ADDRESS BY

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Before the

FEDERAL BAR ASSOCIATION
BRIEFING CONFERENCE ON VARIABLE ANNUITIES

Shoreham Hotel
Washington, D. C.
November 19, 1968

It is a pleasure for me to be here today, and I would like to thank you for your kind introduction. The trouble with luncheon addresses such as this is that the flattering introduction is usually shorter than I would like, while the speech itself is usually longer than you would like. I will try to satisfy your hopes rather than your expectations.

We have all watched, with great interest, the development during these past few years of the insurance-equity package--the variable annuity. Many of the major life insurance companies have now entered the mutual fund business directly. Not too long ago insurance men laughed at a forecast of such a development. The problems with which some life insurance companies are now struggling, in part at least, relate to a reorientation of sales attitudes and techniques. Teaching sales forces, inbred with the different concepts of life insurance, to sell mutual funds is eloquent testimony to the strong rivalry that has existed between these two investment (or savings) media. The advice of fund men to their clients to "buy term and invest the difference" drew long and heated answers from the life insurance men. But the trend is not one way. Fund organizations are entering the life insurance field-- (indeed, some started many years ago) -- and learning the insurance sales message is just as difficult for fund salesmen.

The expansion of life insurance companies into the sale of equity based packages or pure equity vehicles such as mutual funds is one of the most important developments in the securities industry. Another which I shall discuss later and which is not unrelated is the institutionalization of our equity markets.

The addition of mutual funds to the array of products which an insurance salesman may sell assures that more and more Americans will be investing in mutual fund shares. The mere fact that huge sales organizations, which would not have dreamt of offering funds ten years ago but will now be ringing doorbells in an effort to sell funds, makes it very clear that the number of people owning fund shares (now approximately 5,000,000) will probably double in the

next five years. Furthermore, mutual fund assets, which now stand at over $50 billion will probably swell substantially as a result of sales by life insurance company sales forces -- market appreciation aside.

This is only <u>one</u> aspect of the growing role of institutions in our markets. The overall figures are startling. In 1954 institutional ownership of equities amounted to $66.5 billion, in 1968, $230.2 billion -- an increase of 250%. In the aggregate institutions now own 33% of all publicly owned equities, up from 25% in 1954. In certain companies and industries the figures are higher. This increase is due only in part to the growth of equity values which, generally, rose 160% in that period.

Certain other statistics should also be considered.

Institutions were involved in net equity transactions (purchases and sales) of almost $20 billion in 1967 alone-- almost double the rate of the previous year -- 1966.

While the turnover rate for all equities listed on the New York Stock Exchange was more than 20% in 1967-1968, mutual funds turned their portfolios over at a rate near 40% in that period!

Bank trust accounts held an incredible $163 billion in stocks this year and the stock assets of the five largest banks exceeded the stock assets of all the mutual funds put together (over $50 billion).

Corporate pension funds now hold $86 billion in assets-- over 50% in stock (versus only 25% in 1955). This contrasts with only <u>206</u> million in 1956 -- only 12 years ago.

Now, what does this mean for us. It means, among other matters, that, as the regulatory agency charged with supervision of our securities markets and with specific responsibilities for the regulation of certain activities of mutual funds, our job will be more complex and more

challenging in the years to come. But that is a platitude. The real significance is that we will be dealing with vastly expanded markets in which the mix of investment interests is being changed constantly. It means that we will have a fund industry with a large population of insurance salesmen and many more funds with insurance--equity components. Some of these insurance salesmen have been trained in sales techniques which can not be tolerated under the federal securities laws. They will have to learn -- and I am sure they will -- that the sale of an equity instrument is not the same as the sale of a fixed dollar annuity. We, on the other hand, will have to learn (as we are) about the new kinds of securities under development and designed to attract the savings of millions of Americans.

We have no wish to stifle the development of new forms of securities or packages containing substantial equity elements, nor will we apply the statutes committed to our care inflexibly. I hope you will agree that we have not hesitated to act flexibly and with imagination in the past. But we must be careful not to compromise the interests of investors in our efforts to accomodate the statutes to the new and imaginative packages developed by American industry.

Indeed, the anticipated dramatic growth of securities salesmen who sell in large measure in the homes of their clients, as well as the ever growing number of investors to be introduced, perhaps for the first time, to equity ownership through mutual funds emphasize the urgency that regulation and the regulators be alert and prompt in fulfilling the Congressional mandate for investor and general public protection. The confidence of investors, our experience makes clear, varies in direct proportion to the effective protection afforded by reasonable, fair and vigorous regulation. I think we have already learned the lesson that other countries are now learning-- that there can be no sound equity markets without investor confidence and there can be no confidence without meaningful regulation.

I think it important to add that the concern with respect to institutional investors and the impact of their growth and practices on the market is not based on any feeling of mistrust--it is simply grounded in the necessity that you and we understand a great deal more than we do now about what has become a significant and rapidly expanding factor in our markets. During the past session, Congress authorized the Commission to undertake a study to meet this need. We anticipate active support from the various types of institutional investors as well as from the academic community and the securities industry. The proposal for the Study was widely supported by many of these groups and by the Congress. We are in the process of gearing up for this study and we expect to be in operation by the end of the year. We hope very soon to announce the selection of a Director of the Study and to convene a meeting of representatives of the various institutions to be studied as well as those who serve them.

The Commission's current public hearings on the commission rate structure is also of great importance to institutional investors. I am sure that you have been following them closely. While the hearings have received much publicity, most attention has been focused on the question whether there should be a fixed commission or whether commission charges should be freely negotiated. No one, of course, should minimize the importance of that aspect of the hearings. What is often overlooked, however--at least outside of professional circles--is that one of the elements to be considered is whether so-called institutional membership should be allowed--that is, whether insurance companies, mutual funds, etc. should be permitted some form of membership with a consequent savings of the commission or a substantial part of it. The expression is also used to refer to membership by affiliated investment advisers or underwriters who might keep a part of the commission for their effort. This, of course, may be considered solely as another form of volume discount which, in turn, is associated with questions as to the level of commission rates. An inevitably related problem is whether member firms should be allowed to become publicly owned directly or through parent or affiliated organizations. This question of access has other facets. For example, should any firm engaged in some phase of the securities business, whether

domestic or foreign, be allowed some form of professional discount short of that available by reason of membership.

The accelerating tendency of insurance companies to diversify their investment packages, and to form broker-dealer affiliates to sell these packages and to seek exchange membership, makes the questions considered in these hearings more acute and the problems more difficult to resolve. While the record is not now complete, and final resolution of these issues must await completion of our hearings, all of the interested parties are now familiar with the issues, with most of the arguments pro and con, and some range of the possibilities. No doubt the exchanges and their members are now weighing the relevant considerations. We must all join in the effort to develop appropriate solutions.

As of December 5, an interim rate will go into effect which will provide for a significant volume discount and eliminate customer directed give-ups. This should provide a substantial savings to the investing public--especially the institutions through whom so many millions of small investors participate in the markets. The New York Stock Exchange has estimated this as something in excess of $150 million in one year. The abolition of the give-ups is intended as a control of some of the grosser abberations which have developed as a result of the pressures and counter pressures among exchange firms and non-members who advise institutions or distribute interests in them. I think it fair to note that even some of the most sophisticated members of the securities industry were surprised at the twists and turns that give-ups or give-aways developed.

Now that the Commission's jurisdiction over variable annuities has been clarified, many more of you will be visiting us on a regular basis. There are some other interesting aspects of this development. I understand that a whole new technology in legal road shows has developed and that some of you are attending seminars in such terribly uncomfortable places as Las Vegas, Palm Springs and Puerto Rico--all made possible by our far-sighted decisions. As you bask in the sun I would hope that you would think kindly of the Commission for making all this possible.

The courts have held that the variable annuity is a security and that several of the statutes administered by the Commission have an application. These include the Investment Company Act, the Securities Act, the Investment Advisers Act and the Securities Exchange Act. Just as the mutual fund industry has flourished under the investor confidence generated by such regulation, I am sure that insurance company sponsored funds will grow and proliferate. Thirty-five years of experience in good and bad times has provided ample evidence of the wisdom and far-sightedness of those responsible for the relatively mild regulation the securities statutes demand.

This is not to say that you and we will not continue to wrestle with difficult and complex issues. We have dealt with such problems before. I have no doubt that we can, with your help, work out reasonable solutions to those now arising without impeding legitimate business interests and, at the same time, providing adequate investor protection.

We are already in the throes of some of these problems. Your great ingenuity in developing new packages has put a premium on our ability to understand and to fit them within the statutory requirements. No doubt some rules and procedures relevant to other institutions, as well as some of our early positions and decisions concerning your newer packages, may now be dated or otherwise in need of re-examination. I can assure you that they are being subjected to intensive review by the staff.

That adjustment, by you and by us, may be required seems clear. One I have already mentioned will come in the education of salesmen who have sold fixed return or guaranteed investments during all of their careers -- perhaps disparaging other forms of saving and investments-- and will now be selling a security whose value depends -- at least in part -- on the fluctuations of the stock market.

As you know, all registered separate accounts have found it necessary to apply for relief from some provisions of the '40 Act. Our staff is reviewing some of the exemptions which have come to be routinely granted. If that re-examination confirms the propriety of those exemptions and the conclusion that they should continue to be granted as a matter of routine, we will move to codify by rule these "start up" exemptions.

I suppose it is inevitable that we will not always agree on every matter. An agency such as ours is compelled to consider not only the limited matter before it at the time but all of the reasonable implications. But I am certain that, as in the past, differences will be worked out reasonably and responsibly. We have found that there are few situations which do not lend themselves to such treatment. Of course, it requires a willingness by all concerned to discuss, to understand, and to seek imaginative solutions to recognized problems.

All of this is particularly true as it relates to those who wish to enter an industry theretofore more or less the province of others. Fortunately, the Commission has ample exemptive and interpretative authority to meet the particular, and sometimes the special, needs of the insurance industry, without sacrificing the public and investor protection that Congress intended. Thus, while sellers of variable annuities register as broker-dealers, these insurance company affiliates are often exempted from our net capital rule because literal compliance may be unnecessary since an exemption may subject the public to no real risk. I am sure that most of you are aware that the staff of the Commission is presently discussing with representatives of the insurance industry amendment of certain existing rules, and the development of some new ones, to meet other insurance company needs, while providing adequate investor protection. Limitations of time, and the state of our deliberations, preclude a further discussion of these proposals.

I suppose I should turn for a few moments to the mutual fund reform bill. As you are aware, the House Committee on Interstate and Foreign Commerce did not consider the bill, even though it passed the Senate by a substantial margin. I need not dwell on our disappointment. A ten-year effort to deal with the important -- and growing -- problems raised by the growth of investment companies, and the conflicts of interest inherent in that growth, has been frustrated -- at least so far as the last session of Congress was concerned.

It would, however, be a mistake to assume that mutual fund reform efforts are dead. The Senate bill, which survived a determined effort to kill it -- including a good old fashioned floor fight -- contained a number of significant compromise provisions hammered out by the Senate Committee, with the result that a mild bill was made even more so, a result which some of us viewed with mixed emotions. The Commission, you will recall, originally recommended, among other things, that the front-end load be abolished completely and that fund sales loads be limited to 5%. You also know that the Senate bill merely stretched the period for payment of the front-end load but did not abolish it, and authorized the NASD, with Commission oversight, to determine levels of commission charges which are excessive. These were solutions which we considered earlier, but determined not to recommend. The provision relating to management fees was also modified.

Most important, however, in the longer perspective of an important and growing industry, is the fact that the uncompromising attitude of some demonstrates a short-sighted view which, if uncorrected, will serve only to haunt the entire industry.

We did not conjure up the problems, although some have suggested that a more vigorous approach by the Commission earlier would have served to mitigate them. In 1940, the Congress anticipated these problems and directed us to report on them when they raised important issues in the public interest. In 1958, the Commission commissioned the Wharton School Study to conduct a study. The report,

published in 1962, pointed to some of the problems as did the Special Study of the Securities Markets, in 1964. The Commission's own study was issued in 1966. Upon the recommendations of the Banking and Currency Committee, after full hearings, the Senate passed a bill. Many in the House, including some who did not like the particular bill before them for one reason or another, agreed that the problems are there, that they will not disappear and that they deserve and should receive prompt attention, presumably in the next session of the Congress. In short, the failure of the bill to reach the floor in the House did not solve anything.

One Senator has indicated that he intends to introduce and hold hearings on a stronger bill in the next session. Others have articulated similar views. As of this moment, there is every indication that a much stronger bill will be introduced next year.

Conflicts of interests springing from the conventional mutual fund structure have deprived mutual fund shareholders of a fair share of the economies of scale made possible by their willingness to buy ever increasing numbers of fund shares. There is, at the very least, a reasonable question whether an industry, which charged an annual management fee of 1/2 of one percent of average assets when assets managed aggregated $450,000,000 and charges nearly the same rate today, when assets amount to <u>$50 billion</u>, is sharing those economies equitably with shareholders, whose savings are committed to its trust. The savings realized in the cost of management accrue, in some cases, not because of greater skill or efficiency but solely because of the very much larger sums of money managed by essentially the same persons. This problem will become more acute.

The extraordinary protection enjoyed by the industry from free competition in the sale of mutual fund shares because of the retail price maintenance provisions of Section 22(d) of the Investment Company Act has kept the sales load on the sale of shares at a level far in excess of the charges considered appropriate with respect

to the acquisition of practically any other type of security. The growing rate of portfolio turnover with attendant commission costs tends to aggrevate this situation. The Chairman of the Council of Economic Advisers, The Deputy Attorney General and others in and out of Congress have questioned the propriety of continuing such an anti-competitive device. There is already indication that certain members of the Congress will seek a re-examination and revision of the unusual price maintenance provisions found in that section.

The front-end load, by reason of which an investor may lose 50% or more of his investment if he is unable or unwilling to continue his payments after the first year, represents a sales charge which normally affects those investors who are the least sophisticated and least able to bear a loss. There can be little reasonable argument that sales charges under this scheme are not frequently excessive. Here too, statements have been made for the record that the decision to retain a reduced front-end load rather than to secure its abolition will be re-examined. This seems all the more like since certain important distributors have voluntarily, and with great success in sales and maintenance of investment, moved to stretch out the initial load.

It has been urged that excessive charges presently being borne by the mutual fund investors will come under pressure from the funds sponsored by other financial organizations. Undoubtedly, some insurance companies will offer investment programs at a sales cost below that which is now generally charged by conventional mutual funds. Whether the perverse competition which has characterized the growth of the mutual fund industry -- that is the competition for salesmen which has in fact driven sales charges up -- will permit the development of a real trend in this direction, is open to considerable doubt. If competition from the insurance industry should, despite mutual fund experience to the contrary, develop and bring down fund sales charges, it will perform a public service.

We have, after some false starts, begun a relationship with the insurance industry, at least insofar as investment company activities are concerned, which promise to be most helpful to all concerned. With your help we can meet the problems of the next few years in a manner which will permit the industry to develop as quickly and as comprehensively as its genius permits. We will expect you to adhere to the standards developed for the securities industry as you promote and distribute equity packages. It is our hope that you will join us in making this a truly cooperative venture. We have every reason to believe that we shall <u>both</u> be successful.