

HOLD FOR DELIVERY

Address By

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I welcome this opportunity to talk with you today about a subject with which we are all concerned -- standards of conduct in the sale of mutual fund shares.

The protection of investors is not a responsibility of government alone. Under the pattern of securities regulation established by Congress, the Commission, the States, the self-regulatory organizations and the industry itself have joint responsibility for developing practices and establishing standards designed to foster the investor confidence which is essential to the maintenance of sound and orderly securities markets. But the primary responsibility rests with you -- the representatives of the industry, upon whom investors rely for guidance in their investments.

This sharing of responsibility has achieved a remarkable degree of success. However, as in other areas, the pursuit of excellence requires that we continuously re-examine and re-evaluate what we have achieved, where we are headed, and how we may best improve existing procedures and techniques. This should be a constant concern for us -- not one which is brought to the fore only when investigation reveals shocking abuses or glaring deficiencies. This is particularly true in your industry where the public image of professionalism and trust is so widely relied upon in day-to-day selling activities.

During the past quarter of a century, the tremendous growth in mutual funds has been one of the most significant developments in this nation's securities markets. This growth has dictated a comprehensive re-examination of the basic regulatory pattern established in 1940 to meet the problems of a much smaller and far different investment company industry than the one of today. We will shortly complete a major study of the regulatory implications flowing from investment company growth. I know you are all extremely interested in its contents, but I am afraid that discussion must wait until the report is published and you have had an opportunity to give it careful study.

The time is appropriate, however, to discuss with you another area of mutual concern -- selling practices in the mutual fund industry. In this area a great step forward was taken with the passage of the Securities Acts Amendments of 1964. This legislation has furnished the Commission and the industry with a basis for improving the qualifications and elevating the business standards of those who sell fund shares.

The substantial growth of this industry reflects the decisions of a broad cross-section of the investing public who decided to participate in the securities markets through the medium of mutual funds and who are committing ever-increasing amounts of their income and savings to the funds. You sell a good product, and you have earned the confidence of the investing public. But the confidence of these investors -- indeed, of all investors -- must be maintained. It must not be abused. This leads me to a discussion of certain principles which I believe are essential to the maintenance of such investor confidence. These include suitability of securities recommendations,

qualifications of salesmen and quality of supervision. While considerable progress had already been achieved, the 1964 amendments reflect a Congressional mandate for further improvement.

A noteworthy feature of the 1964 amendments is their manifest concern with the development of adequate qualification standards for those who sell securities. Although the NASD and the exchanges had long before developed testing programs for broker-dealer applicants and their personnel, the 1964 amendments, for the first time at the federal level, not only authorized but directed the establishment of qualification standards by a registered securities association such as the NASD, and by the SEC. Thus, these amendments also require that all broker-dealers who do not belong to a registered securities association -- at the present time the NASD is the only such association -- be subject to comparable regulation by the Commission. The broad purpose of the amendments was to close the gap in the regulatory pattern whereby broker-dealers who did not choose to join the NASD were not subject to its qualification standards nor required to adhere to the just and equitable principles of trade and the standards of high commercial honor reflected in its Rules of Fair Practice.

These amendments are of particular importance since by far the largest group of salesmen covered by this amendment are those engaged solely or primarily in the sale of mutual fund shares.

Acting under this statutory mandate, the Commission is already well into the first phase of implementation -- the development of qualification standards for those who sell securities. First, the Commission requires the filing of background information on all persons associated with broker-dealers, including a certificate that the employer, after due and diligent inquiry, has reason to believe that the associated person is of good character and reputation and qualified to perform his functions and duties. Second, the Commission has established a nationwide examination system, complementing those of the national securities exchanges and the NASD, to test the basic knowledge of individuals who hold themselves out as qualified to sell the "intricate merchandise" called "securities." I might add, parenthetically, that in certain respects mutual fund shares, while offering an important and useful investment vehicle, are among the most intricate securities currently being offered to the investing public.

Today, the Commission entered the second phase of implementation by proposing and inviting objective and informed comment on an integrated set of rules governing selling practices of non-member broker-dealers and their personnel. The proposed rules would expressly require these broker-dealers and their salesmen to conduct themselves in conformity with high standards

of commercial honor and just and equitable principles of trade; they would require the exercise of diligent supervision over sales representatives and the maintenance of records adequate to insure that the rules are being complied with. In addition, the rules would require that where broker-dealers or sales representatives recommend securities to their customers they take reasonable steps to see to it that the recommendations are not inconsistent with the customers' needs and do not require commitments which are beyond the customers' financial capabilities.

The concept underlying "suitability" is by no means novel or revolutionary in the securities industry. It is inherent in the concept of professionalism which the industry strives to maintain. It follows in general the NASD's suitability rule set forth in its Rules of Fair Practice. It also draws on similar rules adopted by certain exchanges.

The notion that broker-dealers must not recommend those securities which are clearly unsuitable for their clients is an outgrowth of the so-called "shingle" and "fiduciary" standards first articulated in disciplinary decisions by the Commission almost a generation ago. The "shingle" theory recognizes that a broker-dealer by hanging up his shingle, that is, holding himself out as ready to do business with the public, impliedly represents that he will deal fairly with his customers in accordance with the standards of the profession. The Commission and the courts have accepted the view that this demands a reasonable knowledge of the merchandise offered and that the offering of securities without knowledge of the needs or abilities of investors raises serious questions under the securities laws.

This concept also was articulated in cases where the broker-dealer placed himself in a special position of trust and confidence with his customer. In such situations the broker-dealer and his salesmen are under a traditional common law fiduciary duty to act in the customer's best interests.

Over the years, the Commission has stressed repeatedly the duty of securities dealers to treat their customers fairly. Broker-dealers, hold themselves out as possessing specialized knowledge and skill and invite their customers' trust and confidence. Much of your sales literature characterizes your services as "financial planning". The suitability principle simply recognizes these facts. It reflects what you have led your customers to expect -- that you will not make recommendations to them when you have no reasonable basis to believe that such recommendations are suitable for them.

The proposed rule would require the salesman, if he makes a recommendation, to make a reasonable inquiry about his customer's financial position and needs. This codifies a decision by the Commission in 1960, affirming an NASD ruling that a broker-dealer could not avoid the impact of that organization's suitability rule by not making inquiry about the financial situation and needs of his customer.

The proposed rule is not an attempt to second-guess a broker-dealer's exercise of reasonable business judgment or to make him an insurer of favorable investment performance. The suitability of his recommendations would be judged in the light of the facts which his customer provided or concerning which the broker-dealer was otherwise informed at the time of the recommendation, and not by reference to subsequent events. A broker-dealer can protect himself by making a reasonable inquiry about the customer's financial situation before making recommendations and by recommending only those securities which he reasonably believes not to be unsuitable for a customer in that situation.

The proposed rule is not intended to interfere with a salesman's legitimate selling efforts in making specific recommendations to his customers. Good practice is good business. It is not inconsistent with good selling effort to ask that a salesman, who is selling mutual funds to people who are often unsophisticated in securities matters, be reasonably informed of, and take into account, his customers' objectives and financial situation when recommending securities. Although the customer is the only one who can disclose adequately his investment objectives and needs, it is not unreasonable to suggest that you assume the duty of inquiry. A more fully informed salesman has less chance of making an improper recommendation, and his inquiries would require the customer to examine his own situation more carefully. Needless to say, this salutary process would reduce, if not eliminate, subsequent dissatisfaction and complaints by customers.

I should re-emphasize that the proposed rule would impose no additional duty on broker-dealers beyond that which is already inherent in the obligation to deal fairly with the investing public. In effect, the suitability doctrine is a specific application of the requirement that you must "know your merchandise" and "know your customer" if you are to serve the investing public in a truly professional manner.

Under the existing pattern of cooperative securities regulation, the primary responsibility for enforcing the suitability rule, as well as all other standards of business conduct, rests upon you. The Commission's proposed rules would focus this responsibility on the broker-dealer and his salesmen. They would also expressly require that the broker-dealer exercise diligent supervision over the securities activities of all his associated persons and maintain and enforce written procedures setting forth the ways to comply with the rule. The adequacy of any particular system of supervision would be judged on the basis of such factors as the size and organizational structure of the firm, the nature of the business, the type of customers, and the experience of its personnel.

These proposals reflect the long-standing recognition by the SEC and industry groups of the importance of adequate and responsible supervision within the securities industry. The Special Study emphasized the need for greater supervision over selling activities, particularly in branch offices, and this responsibility was re-emphasized by Congress in the 1964 amendments. The Commission, in many of its decisions, including one handed down a few weeks ago, has emphasized the importance of supervision. The NASD and the exchanges have recognized this need by requiring their members to maintain a program of supervision, evidenced by written procedures. The Commission's proposed rule will complement the rules of the exchanges and the NASD in this area.

The prevention of improper selling efforts is essential to the well-being of the mutual fund industry and the securities markets. Inherent in mutual fund investments, as in other equity investments, is the risk of loss as well as the possibility of gain. Wholly apart from any impropriety, it is not good business to lull an investor into unrealistic appraisals of the risks involved and into larger commitments than his circumstances warrant. The investor who is not financially able to retain his fund investment in the face of generally recognized and anticipated economic pressures needs and deserves your thoughtful concern and careful attention.

You go into investors' homes and sell them securities designed to fulfil their dreams of college for their children, carefree retirement and other major life goals. You are selling a product, but you are also selling a service, one which you have carefully portrayed as a "professional" service. Why should not the public expect the highest standards of selling excellence from you, particularly since you often plan the investments of major portions of their savings? I need not remind you that professionalism requires the highest standards of honor and business integrity.

In a symposium last year on ethics and the securities markets, a noted law professor summed up the basic prerequisites of a professional group. First, the group must feel a responsibility to see that the services provided by the members of the group are in the public interest. Second, there must be an organization that can effectuate these standards. Underlying these concepts is a recognition that as a man practices his calling, as a securities salesman or anything else, there will be conflicts between his private interest and the public interest. The function of professionalism is to insure that the private interest does not override the public interest.

Anyone can call himself a professional; but you become a professional only by acting like one. By adhering to selling practices that avoid overselling; by adhering to presentations that furnish a balanced picture of the characteristics of mutual funds; by limiting recommendations to those not unsuitable for your customers, you help to assure the continued health and vitality of the securities markets in general and the mutual fund industry in particular. Make no mistake -- the maintenance of high standards in the sale of fund shares is vital to you, vital to your funds and vital to the success of your industry. It is also vital to the needs of an economy that must continually marshal the savings of the investing public for the continued growth of our nation.