Remarks

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The Mutual Fund Industry and the SEC

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It is a pleasure to be here today to discuss some of the activities of the Securities and Exchange Commission relating to the mutual fund industry.

Legislation, U. S. and Foreign

As you know, the Commission has for several years been very concerned about the problems that have arisen in connection with the industry's dramatic growth and has proposed legislation to remedy those problems. At the present time two bills -- one passed by the Senate and the other by the House of Representatives -- are pending before Congress and awaiting further action. Before discussing this pending legislation and the major differences between the two bills, however, I would like to comment upon recent developments with respect to certain foreign or so-called "offshore" funds. Not only are these situations of interest in and of themselves, but they also, I believe, provide clear and persuasive evidence of the need for and value of comprehensive regulation of the investment company industry in the United States.

Foreign Sales of U. S. Funds

With respect to off-shore funds, to set the subject in context, let me review our approach to the question of how the securities laws should be applied to the foreign sale of shares of mutual funds domiciled in the United States and registered with the Commission.

As a general proposition, the Commission encourages the sale of shares of United States mutual funds abroad as one measure which will help alleviate the United States balance of payments deficit. However, we believe that foreign investors in United States mutual funds are entitled to essentially the same protections which the federal securities laws make available to United States citizens, provided no undue burdens are imposed on the funds.

In order to clarify our position as to the applicability of the securities laws to foreign sales of registered fund shares, the Commission recently adopted guidelines in the area (Investment Company Act Release No. 5068 (June 23, 1970)). These guidelines are designed to assist United States funds engaged in foreign sales programs and their underwriters. We do not intend that they be applied so as to conflict with any foreign law and we do not believe that they place any undue burdens on companies engaged in foreign sales programs.

Basically, the guidelines are designed to insure that foreign offerees of United States mutual funds will have available to them the same kind of information the Securities Act provides to investors in this country. Since the United States funds which sell abroad are already subject to the provisions of the Investment Company Act, the guidelines also indicate that the regulatory safeguards in the 1940 Act should be available to the foreign investors who buy their shares. The guidelines suggest, however, that necessary exemptions to allow for different circumstances in foreign countries may be granted in appropriate situations.

In this connection, I understand that some mutual funds registered under the Investment Company Act have encountered difficulty in meeting the requirements of the new German law governing foreign-based investment companies. In 1969, before the German law was adopted, at the request of the German government, one of our staff members testified at their hearings on mutual fund legislation and pointed out some differences between their proposed law and our regulatory pattern. They have not followed our pattern in some important respects, and this has led to some of the present difficulties. In order to promote international cooperation in the area of mutual fund regulation, the Commission has also sent a representative to a work group of

governmental experts of the Organization for Economic Cooperation and Development in Paris. Recently, the Director of our Division of Corporate Regulation, as United States delegate, met with officials of twelve other countries to consider proposals for standard rules for the operations of mutual funds, including prospectus requirements, sales literature, sales loads, management fees and portfolio investments. Discussion of these proposals are continuing and we await the final recommendations with great interest.

"Off-Shore" Funds

The situation with respect to non-registered off-shore funds is, of course, very different. What is an off-shore fund? Generally, it is a fund domiciled outside the U. S. -- usually in tax haven countries. Their shares probably are sold to residents of foreign countries other than their domicile and never to Americans. However, frequently they have been created and managed by Americans and have invested in large part or entirely in U. S. securities. If the mails or instrumentalities of interstate commerce are not used in connection with the offer and sale, such funds are generally not subject to the federal securities laws.

The Commission has been aware of the proliferation of such investment vehicles, and is concerned that many of them appear to raise questions as to possible U. S. market impact. As some of

you may know, the pending Institutional Investor Study, due to be completed by the end of this year, will touch on this aspect of off-shore fund operations. In operating off-shore, such funds create other problems, including the absence of protections against overreaching of foreign investors, possible inadequate disclosures in prospectuses, and heightened conflicts of interest of off-shore managers who also have domestic clients. Recently, several of such funds and their managements appear to have suffered severe reverses. In some part, this may be attributable to the fact that the management of these funds engaged in business conduct and financial transactions which would be prohibited if they were subject to the Investment Company Act.

For example, many if not most of the recently disclosed self-dealing transactions engaged in by the management of one large off-shore mutual fund complex would be unlawful if the investment companies were registered under the Investment Company Act. In another recent instance, a real estate investment trust which sold redeemable securities encountered liquidity problems, and reportedly has had to stop sales and redemptions. If the company had been organized and operated from the United States, this could not have happened because the federal securities laws would prohibit such a trust from selling securities redeemable at the option of the holder. It is somewhat ironic that the

managements and promoters of these off-shore funds would not sell to Americans because they believed that it was advantageous to avoid registration and regulation by the Commission under the federal securities laws.

The Investment Company Act

In the United States, of course, investment companies cannot be organized or operated in such a regulatory vacuum. The Investment Company Act was the Congressional answer to abuses that had taken place in the investment company industry. The decade following 1929 saw many instances of substantial losses caused by selfish or unscrupulous persons who engaged in self-dealing transactions with investment companies they managed, often looting them.

Congress enacted the Investment Company Act principally to restore investor confidence in the investment company industry and to provide a comprehensive regulatory scheme to protect investors against a recurrence of such abuses. Among other things, the Act prohibits changes in the nature of a mutual fund's business or its investment policies without shareholder approval; protects against outright theft or abuse of trust; and provides safeguards to eliminate or to mitigate inequitable capital structures. The Commission has interpreted the Act as requiring a mutual fund to

maintain a liquid portfolio in order to meet its obligation to redeem its shares. The Act also requires that a fund disclose its financial condition and investment policies; requires that management contracts be submitted to shareholders for approval; prohibits underwriters, investment bankers, or brokers from constituting more than a minority of the investment company's board of directors; regulates the custody of its assets, and provides specific controls designed to protect against managerial self-dealing and other unfair transactions between funds and their affiliates. In addition to the requirements of the Investment Company Act, a mutual fund must comply with the Securities Act of 1933 when it makes an offering of its securities and is subject to certain provisions of the Securities Exchange Act of 1934, including those relating to proxy and tender offer solicitations and insider trading and reporting rules.

Since 1940 the investment company industry has experienced extraordinarily rapid growth, with its mutual fund segment increasing from $450 million in assets in 1940 to about $48 billion in assets this year. Managers of mutual fund organizations have prospered and, in many cases, investors have had favorable results with their mutual fund investments.

The mutual fund industry has not always agreed with the Commission, nor with all of our legislative proposals. However,

I think you will agree that this spectacular growth of the industry probably would not have been possible without the confidence of the American investing public which has been engendered by the successful implementation of the Investment Company Act and the other federal securities laws.

The recent experience of certain well-known off-shore mutual funds which I have already referred to is strong evidence for the proposition that the pattern of regulation under the Investment Company Act is beneficial for the managers and promoters of mutual funds as well as for fund investors.

With these observations in mind, I would now like to discuss our mutual fund proposals.

Brief History of SEC's Legislative Proposals

As you know, the Commission's efforts to obtain reform of the Investment Company Act of 1940 began in 1966 when we made our recommendations in a report to Congress which represented many years of careful study and thought. Legislation which would have implemented these recommendations was originally introduced in May 1967.

The principal Commission proposals were directed at the level of sales loads imposed on the acquisition of mutual fund shares, the so-called "front-end load" on contractual periodic

payment plans, and the establishment of a means to test the fairness of management fees. The proposals also dealt with a number of other areas -- including oil and gas funds and performance fees -- which in the Commission's opinion required legislative action.

In proposing mutual fund legislation in 1967, the Commission made clear that it felt that most of the specific abuses aimed at in the Investment Company Act had been substantially eliminated. We pointed out, however, that the dramatic growth of the industry and accompanying changes have created new problems and situations which were not anticipated in 1940.

The 1967 proposals were not greeted with enthusiasm by the industry. In fact, the principal proposals met with substantial industry opposition and, as a result, have been modified. Many of the changes were made as a result of compromises worked out by the industry and the Commission. I might add that throughout the deliberations on the legislation, the Commission always expressed to industry its willingness to discuss their objections and to try to seek a common ground.

Need for Conference to Resolve Differences Between House and Senate Bills

These modifications, as well as many of the Commission's original recommendations, are embodied in S. 2224, which was

unanimously passed by the Senate on May 26, 1969. On September 23, 1970, the House of Representatives passed H.R. 17333 by voice vote. While many of the provisions of H.R. 17333 are the same as those found in S. 2224, the Commission believes that there are significant differences and we have some decided preferences. We therefore do not agree with those who think that the Senate should adopt the House bill on the basis that the differences are minimal. We are gratified that on October 13, 1970, the Senate appointed conferees to meet with the House conferees to attempt to reconcile the two bills. You may be interested to know the Commission's views of those differences which are of particular importance to mutual fund investors.

Difference in Major Provisions of House and Senate Bills and SEC Position

Management Fees

In the area of management fees, both the Senate and House bills would amend the Investment Company Act by adding a new provision which would specify that the investment adviser of a mutual fund or other registered investment company has a fiduciary duty with respect to the receipt of compensation. Both bills would also authorize the Commission or a fund shareholder to bring an action in federal court against any person who has breached his fiduciary duty.

In actions for breach of fiduciary duty, the Senate bill provides that the plaintiff shall have the burden of proving such breach. It is our understanding that the Senate intends that the normal rules of evidence would apply, which would mean that the plaintiff would have to establish his case by a preponderance of the evidence. In contrast, the House bill provides that the plaintiff shall have the burden of proving a breach of fiduciary duty by "clear and convincing evidence".

The Commission much prefers the Senate bill because it believes that the standard of "clear and convincing" is inappropriate in a civil action. Some state courts have utilized this test in quasi-criminal actions such as a proceeding to disbar a lawyer but, even there, many states do not. The clear words of both bills indicate that both the Senate and the House intended that no penalties even remotely resembling those imposed in quasi-criminal proceedings could be imposed in an action for breach of fiduciary duty with respect to the receipt of management compensation. The only remedy permitted under both bills is for recovery of actual damages resulting from a breach of fiduciary duty in a civil proceeding brought by the Commission or a shareholder on behalf of the aggrieved fund. Also, such damages may in no event exceed the amount of compensation or payments received from the fund and its shareholders, and a court finding that an investment

adviser has breached its fiduciary duty could not bar the adviser from engaging in the securities business. In fact, both bills specifically preclude administrative, criminal and quasi-criminal sanctions based on a finding of a breach under this new provision.

The House Report indicates that the purpose of the "clear and convincing evidence" standard is to eliminate nuisance suits designed to harass defendants. The irony of this, in our view, is that such a standard would adversely affect only the meritorious suit where persons are substantially damaged by excessive or unreasonable advisory fees. On the other hand, it is easy to see that a so-called "strike-suit" plaintiff, whose primary interest is the suit's nuisance value, would be the least affected by raising the level of proof required for winning the action.

Sales Loads

In the area of sales loads charged on the acquisition of mutual fund shares, the Senate bill would require the National Association of Securities Dealers, in adopting rules to prevent excessive sales loads, to allow for "reasonable" compensation for broker-dealers and underwriters. The House bill would go further and require the NASD to allow for a "reasonable opportunity for profit" for these persons.

The Commission is opposed to the language in the House bill because it seems to shift the primary thrust of sales load regulation from investor protection to the profitability of fund sellers. Moreover, the profitability language deviates from the other language used in both bills which provides that the NASD shall allow for "reasonable compensation for sales personnel . . . and for reasonable sales loads to investors."

The Front-End Load on Contractual Plans

In the area of the front-end load on contractual or periodic payment plans, both the Senate and House bills contain two alternative provisions which would afford additional investor protections. Under the first alternative, which is identical in both bills, sellers of periodic payment plan certificates would be permitted to charge a sales load which does not exceed twenty percent of any payment or average more than sixteen percent over the first four years of the plan.

Under the second alternative, periodic payment plan certificates could be sold with the presently authorized fifty percent front-end load, but the Senate bill would require contractual plan sponsors to refund to any investor surrendering his certificates with the first three years of the plan that portion of the sales charges which exceeds fifteen percent of the gross

payments made. The House bill, on the other hand, would permit a refund only within the first year and then only of the portion of the sales charges which exceeds twenty percent of the gross payments made.

Because experience has demonstrated that substantial percentages of investors drop out during the second and third years of contractual plans -- thus paying effective sales loads of sixteen to fifty percent -- the Commission believes that the one year refund period and the amount of the refund provided by the House bill are inadequate.

Oil and Gas Funds

Many of you may be also interested in the Commission's proposals dealing with oil and gas funds.

The Investment Company Act in its present form excludes oil and gas funds from the definition of an investment company subject to the Act. The Senate bill would delete the exclusion for those oil and gas funds which issue redeemable securities or periodic payment plan certificates.

Oil and gas funds issuing these kinds of securities would thereby be required to register and be regulated under the Investment Company Act. Oil and gas funds in which investors make only a single investment and which do not issue redeemable securities would, however, continue to be excluded from the definition of an

investment company. The House bill, in contrast, would not change the present exclusion in the Act at all.

In the course of the Senate and House Committee hearings on the mutual fund legislation, the oil and gas industry vigorously opposed regulation under the Investment Company Act. The industry argued that such regulation would present substantial problems, primarily because of the difficulty of accommodating the company structure contemplated by the Act with the structure in fact adopted by the industry in order to secure favorable treatment for oil and gas fund investors under the Internal Revenue Code. For this reason, although we feel quite strongly that there is a need to regulate oil and gas funds to some extent in the manner provided in the Investment Company Act, we do not object to the House bill.

Some time ago, our staff met with representatives of the Oil Investment Institute and reached a tentative understanding that we could arrive at a mutually satisfactory solution by sitting down with them and drafting a regulatory statute which would provide safeguards for investors which they recognize may well be needed. It was contemplated that the proposed statute would, in some instances, parallel provisions of the Investment Company Act but would be specifically tailored to the practices, problems and operating methods of the oil and gas funds.

Consequently, we proposed to the House Subcommittee that we sit down with oil and gas fund representatives and work out a separate piece of legislation which would be submitted to the Congress before eighteen months after passage of the legislation. Of course, we made this suggestion on the assumption that representatives of the oil and gas industry will cooperate in working out a reasonable regulatory statute consistent with the protection of investors. If we fail to receive the promised cooperation we will submit appropriate legislation early in the next Congress to provide necessary investor protection in this area.

Performance Fees

In the area of performance fees, both the House and Senate bills would amend the Investment Advisers Act of 1940 to prohibit a registered investment adviser from charging an investment company client such a fee, except where such a fee is scaled to an appropriate index, increasing and decreasing in equal proportion from the base fee that would be paid if the Fund's performance is exactly equal to that of the index. However, contrary to the Senate bill, the House bill would exempt from this and all other regulatory provisions of the Investment Advisers Act, advisory contract with foreign-based investment companies or "off-shore funds".

The Commission is opposed to this exemption in the House bill. It would result in an anomalous situation in which an investment adviser, who is clearly subject to SEC jurisdiction and regulation under the Investment Advisers Act, would not be required to afford the protections provided by the Act to certain clients merely because they are foreigners. Furthermore, such an exemption may result in a conflict of interest between a registered investment adviser's duty to his American and foreign investment company clients. For example, without the restrictions of the Advisers Act, a registered adviser may be able to exact higher fees from his foreign investment company clients which could tend to compel him, consciously or unconsciously, to give his better investment ideas to those clients to the detriment of American investment company clients.

The exemption in the House bill is also inconsistent with the policy followed by the Commission with respect to sales outside the United States of shares of registered mutual funds. As I have already noted, we indicated in the foreign sales guidelines issued by the Commission on June 23, 1970, that foreign investors who are purchasing shares of registered American mutual funds should be afforded substantially the same protections afforded to American investors, where this would not involve substantial additional burdens upon such funds.

We believe that this policy engenders foreign investor confidence in registered American funds. Thus, the Senate bill's requirement that United States registered investment advisers charge foreign investors, including foreign investment companies, the same fees as domestic clients and mutual funds will in the long run help prevent foreign investors from becoming disenchanted with United States registered investment advisers. On the other hand, the House bill might have the opposite effect, since it would not, in our view, adequately regulate the foreign activities of such advisers.

Bank Administered Investment Companies

There are provisions in both the Senate and House bills dealing with bank administered investment companies which were not a part of the Commission's legislative proposals. The Senate bill would expressly permit, subject to specified restrictions, the operation by bank and savings and loan associations of so-called commingled agency managed accounts (which are investment companies), and would make it clear that no other provision of law shall be deemed to prohibit such activities. The House bill would also permit banks and savings and loan associations to operate such accounts as investment companies subject to substantially the same restrictions specified in the Senate bill and also subject, in addition, "to any provision of any law of any state or of the United States prohibiting the creation of an investment company by a bank or banks or by a savings and loan association or savings

"and loan associations and also subject to any restrictions or requirements imposed by any law of any state or of the United States."

The proviso in the House bill would leave the right of banks and savings and loan associations to operate registered investment companies to be determined by subsequent state and federal legislation or by existing state and federal law. The question of whether banks may operate investment companies consistently with present national banking laws is now pending, upon the granting of certiorari, before the Supreme Court of the United States in the case of Investment Company Institute v. Camp (No. 61, October Term 1970).

While we express no opinion on the national policy question of whether banks and savings and loan associations should be permitted to operate investment companies, we see merit in the House provision, which leaves the question to the Congress to resolve in other legislation and to the courts.

There are many other matters of difference between the two bills. Some of these differences, while not as critical as some of the matters I have just mentioned, are very important. I am hopeful that the conference committee will substantially adopt our recommendations. I am optimistic that the 91st Congress will enact the first major revisions of the Investment Company

Act since its passage in 1940. I believe that enactment of legislation that will provide significant and necessary protections for the Nation's five million mutual fund investors will enhance the climate for the industry's constructive development in the future.

Conclusion

Thank you for giving me this opportunity to explain our legislative proposals and their relationship to foreign laws.