NEWS
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-4846

REMARKS OF

PHILIP A. LOOMIS, JR., COMMISSIONER
SECURITIES AND EXCHANGE COMMISSION

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When Dave Silver invited me to talk to you today, I accepted promptly and with pleasure. It is always pleasant to be with you and, in addition, I felt that it would not be at all difficult to find something to talk about because there always seems to be something interesting going on with respect to the investment company business and its regulation.

At the present time, however, we are approaching decisions on a number of matters which are significant both to you and to us, but these decisions have not as yet been made, nor is our eventual determination a foregone conclusion either way.

This creates a problem. I would like to discuss these matters with you and to get your views on them and thus learn more than I now know about the issues that will in due course be coming to us. On the other hand, even if I restrict myself to my own personal views, and, it should be taken as understood that I certainly cannot do more than that, for me to discuss these issues in any detail could create some confusion, some possible embarrassment for the Commission and more significantly it might mislead the industry as to where the Commission is going on these issues.

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For example, we will have before us a number of, to some degree, inter-related, questions regarding the distribution of mutual fund shares. There is the primary question of whether or not a fund and its shareholders could properly bear distribution expenses and the incidential question of whether they are doing so now, in a somewhat disguised fashion. There is the question of reciprocal brokerage and there is the question of the extent to which existing restrictions on advertising by mutual funds should be relaxed and if so to what extent and on what theory.

With respect to the primary question of whether an open-end fund should bear any distribution costs, it used to be thought of as axiomatic that it should not, since distribution was the responsibility of the underwriter who had substantial sales loads at his disposal and the benefit to shareholders from having additional capital put into the pot was apt to be off-set by the fact that more people would be entitled to share in that pot. I have said things like this in my former capacity and these are now regularly cited back to me, but these issues were raised in a rather different factual and economic context. There was concern in the '50's and '60's as to whether mutual funds were growing too big too quickly, whether an organizational and compensation structure designed for a rather minor off-shoot of existing investment management businesses were adequate for what had become a major financial institution and whether the lure to dealers of substantial sales loads was not producing, if anything, an excessive distribution pressure. As you are all aware, times have changed. There is a problem now as to whether investment companies can grow enough, and it seems that a more sophisticated generation of investors are deterred by substantial sales loads. In other words, we may now have a different ball game.

There is, of course, also the related question of whether or not payment of some portion of distribution costs out of the investment advisory fee is the functional equivalent of a direct charge to the fund or, on the contrary, whether this is merely a question of business judgment on the part of the adviser and the fund directors. In that regard, I think, the really difficult issue is the extent of the responsibility which any such practice places upon the independent directors.

With respect to reciprocal brokerage, I personally have been inclined, unless and until persuaded otherwise, that in selecting brokers to execute portfolio transactions, funds should not be required to discriminate against brokers who sell fund shares. On the other hand, funds should not be entitled in selecting brokers to discriminate in favor of brokers who sell the funds. I recognize that there are significant arguments to be made against the latter conclusion on the theory that selling fund shares is a useful service to the fund and, therefore, should be given weight in the selection of brokers to handle portfolio trades. Notwithstanding the merits of this argument, I am troubled by authorizing the overt use of fund sales as a criteria for selecting portfolio brokers because it seems to raise again issues of reciprocal dealings, not to speak of give-ups, which I hoped had been laid to rest when we got rid of fixed commission rates on the exchanges. I don't want to go through all that again. The real problem with the distinction which I have attempted to draw is how you tell the difference between not discriminating against, and discriminating in favor of, a particular broker bearing in mind the great variety of considerations, often intangible, which may cause an institution to select a particular broker to do a particular trade and the variety of explanations, not to say rationalizations, which can be advanced after the fact to justify a selection.

Yesterday morning we had a meeting with the NASD on the subject of its Rule 24 and the application of that rule to situations where the underwriter for a fund becomes a member of the underwriting or selling group for a new issue and is designated to receive credit for a purchase by the fund of that issue and then credits his dealer's concession against the advisory fees. Since this meeting was open to the public under the Government in the Sunshine Act, and I observed some representatives of your community in the audience, I will not attempt to summarize the discussion which went on for over an hour. In essence, the NASD urged us to take no action in this area, at least until their committees could examine not only this narrow issue but all sorts of perhaps related issues arising from the purchase by funds and other institutions of securities being offered in an underwriting. While I can understand why the NASD takes this position, I am somewhat troubled as to where such a course would leave funds and their directors during this perhaps lengthly process of analysis by the NASD. Maybe you would not be sued but maybe some plaintiff's counsel would be sufficiently ingenious as to conceive a legal theory extending beyond the Papilsky case.

This discussion illustrated a phenomenon which is also relevant to the matters which I have mentioned earlier. This phenomenon is that anytime we attempt to dispose of any particular issue in the complex world of securities dealings, particularly where funds and other institutions are involved, the effort to resolve the particular question immediately raises several or several dozen related issues which in theory should be resolved at the same time. If one yields to that rather compelling consideration one is apt to wind up by not resolving anything for an indefinite period. This phenomenon makes our life and yours interesting but also difficult.

I do have one somewhat more concrete matter in the area of mutual fund distribution to report on. Last week the Commission authorized the publication for comment of a proposed rule which would relax to some degree, probably not enough to satisfy you, the existing restrictions on advertising by investment companies and particularly mutual funds. I should emphasize that we only authorized the publication of this proposed rule for comment. We are conforming to the letter and spirit of the Administrative Procedure Act by not deciding anything until the comments are in.

I think, however, that if we are to have such a rule, the proposal in general concept and direction is a good one, although it is likely that comments will direct our attention to various specific provisions and details which will require modification. The proposed rule and the commentary which will accompany it are fairly detailed and extensive covering some 30 pages and I will not attempt to summarize them here.

Any proposal to relax existing restrictions on investment company advertising encounters two principal objections. One is primarily legal and the other a matter primarily of principle and policy. The legal issue arises from the Securities Act of 1933. It is and was a basic principle of that Act that securities being offered pursuant to registration under that Act should be offered and sold, insofar as written solicitations are concerned, only by means of the prospectus or at least to persons who have received the prospectus concurrently with or before they receive any other selling literature. To that end the Securities Act imposes very rigid restrictions upon written documents not accompanied or preceded by the prospectus. Since the circulation of an advertisement in a newspaper or magazine cannot possibly be restricted to people who have received the prospectus, these restrictions operate in full rigor in connection with advertisements by mutual funds which are always offering their shares pursuant to a registration statement. The issue of principle and policy is simply the idea that securities are both intangible and intricate and consequently they cannot be sold or advertised by the use of tactics accepted in the business world for selling soap or breakfast cereals with all the seductive appeals which accompany such advertising.

The proposed rule, I think, deals in a reasonably satisfactory way with the first or legal objection. It would, in effect, provide for the use of an advertisement which is technically a summary prospectus within the meaning of Section 10(b) of the Securities Act and, therefore, it could be used consistently with the Securities Act. This necessarily involved certain constraints on the content of the advertisement which you may not welcome, but, which I think, may well be called for by law. The second or policy obstacle is, of course, considerably more difficult to deal with and there is certainly room for differences of opinion as to whether the proposal meets that objection or, indeed, whether any advertisement, aside from the conventional "tombstone ad", can adequately meet that objection. I believe it probably can be done but whether our proposal, or any version thereof, does so is a different question.

There are a number of other matters which the Commission has recently considered or will consider in the near future and which I propose to discuss briefly, if only to convey the message that we continue to be very much interested in your affairs and that a fair amount is going on with respect to them at 500 North Capitol Street.

As you are aware, Section 28(e) of the Securities Exchange Act, as added by the 1975 Amendments, authorized fiduciaries to engage in the practice commonly referred to as "paying up" for research. How much of this is actually occurring is a debatable question and when you ask an investment manager whether he is engaged in paying up for research, he will commonly deny it. On the other hand, there is reason to believe that this statutory provision is by no means a dead letter and that it can be and is used. Subsection 2 of that section requires investment managers to make such disclosure of their policies and practices with respect to commissions as the appropriate regulatory agencies in practice, primarily the Commission and the bank regulatory agencies, may prescribe. We were somewhat late in attempting to exercise this authority, a fact which has been called to our attention by the Congress. We did, however, propose rules in response to that provision. I have not as yet had a chance to examine all of the comments which we have received, but I have the impression that these comments are numerous and many of them are detailed and thoughtful and will be very helpful, that there are some misapprehensions as to what we were trying to do and that probably a good many of you would have preferred it if we had not embarked upon this exercise at all. However, this statutory provision exists, and we have to do something with it. I frankly also had the impression when we proposed the rule that perhaps some of its requirements were more detailed and specific than was clearly necessary, but I assumed, correctly, that if this were the fact it would be called to our attention quite forceably. With respect to misapprehension, we do not intend that there be detailed lists of each specific item of research or other service provided by brokers, but I do believe that investors probably would be interested to know in a general way what research services are received from brokers and how these services are used in the management of their portfolios. Clearly, it would not be practicable, desirable or consistent with the Act to require investment managers to allocate research on any account by account or transaction by transaction basis and yet unsophisticated investors should not be under the impression that all research received from brokers will be utilized for their account. I doubt if it is possible to devise disclosure requirements which will enable the average investor to evaluate independently the wisdom of an investment company's brokerage placement practices. There are too many imponderables involved. On the other hand, the board of directors should understand as accurately as possible what services their investment manager receives from brokers whether, and to what extent, these services are being used and what they cost. There is something of a paradox with respect to investment advisers as distinguished from investment companies in this area. On the one hand, detailed disclosure requirements may be particularly burdensome for small advisers, but on the other hand, clients of such advisers may have a more particular need for disclosure as to what services they are receiving, what they are paying for them and in what way and, in general, how their account is being handled.

In recent years various new and different types of investment companies have been created in response to opportunities to provide mutual fund investors with new vehicles catering to their particular needs. This process, of course, has gone on for years, but it seems to me that recent periods have been particularly productive of such innovations. Examples are municipal bond funds, which have been made economically feasible by a recent amendment to the tax laws and so-called money market funds which meet a need not only of substantial individual investors but of institutions and corporations as well, for short-term investments of great liquidity and safety in which otherwise idle cash can be usefully employed. These innovative vehicles present special problems, some of which are now before us. For example, we have an application, filed on behalf of a municipal bond fund which is sponsored by a large and diversified securities firm, for an exemption from Section 10(f) of the Investment Company Act to permit the fund to purchase municipal bonds which are underwritten by a syndicate including the sponsoring firm.

Our existing Rule 10f-3 is not available in this situation, among other reasons because one of the conditions of that rule is that the offering be effectively registered under the Securities Act and municipal bonds, of course, are exempt from registration and are never so registered. In support of this application it is urged upon us that the municipal bond market, unlike some other bond markets, is of such a nature that desirable bonds cannot be obtained in substantial quantities and at advantageous prices except by purchasing them in an underwriting of a new issue. If this is so, there would appear to be considerable merit in the application, assuming that adequate conditions and restrictions are provided and our staff believes that it is perfectly possible for it to do this. Section 10(f), however, was designed as a prophylactic measure to deal with a situation which not only presents a possible conflict of interest but also affords opportunities for abuse.

Our experience with the municipal bond market is of recent vintage, dating from the 1975 Amendments to the Securities Exchange Act, aside from our Enforcement Division's long time concern with fraudulent activities in this area. Consequently, we are at some disadvantage in evaluating applicant's contentions with respect to the nature of that market and we are interested in such guidance as we can obtain as to the situation. There, of course, is also the question of whether or not, assuming that the proposition has merit, the exemption should be made more widely available, perhaps by a rule and if so exactly what kind of a rule.

We have also had before us this week some rather important questions with respect to money market funds. Money market funds by their very nature present a number of rather unique and difficult questions under the Act. They invest in short-term debt securities such as treasury notes, commercial paper, bankers acceptances and so forth. This means that the entire portfolio of the fund, or at least most of it, changes several times each year which is certainly the exact opposite of the buy and hold strategy which we used to hear about. Investors in these funds also go in and out with great rapidity, which is again the opposite of the pre-existing doctrine that mutual funds were designed for long-term investment. Further the desirability of particular money market instruments is highly dependent upon often temporary and short-term fluctuations in interest rates. Investors in these instruments calculate their yield with great frequency and down to the third decimal place or more. In addition, some money market funds endeavor to emphasize the analogy to cash by maintaining, through daily evaluations and distributions, a fixed net asset value of, say, $10 a share which is again otherwise unknown in the mutual fund field. These special characteristics create special problems. It is, I understand it, a not infrequent practice for investors in money market instruments to value them by simplying calculating the yield to maturity and amortizing the differencebetween that and original cost daily over the life of the instrument. This practice is not only relatively simple but is alleged to reflect the fact that, because of the diverse nature of the instruments involved, there may not be a continuous and active market for a particular security. On the other hand, as explained in Investment Company Act Release No. 8757 of April, 1975, this practice raises serious questions under the Act as to whether investors buying or redeeming their securities are doing so on the basis of current net asset value, rather than receiving either less than their proportionate share, which is unfair to them, or more than their proportionate share which is unfair to existing shareholders. The problem is aggravated by the significance of even relatively minor changes in interest rates to those dealing in money market instruments. The Commission, accordingly, has authorized the issuance of an interpretation which will generally require that money market funds should value their portfolios on the basis of current market value if readily available or otherwise in a manner which takes into account unrealized appreciation or depreciation due to changes in interest rates or other relevant factors. The amortized cost method of valuation may, however, be used in case of instruments having a remaining life to maturity of 60 days or less, in the absence of particular circumstances such as impairment of the credit worthiness of the issuer.

Furthermore, the portfolio of money market funds changes so substantially within a year that the usual practice of reporting the composition of the portfolio and related matters only on an annual basis is inadequate, since a few months later the fund may have an entirely new portfolio. Consequently, it may be desirable to require that money market funds and other funds having a substantial part of their portfolio in short-term instruments, provide supplementary data to the portfolio at intervals of least quarterly, by means of a sticker applied to the prospectus pursuant to Rule 424(c). Accordingly, a rule to that effect will be proposed.

Finally, I wish to call your attention to a proposal, likewise recently considered by the Commission, which may seem at first glance to be both a mere housekeeping change and also a source of temporary aggravation and paperwork, as if you did not already have enough of that. I think, however, that this proposal has more significance and, in the long run, should make your life and ours considerably simplier as well as improving the quality of disclosure by investment companies.

At the present time, a management investment company is subject to at least eight different registration and periodic filing requirements. These include the initial notification of registration on Form N-8A, registration on Form N-8B-1, registration of securities on Form S-4 or S-5, the annual update of registration statement for open-end companies, the annual report on Form N-1R, semi-annual report to shareholders, the quarterly report on Form N-1Q and the proxy statement. It is proposed to provide an integrating reporting system for management investment companies which is designed to eliminate duplication and overlap. The essential concept is to have a single form which may be used both to register a company pursuant to Section 8(b) of the Investment Company Act and to register its securities under the Securities Act, and to simplify and shorten the N-8A notification of registration. There would also be an annual update, particularly for open-end investment companies, which would combine the N-1R annual report and the annual update of the registration statement. This idea sounds very simple, but its implementation is not, and in fact, the effort had its genesis back in 1972 with the advisory committee which considered reporting and paperwork by investment companies. In one respect there would be an additional burden, but, I think, it would be counter-balanced by benefits to investors. This involves closed-end investment companies which do not periodically update their 1933 Act prospectus, although they do file a Form N-1R. That report is primarily designed for the use of our staff in carrying out its regulatory responsibilities and does not provide meaningful disclosure to investors in closed-end investment companies. Consequently an annual update of their registration would be required for them as well as for open-end companies.

The updating proposal would permit the elimination of the separate narrative annual reports currently required to be filed by management investment companies and would substitute essentially a system of exception reporting in the N-1R part. If a registrant responds to a short question in such a manner as to indicate a problem as by answering "no" when the usual answer is "yes", an explanation would be necessary. In designing this system the staff was, of course, tempted to at the same time revise the substance of its disclosure requirements, particularly those embodied in existing guidelines. This temptation has been in large measure resisted, although some of the material now in the guidelines will be incorporated into the forms. The conclusion is that the effort to provide an integrated system which, has already taken several years, would be postponed for several more years if substantive revision was attempted at the same time. It is contemplated that substantive revision may now proceed in the context of an integrated system.

From my recital of the number of things pertinent to investment companies which we have been considering very recently, you might arrive at the conclusion that there has been a concerted drive in the investment company area, timed to coincide with your Annual General Membership Meeting. I can assure you that this is not the case, rather the timing of our activity results from the operation of the Government in the Sunshine Act. That statute requires elaborate procedures for scheduling Commission meetings, giving advance notice, including the agenda in the Federal Register and elsewhere, and a number of other rather intricate procedures. We are, incidentially, in the process of accustoming ourselves to this new regime which replaces our prior practice of simply sitting down and having a meeting whenever we were ready or in the mood to. If just happened that the operation of these procedural requirements threw a rather greater than usual proportion of investment company matters into what may be referred to as the current Government in the Sunshine cycle.

I have attempted in the foregoing to refer to some of the significant matters relating to investment companies which are currently receiving our attention. Speaking more broadly, we continue to believe that investment companies, including mutual funds, are an important investment medium, the success of which should be furthered. They have, in the past, provided substantial benefits both to investors and to those who have chosen to labor in this particular vineyard, and we hope and believe that they will continue to do so. At the same time, this is an industry which requires careful regulation, both to protect investors and to preserve their confidence and thus the continuing prospects for the industry. This was a conclusion in which your industry concurred some forty years ago and which continues, I believe, to be valid today. A system of regulation created forty years ago has, however, no doubt, grown a certain number of unnecessary barnacles which should be eliminated and in general the burdens of regulation should be reduced to the extent possible.

We have, I believe, passed through the era of the late '60's when economic factors and also certain aberrations produced a somewhat adversary relationship between the Commission and the investment company industry, and I believe that we now can, and are, going forward on a more cooperative basis. This industry is not a leading candidate for deregulation, but it can no doubt do with some regulatory reform and this is very much on our minds. I expect that this process can also proceed at a fairly lively pace.