mind.

Most persons are motivated, at least in substantial part, in making their investments by their desire to accumulate a fund for future use. For some it is to provide financial security in old age; for others, it is to provide the necessary funds for the education of their children; and still others seek to provide for some deferred pleasure, such as long-dreamed-of travel.

The investment trust industry was quick to realize the effectiveness of appealing to this desire. For example, supplemental sales literature in the pre-Statement of Policy era contained enticing promises of security in one's old age (sometimes illustrated by an elderly couple walking hand-in-hand toward the sunset with contented and carefree smiles upon their faces). Of course the possibility of lower security prices was nowhere alluded to.

Under the Statement of Policy such emotional appeals are no longer permissible. The results and achievements of investment companies must be stated with an accuracy and objectiveness in keeping with the investment hazards involved.

Much of the credit for the measure of success already achieved under the Statement of Policy goes to the Investment Companies Committee of the NASD. That Committee, under the direction of its Chairman, Harry Prankard, and through the labors of its Secretary, Ray Moulden, has assumed great responsibility for the enforcement of the Statement of Policy as a substantial measure of self-regulation. The Commission has cooperated closely with the Committee and has, of course, acted in those areas not subject to the jurisdiction of the NASD.

As might be expected, administration of the Statement of Policy has revealed certain defects in its provisions. It was prepared with a view to correcting certain specific evils which our previous experience had revealed to be prevalent. As we have worked with the Statement of Policy, it has become apparent that its provisions could now be improved so as to make it a more effective document. It is our intention to undertake such a revision in due course.

One of the difficulties in the operation of the Statement of Policy arises from the fact that sales literature is frequently not filed with the Commission or the NASD until after it has been widely distributed to the public. Section 24(b) of the Investment Company Act only requires that sales literature be filed within ten days after it is used.

Frequently, where the literature contains misleading statements, it has had its damaging effect before the Commission or the NASD has had an opportunity to require a correction. The NASD's requirement is that such literature need only be filed within three days after its use. Thus, both the Commission and the NASD are required to rely on the voluntary cooperation of the companies to submit literature for examination prior to its use. "Withdrawal" of the material after it has been widely distributed obviously does not undo any damage that has been done. However, as a matter of practice, and to the credit of the industry, much of the sales literature used is submitted to the NASD or to the Commission, or both, prior to its distribution. This makes it possible for us to make suggestions or comments before the material is put in final form, and distributed to the public.

In spite of the progress which has been made in the policing of investment companies' sales literature, it still all too frequently contains misleading material. While a revision of the Statement of Policy might go far in correcting the defects which have become apparent since it was promulgated, it is doubtful that any code of disclosure can ever completely curb the activities of those bent upon evasion. For this reason there are some who believe that the use of supplemental sales literature should be prohibited altogether and that the prospectus should be the sole selling document. I am not yet prepared to subscribe to such an extreme measure. In the light of the progress already made, it seems to me entirely possible, in due course, through the joint efforts of the Commission, the NASD and the individual members of the industry itself, to keep the content of supplemental sales literature within reasonable bounds. Further, the Commission desires it to be understood that it intends to deal very firmly with any future violations so that the temptation to both mislead investors and to steal a march on competitors will be greatly minimized.

One type of sales literature being used with increasing frequency is a certain standardized "performance" chart which we have permitted as being within the Statement of Policy. This chart, as you know, is one which shows the net asset value of a given investment over a period of ten or more years, together with accumulated capital gains distributions and dividends from investment income. Previously charts containing such information had been used in highly misleading forms but as a result of the joint study by the Commission and the industry certain basic revisions were agreed upon. It was only then that the Commission decided that for the time being, at least, it would raise no objection to the use of the standardized chart.

Although the charts now in use are much less objectionable than they were prior to the formulation of the standardized chart, they are still not wholly satisfactory. For example, such charts do not clearly show the sales load, a matter about which the entire industry seems unduly self-conscious. Further problems regarding the presentation of capital gains distributions still exist. It is to be hoped that we can soon jointly work out some reasonable solutions to these problems.

Another problem the Commission has wrestled with is the use of so-called "institutional" literature. Institutional literature is that which does not advertise the securities of any particular company but which seeks to interest the public in a particular class of securities, such as mutual funds generally, or in a particular type of service, such as the advisory services rendered by a broker or dealer.

Back in 1948, the staff of the Commission expressed the opinion in a letter, since referred to as the "Cashion letter", that institutional advertising by a dealer in investment company securities would not constitute an offering of securities of any investment company, if the dealer was prepared to offer more than one security and, before determining which security to offer, considered the individual needs of the prospective investor. Since that time most institutional advertising with respect to investment companies has been done on the basis of that opinion.

The so-called Cashion letter has proved to be an unsatisfactory basis for the authorization and regulation of institutional advertising, both from the standpoint of the industry as well as from that of the Commission. We believe it is unrealistic in its approach in that a certain type of advertising by a dealer who has only one security for sale is deemed to violate the Securities Act of 1933, whereas another dealer using precisely the same advertising does not violate that Act if he has more than one security for sale and the proper state of mind. Such a construction of the statute is obviously very difficult to administer since compliance with it rests upon the dealer's unexpressed intention. For example, if he determines in advance to offer prospective investors

a particular security, then he does not come within the principles enunciated in the letter. If, however, he fully intends to consider the investor's needs he may use such advertising material:

For some time now the Commission has been considering the possibility of formulating a more practical basis for institutional advertising. Specifically, we have been thinking in terms of a rule which might permit the distribution without the use of a prospectus of articles, brochures, pamphlets or other publications which meet certain standards of comprehensiveness and objectivity. Such a rule might also permit, subject to appropriate conditions, advertising that such publications are available.

We doubt that it would be wise to permit such a publication to identify by name or context any particular investment company or security. In our opinion, it should only present a fair and objective description of the nature and method of operation of investment companies generally, or of one or more of certain classes of them. Further, we believe that any advertising of such a publication should be limited to such a description of the publication and its contents as would tend to arouse interest only in the publication and not in any particular company or security. Further, any person advertising the publication should be required to furnish a copy of it to every person who requests it and should be prohibited from offering the securities of any investment company to any such person until that person has received the publication and had an opportunity to examine it.

It is our hope that such a rule will entirely replace the interpretation contained in the Cashion letter and that all future institutional advertising with respect to investment companies would be governed by its provisions.

If such a rule is worked out it might also serve as a useful medium for educating the public about investment companies. This is a well worthwhile objective. Of course, as you know, if such a rule seems feasible it will be circulated for public comment and the Commission will carefully analyze and weigh all comments and suggestions received.

Still another problem with which the Commission has been concerned for some time, but which it has not yet been able to explore, is the practice of reciprocal business, or as it is sometimes called, "give-ups." Reciprocal business involves the practice on the part of investment companies or their underwriters of allotting to dealers, who sell the company's securities, a portion of the brokerage commissions on the company's portfolio transactions. Usually portfolio transactions, as a matter of convenience and efficiency, are effected through one or a limited number of brokers. However, since the dealers who sell the company's securities have indirectly produced the business which necessitates the effecting of at least some portfolio transactions, many dealers and some



issuers feel that they are entitled to a portion of the commissions on such transactions.

One of the obvious dangers in the practice of allotting brokerage commissions to selling dealers is the necessity of churning the portfolio for the purposes of producing enough commissions to satisfy the dealers. Such churning is more apt to occur where dealers have been promised in advance that they will receive a portion of the commissions. But it should be remembered that where there has been an express advance promise, the commissions really constitute additional remuneration for selling the company's securities and therefore should be fully disclosed in the prospectus.

In other cases, there is no advance promise to dealers that they will share in the commissions on portfolio securities. But where a company has followed the practice of voluntarily allotting such commissions the dealers may well regard themselves as being entitled to a portion of the commissions as a matter of right. Therefore, it is questionable whether there is more than a difference of degree in those cases where a share of the commissions is promised in advance and those where such commissions are distributed as a matter of custom. Thus in either case there is a violation of the statute if adequate disclosure is not made in the prospectus. Further, where a portfolio is churned to provide for brokerage commissions, charges of breach of trust or fraud might well be made.

The Commission is now engaged in the preparation of a questionnaire the purpose of which is to furnish more accurate information than it now has as to the nature and scope of the practice of allotting brokerage commissions to dealers in investment company securities. It is intended to be sent to all open-end investment companies and their underwriters as well as dealers. After the survey has been made, the Commission will be in a position to determine what action should be taken.

Today we hear on all sides the cry that the sources of venture capital are drying up and that new undertakings are finding it increasingly hard to obtain the necessary capital to explore new fields. For the most part organized investing has overlooked the fact that the blue chips of today were the promotions of yesterday.

Most new enterprises have been largely dependent upon such funds as they were able to obtain from venturesome individuals. Institutional investors do not, as a rule, place their funds in such undertakings.

Prior to the adoption of the Statement of Policy many mutual funds claimed in their literature that they were an important source of new capital. This was not true in the sense in which it was intended to be understood, although a few such funds did provide venture capital for new

enterprises. Hence, the Statement of Policy now provides that it is misleading to represent or imply that investment companies in general are direct sources of new capital to industry or that a particular investment company is such a source unless the extent to which such investments are made is disclosed. It is hardly necessary to add that this provision of the Statement of Policy virtually put an end to such advertising for the simple reason that investment companies had generally not been furnishing such capital.

It has been suggested to me that here is a field in which mutual funds might make a real and very constructive contribution to our economy; that here is an opportunity to show, not just by words, but by deeds; a faith in the strength and dynamic character of our great democratic capitalistic system. This would not mean, of course, that mutual funds would proceed to load their portfolios recklessly and indiscriminately with large amounts of securities of immature enterprises with only remote hope of success. What is meant, I take it, is this: there are today, as there have always been, worthwhile business ventures in the early stages of development which need and merit the reasonable support of those in control of large pools of capital, such as the mutual funds. If such support were forthcoming many of them would no doubt in due course become seasoned companies whose securities would then be suitable for inclusion on a larger scale in the portfolios of mutual funds as well as in those of other types of investors.

Limited financial support by the mutual funds might well produce profits more than commensurate with the risks assumed. It was pointed out that as a matter of technique such investments could be made through a corporation organized for that purpose in which a number of mutual funds might invest a limited portion of their assets. Such an undertaking seems to merit careful consideration. It may well be in view of the enormous growth enjoyed by mutual funds in recent years, and in view of their consequent greater role in the investment field, that such activities may now be safely undertaken on a scale which would be important to the economy, while limiting the exposure of any one fund, and would hold real hope of a substantial excess of profits over losses. Further, it would be an answer to the charge that mutual funds are parasites in the investment field, standing between investor and issuer and performing relatively useless functions.

It has been also suggested that there is yet another field in which mutual funds might well operate to maintain and strengthen our industrial economy. This is the field of so-called special situations. Large profits have been made in this area by those who have been wise enough to invest

in companies whose securities were undervalued because of special but essentially temporary circumstances. These circumstances might be a lack of adequate working capital and a resulting inability to obtain new funds. Or, paradoxically, they might be an excess of current assets not yet profitably employed or a niggardly dividend policy in relation to earnings both present and anticipated.

The primary reason for mutual funds is expert management. Hence it is said that they should be in a peculiarly favorable position to locate and exploit such situations. It is argued that a group of investment companies could, either as a syndicate or through a new company, acquire enough of the securities of individual special situations so as to enable them to be a real force in the elimination of the factors causing undervaluation. Such activity, the argument goes, could make a real contribution to our economy as well as proving profitable for the mutual funds themselves. This suggestion also merits careful consideration.

I have commented on these matters of managerial concern only because I believe that all of you are entitled to hear publicly some of the views which have been sought privately.

Mutual funds have grown rapidly over the past ten years, both in number and in size. At the beginning of 1942 there were 73 companies in the field, having total assets of about \$412,000,000. At the end of June 1952 the number of companies had increased to 133 and their total assets had increased to approximately 3.6 billion dollars. Of course, some of this growth has been due to the upward trend in the market during that period, but much of it is also due to the increasing popularity of mutual funds.

While the great majority of mutual funds have less than \$50,000,000 each in total assets, there are ten companies having total assets between \$50,000,000 and \$100,000,000; four companies have total assets between \$100,000,000 and \$200,000,000; and there are two companies with total assets of more than \$300,000,000. One of these has total assets in excess of \$400,000,000. The Commission has been carefully following this growth process and intends to give it increasing attention.

In this connection Section 14(b) of the Investment Company Act of 1940 provides as follows:

"The Commission is authorized, at such times as it deems that any substantial further increase in size of investment companies creates any problem involving the protection of investors or the public interest, to make a study and investigation of the effects of size on the

investment policy of investment companies and on security markets, on concentration of control of wealth and industry, and on companies in which investment companies are interested, and from time to time to report the results of its studies and investigations and its recommendations to the Congress."

The Commission believes that the mutual funds have reached a point where the Commission must give serious thought to undertaking a Section 14 study. If any of them have reached the point where their size seriously hampers the performance of their true function, it might well be misleading for them to continue to advertise and sell securities on the assumption and representation that those functions will be performed. Investors should not be sold on the promise of professional management, if such management, as a practical matter, is impossible because of the size of the company. Nor should the investor be sold on the promise of the liquidity of his investment, if an attempt to liquidate on any substantial scale would result in a disastrous price decline or in the necessity for suspending the redemption privilege.

Mutual funds shares are sold to the public as a medium through which the investor can obtain both a diversification of risk and professional management of his funds. It is important to know whether a mutual fund, after it reaches a certain size, can continue to exercise real management of its investments or whether the amounts of securities in which it deals are of necessity so large that that degree of flexibility essential to the achievement of the best investment results is no longer possible.

It is important to know whether excessive size renders it impossible to shift from one security to another when conditions indicate that it would be desirable to do so. Would the effort to liquidate large holdings of a given security break the market and hence either make it impossible to liquidate the holdings or if liquidation is forced through, then only at a substantial loss? It is possible that after a certain size is reached the most that can be done is to hold on to the securities and watch the value of the portfolio rise and fall with the market as a ship rises and falls on an ocean swell?

These are questions which can only be answered, if at all, after a thorough study of the many problems involved. Serious consideration is now being given to the undertaking of such a study.

These, then, are some of the problems that we at the S.E.C. are pondering today. They are not problems of easy solution. At the least they will require a great deal of careful study; and even then easy solutions will not be found. But the more closely the industry cooperates with the Commission, the more likely it will be that a solution satisfactory to all concerned will be found. I can assure you that you will have our cooperation and I believe that it is desirable for you to give us yours. If we work together, this industry, in the basic soundness of which all of us believe, will come to realize the high hopes we have for it.