A LOOK FORWARD

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On more than one occasion some of you have suggested, albeit always with an appropriate amount of deference, that perhaps I suffer from the malaise - allegedly common among regulators - of being so close to the mountain that I sometimes can't see its shadow. On the other hand, I have criticized some of you for not hearing and responding to obvious investor protection needs as promptly and vigorously as perhaps you might. With this background of sight and hearing afflictions, I hope that in talking with you this morning about what I see when I look ahead,it will not be a case of the blind leading the deaf.

Actually, the topic is not an unreasonable assignment. As the group responsible for implementing the Commission's regulatory program under the Investment Company Act and the Investment Advisers Act, the Division of Investment Management Regulation does have, of course, considerable responsibility to try to focus on what may lie ahead. But, I must caution you that we do not have a crystal ball. When the count is taken at the end of the year, some of what I have to say to you this morning may prove to be far wide of the mark.

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* Director, Division of Investment Management Regulation, Securities and Exchange Commission. As a matter of policy, the Commission disclaims responsibility for any private publication of any of its employees. The views expressed are Mr. Mostoff's; they do not necessarily reflect those of the Securities and Exchange Commission, or other members of the Commission's staff.

From my vantage point however, certain things do seem clear. We have heard much of the problems, abuses, and losses which have troubled the mutual fund industry in recent years - and I will share with you some observations about this later. But, despite the difficulties and criticisms, the mutual fund concept remains a sound one, of proven benefit to large numbers of investors. Obviously, the industry is disappointed with the current rate of asset growth - or in some cases "non-growth" - and I know it is small consolation to observe that the entire securities market has been doing poorly. Nevertheless, the industry should not be held to an impossible standard; it would be unreasonable to expect everyone to achieve portfolio appreciation when the market average is falling. To be sure, some might be able to make enough brilliant investments to beat the average but if all were able to do this, the average wouldn't be down anymore, according to my lightning-quick calculations. On the sales side many people simply aren't inclined to buy mutual fund shares - or any other type of security - when the market is performing badly. Salesmen can argue until they're blue in the face that the time to buy is when the market is down, but there is a limit to how much they can change people's basic assumptions or ride the horse of dollar cost averaging.

At the same time, however, I am aware of the point made very clearly in "Fiddler on the Roof" that while it's no shame to be poor, neither is it any great honor. So let me emphasize that I think that there are positive changes ahead for those who sell fund shares. The fund industry seems certain to move to more experimentation with new techniques of distribution. Certainly the pending enactment of pension legislation opens up new markets for funds and, no doubt, ways will be developed to reach this market on an economic basis. At the same time, however, I would hope the industry will reassess and improve existing strategies for moving toward a net sales position.

Let me give you an example. Data issued by the Investment Company Institute shows that redemptions of fund shares have decreased. However, some analysts speculate that this fall-off in redemptions is due largely to the shares' depressed value at the present time, and that as soon as the market - and the fund shares - move back up, many people who have been holding their shares will redeem them. Let's not try to decide at the moment whether these pundits are correct in their assessment of the situation; let's just agree that they _might_ be correct.

Presumably the industry agrees on the continuing value of the product despite current performance figures. But, how many are mounting a meaningful campaign now to communicate with shareholders and explain to them why they should not be poised to redeem on the market's first good day?

During the mutual fund distribution hearings, the head of one of the country's most successful no-load fund complexes told us that one thing his organization has tried to do is maintain good service to and communication with its shareholders. Clearly, this isn't the one secret to the complex's success, but it doesn't seem to have hurt. Another way to approach existing shareholders is through a special offering perhaps at low load or no-load for a limited period of time. Both ideas focus on the importance of existing shareholders and, given the possibility of the "redemption over-hang" to which I have referred, it seems to make sense now more than ever to consider ways of maintaining communications and improving relations with your shareholders. To the extent the story is still a good one to tell, by doing so, perhaps at least some redemptions can be forestalled.

Returning to the sales side, the Commission will be dealing with the difficult issues involved in the mutual fund distribution hearings, and this will very likely lead to a number of changes including further relaxation of the advertising rules and providing more flexibility to merchandise fund shares to groups at a quantity discount.

Having reminded you of the mutual fund advertising problems, let me digress for a moment. The Commission has on several occasions indicated its strong inclination to relax the advertising restrictions to the fullest extent permissible. This does not mean, however, that you can realistically hope for a situation where, short of statutory fraud, no holds will be barred. I know that we and the NASD may seem unduly restricti and perhaps even silly when we exclude certain factual statements from ads,

but we are faced with the Securities Act which reflects a determination by Congress that an ad which is not a statutory prospectus cannot be used by an issuer to sell its securities. I do think that a line can and should be drawn between selling securities through an ad - which is not permitted - and motivating the reader to obtain the prospectus, the legally sanctioned selling document - which should be the principal document used in the distribution process. Of course, it is a delicate and difficult task to make this distinction meaningful in practice, and I hope you will try to understand this and cooperate with us when you prepare ads and submit them to the NASD or to us for review.

While we are on the subject of how funds are sold, let me share with you a matter of some concern -- the use of sales literature seen only by dealers. I have seen situations where a great deal of care and attention is lavished on the prospectus presentation with little heed to what retailers are told in "dealer-only" material. This can be a serious problem, for the dealer-only material directly impacts the nature of the presentation made at the point of sale. To the extent this results in giving an impression to the investor materially different from or inconsistent with that which he would develop from a careful reading of the prospectus, the disclosure process can be frustrated and we all have a problem. One solution to this might be to require any such material to be limited to the disclosures made in the prospectus. At a minimum, it behooves all of you who are involved in the distribution of mutual funds to think about your responsibilities and to carefully review any materials before you allow them to be distributed to and used by dealers.

Resuming our look forward, March 25th will see the start of a second but this time presumably more abbreviated - round of hearings with respect to variable life insurance. This time the hearings will focus on the Commission's proposal to amend the existing exemptive rules to condition their availability on a finding by the Commission that the laws and regulations of the states in which contracts are sold provide protections substantially equivalent to the relevant provisions of the Investment Company and Investment Advisers Acts.

Yesterday, according to schedule, all written statements and the text of oral statements were due to be filed. By March 20, all questions which interested persons wish to have asked of hearing participants must be submitted. Incidentally, we have been asked whether these questions will be made public as we receive them, and the answer, of course, is "yes." Whatever the outcome of the March 25 hearings, although I have heard some rumors to the contrary, my own guess is that one way or another, variable life insurance will be mass marketed in the United States.

In the year ahead, I also expect we will have to come to grips with new problems and wrestle with new concepts. One of particular concern to me is the plight of the small fund investor. A fund with assets of less than, say, $1 million stands little chance of making a go of it unless it is part of a large complex or unless its manager has adequate reserves to service the fund until it grows. Without this backing, the fund is dependent upon the quality of services it can purchase for itself directly. But, the arithmetic of the situation proves its impossibility. Assuming a management fee of, say, 1/2 of 1%, how much can be bought with $5,000 in today's world? Even a 2% advisory fee for a $1 million fund would amount to only $20,000.

The number of such small funds now in existence is surprising and, in a sense, frightening. As of June 30, 1973, at least 165 were registered with the Commission. Of that number, 90 (10.9% of all open-end funds in existence on that date) were actually in operation. Although small in assets, these funds impact thousands of shareholders and confront us with a host of regulatory and enforcement problems.

Many small funds, hard hit by declining markets and shrinking assets and confronted also with rising costs of operation, are floundering. Some suffer from poorly qualified or undermanned management staffs;

others have been subjected to questionable practices on the part of advisers hard pressed to make ends meet; still others have been abandoned or forced to go out of business.

I am concerned that many investors simply do not understand the economics - or "uneconomics" - of this situation. Perhaps more can be done through disclosure to assure that investors are fully advised of the risks Perhaps too, those who offer these funds can be required to exercise more care to assure that the risks inherent in small funds are brought home to prospective purchasers. But, I believe the solution lies beyond these possibilities.

Perhaps the small fund as we know it today should be eliminated from the investment scene. The $100,000 minimum capitalization requirement in the Investment Company Act is obviously inadequate. Another approach might be to require that funds attain a net asset level of some reasonable amount within a specific time period after the initial public offering is commenced. But, how does one determine the right dollar amount and the appropriate time period? Still another approach might be to view the small fund problem as a question of the net capital of the adviser. The answer then might be to develop minimum capital requirements for fund advisers. Each of these possibilities, and no doubt others, call for careful analysis.

Perhaps the answer will come from another source in the form of legislation designed to deal with the Rosenfeld v. Black doctrine. Once this "solution" is enacted, we are told, the log-jam of those who are treading water for now will break and there will be a rapid surge of small fund transfers and consolidations. I would suggest, however, that those in this situation should not count their chickens before Congress lays its eggs. The legislative course, even if unopposed, can sometimes be tortuous to negotiate. During this period, fund shareholders pay for and deserve bona fide investment management efforts, and it would be most unwise to operate on an interim or caretaker basis.

Another intriguing problem area ahead arises from the growing interest in the option market. Two funds whose primary investment objective will be to write options have already registered with the Commission. In addition another fund has proposed to change its primary investment objective to that of writing options.

Focusing solely on the regulatory requirements of the Investment Company Act, these funds raise several questions. For example, Section 17 may impose certain restraints when an option fund is part of a fund complex and the other funds intend to buy or sell large blocks at the same time the option fund is writing options on the same security. Section 17 may also apply where , apart from this fund, the adviser itself is in the business of writing options. In addition, in certain instances the writing of options may be inconsistent with the provisions of Section 18 prohibiting the issuance by open-end companies of senior securities. Further, any arrangement requiring that securities

which are the subject of an option be deposited with anyone other than the fund's official custodian would be contrary to the Act's custodianship provisions.

It seems clear that option writing is very different from the traditional business of investment companies and involves a high degree of risk. Consequently, these and other questions these funds may present will require very serious consideration.

Another subject which recently has been of great interest is the practice by mutual funds and other investment companies of lending portfolio securities to brokers and others. As you probably know, our Division has issued several no-action letters which generally permit the practice, subject to certain safeguards to assure that the fund is not put at excessive risk and that it gets substantially all the benefits of the loans. In essence, these safeguards require that the fund receive 100% cash collateral from the borrower. The borrower must add to the collateral whenever the price of the securities rises - that is mark to the market on a daily basis; the fund must receive reasonable interest on the loan as well as any distributions on the securities; and, the fund should have the right to terminate the loan at any time. Of course, the fund's policy must specifically authorize the practice and the fund must retain the voting rights. Originally, we required also that the fund not pay any fees in connection with the loan, but we recently modified that position to allow fees for actual services rendered, but only if the directors first approve the practice after having received adequate disclosure that the fund may arrange such loans directly, without payment of any fees.

We believe that these guidelines are appropriate but we recently have been hearing rumors that some investment companies which lend their portfolio securities are not taking adequate steps to monitor compliance with them, notably in the area of marking to the market on a daily basis. Also, we suspect there are enforcement problems in the fee area. In conducting inspections this year we will be taking a hard look at what the actual industry practice is in both respects.

This leads us to a particularly important area, the total investment company inspection program. During the past year the staff has been working very hard to lay the groundwork for launching an improved and more effective inspection effort. The Commission's goal is better compliance - to assist those in the industry who strive to meet regulatory requirements and to minimize situations which, if ignored, might result in investor losses. In the investment company area,where inspections are conducted only by the Commission, this means a regular program of routine inspections. In fiscal 1973, we moved away from "for cause" inspections only and achieved an annual inspection cycle of 7 1/2 years. The Commission has mapped out a program to increase the frequency as well as the quality of inspections. By 1976 we hope to be inspecting investment companies on an average of every two years, with every new registrant inspected in its first year of operations.

This means that you should be seeing much more of us. Our experience so far this year suggests that this also means that we will be calling for greater in-house compliance efforts on your part.

From our inspections to date, we have found that while some investment companies meet commendably high standards of conduct, there is nevertheless a disturbingly high instance of troublesome situations. For example, there seems to be a virtual epidemic of violations of the bookkeeping requirements -- many minor but some more serious. Moreover, there have been cases where, in apparent violation of Section 10(f) of the Investment Company Act, investment companies have purchased securities during an underwriting when a member of the selling syndicate has been an affiliate of the fund's adviser. Similarly, we have seen careless controls lead to apparent violation of Section 12(d)(3) which, essentially, prohibits a registered company, with certain exceptions, from purchasing any security issued by broker-dealers, underwriters, or investment advisers.

Another troublesome situation, which we hope is not an indication of a widespread breakdown in controls, involved a large commercial bank acting as custodian to a mutual fund. Although the bank was instructed to purchase U.S. Treasury bills for the fund,it did not do so. Instead cash was transferred to the bank's general cash accounts, and a bank due bill was issued to the fund. At the date the Treasury bills would have been due, the cash and interest due was then paid to the fund, all done, the fund tells us, without its knowledge.

Unfortunately, we have also found instances of more blatant, overt violations within the operations of fund advisers themselves. Several cases apparently involve fund trading designed largely to generate cash used for payoffs to or by fund managers. In one instance

a fund purchased a large private placement. The issuer was directed to pay a finder's fee to a foreign corporation which in turn used the money to purchase stock which was then turned over to the fund manager. In another situation, a fund manager arranged to have shares of a security purchased through an agency account at a discount from the market. The shares were then resold to the fund at a substantial profit for the fund manager and his "agent".

Other instances of real concern involve wholesale trading by employees or other affiliates of the adviser on or against recommendations to the managed funds. In one situation an employee of the adviser realized a substantial profit from trading shares of a security on the very same day the fund started to buy the same security. In other instances, persons affiliated with the adviser, apparently acting on advance information, purchased or sold securities shortly before the fund.

It goes without saying that our inspectors will be looking very closely for similar situations in future inspections. These and other abuses are real problems and we hope our inspection efforts will help prevent them. But they are your problems too, and you should not wait for SEC inspectors to discover violations which you are obliged to guard against in the first instance. Vigilance against wrongdoing -- whether deliberate or inadvertent -- should be as much a part of operating a mutual fund as selling shares and managing a portfolio.

In this connection I should mention another important project that lies ahead. At our request, the Investment Company Institute is now developing the framework for a proposed manual designed to be used by the industry to assist in compliance with the various regulations to which investment companies are subject. Progress has been made, but I hope this effort will be accelerated.

There are a host of other regulatory ideas presently in one stage or another of our trans-bureaucracy pipeline, too numerous to detail now, which I expect to be emerging by the end of the year.

Some will deal directly with troublesome practices we have seen through our inspections both of investment companies and investment advisers. I have in mind proposed Rule 17j-1 under the Investment Company Act, possible standards for a brochure to be used by any registered adviser soliciting clients, and rules under the Advisers Act aimed at elevating standards of practice and dealing with conflicts of interest. Others will deal with long standing problems under the Investment Company Act, such as sharpening the focus of Section 17(d) and Rule 17d-1, perhaps clarifying the reach of Section 17(a) as well, and rethinking positions on the difficult status question "when is an investment company?"

In various ways, as each of these projects emerge from our pipeline and are implemented, I expect they will help increase public confidence in the industry, and let's face it, confidence is one commodity in short supply today.