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CURRENT PROBLEMS IN THE MUTUAL FUND AREA

AN ADDRESS BY

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SECURITIES AND EXCHANGE COMMISSION

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Sales/Management Conference
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Ladies and Gentlemen, it gives me great pleasure to address your conference, particularly in light of the many developments in the mutual fund area over the past year. I must apologize for my whirlwind appearance here, but as you know we are holding hearings at the Commission on the future structure of the United States capital market, to which I must return. I bring to your attention these hearings, as the deliberations and the decisions arising from them can profoundly affect your business as well as the structure of the future of the American securities markets.

Today let me talk to you about some specific problems in the mutual fund area and describe what the Commission is doing to meet them. The great forerunner for our deliberations has been, of course, the Institutional Investor Study, which pointed out areas of concern for future examination. The three areas I particularly want to mention are, first, our increasing participation in the international arena, second, the renewed problem of oil and gas offerings and, lastly, new concerns in domestic mutual fund advertising and sales.

In the past it was often felt that the jurisdiction and interest of the Commission stopped at the 12 mile limit. We had much to do here at home regulating United States capital markets, and we did not attempt to expand into areas beyond the reach of a United States process server. We have seen as a result the growth of the unregulated "offshore" fund -- sometimes called a foreign hedge fund -- through which foreigners invest indirectly in our markets. We also found problems in our enforcement proceedings as a result of the use of foreign institutions in connection with stolen securities and stock manipulations here in the United States, often closely connected with organized crime. The effect of these latter disruptions were revealed through numerous channels during the 1960's, and the collapse of IOS, together with the attendant problems of many foreign-sited but domestically-oriented funds arising from the bear market of the late sixties, has caused us to take a second look at our posture in an increasingly internationalized capital market.

The attraction of the American capital market is naturally the main reason for the growth of the "offshore" fund; foreign investors are eager to place their money in a market that has remained stable while growing at an unprecedented rate these many years rather than committing their funds to the often Byzantine intricacies of the European capital markets. Investment advisers set up funds outside the United States to gather funds from foreigners to invest here; these funds were free from S.E.C. regulation and had certain tax advantages for the foreigners. At the same time, the advisers often engaged in overreaching regarding compensation, and the lack of regulation was an open invitation to make improper use of fund assets. All was well while the market went up. When it finally went down, those funds crashed and the reputation of the American capital market suffered severe damage.

The influx of foreign capital is important to the United States balance of payments and we at the S.E.C. are eager to keep the flow open, but this can only be done by putting the offshore funds on a sound basis. The outflow of capital has been severe since 1968, as foreigners take the natural once-burned-twice-shy position. To encourage the return of these funds will require the assurance that there will be adequate supervision in the future. We are faced, therefore, with the ironic result that we are seeking jurisdiction over these vehicles, which originally went "offshore" to get away from regulation, for the purpose of preserving their credibility and performance in future markets.

The Commission is working on a joint task force with the Treasury, State Department and the Federal Reserve in an effort to formulate rules which will encourage the creation of a hybrid fund vehicle which retains much of the flexibility and tax advantages of old funds, including the use of bearer shares so dear to the hearts of European investors, but also has the added protection of S.E.C. registration and regulation. Our deliberations in this area are going forward rapidly and we hope to see concrete results in the near future. After the promulgation of these rules, only time will tell whether these "domestic portfolio sales corporations" will be able to compete successfully with the established funds. We hope, however, that the current funds will be encouraged to come back "onshore" and voluntarily submit to our supervision. We believe that without the protection afforded by S.E.C. regulation, the offshore fund investing in the American capital market may well dry up. Our Institutional Investor Study also suggests a further advantage of bringing these funds home: the gathering for the first time of reliable information about size and performance that is now sadly lacking.

Regulation of the offshore fund will, we hope, help make it a more attractive investment for foreigners. Those of you, however, who are involved with the sale of both offshore and domestic funds abroad know that many European governments have passed laws inhibiting such sales in various ways. These legal restrictions were initiated in the aftermath of the IOS and Gramco debacles and represent, to some degree, an overreaction to the disclosures arising from those spectacular collapses. We are now working with European governments through OECD -- the Organization for Económic Cooperation and Development -- and the European community organization to agree upon minimum standards for regulation of international mutual funds. A working group of OECD experts, including our own Sol Freedman, have completed their efforts on a set of so-called "Standard Rules", which deal with the kinds of funds that may be offered, the management and investment methods to be followed by fund advisers, and permissible techniques to be used in selling funds. If passed by each jurisdiction the Standard Rules, which I am told may be released in draft form early next year, will have the effect of reducing variences between mutual fund sales efforts in each country and assuring that any fund wishing to reach the rich markets of the world will be required to meet satisfactory standards of conduct.

Another development in the international area has been our discussions with foreign governments and representatives of their capital markets to share experiences in developing market structure and regulating stock exchanges. These visitors felt that our experience here in the United States can be most valuable in guiding exchanges which are just now becoming adjusted to the volumes and regulatory problems we have known here since the thirties. I have personally met with representatives from Luxembourg, Brazil, Japan and Spain, and members of our staff and other Commissioners have talked with representatives of many other European countries. A general attitude of reform among other capital markets can only help to make foreign investors more willing to put their capital at risk. Naturally, most of this capital will be invested in local markets. But the strength of the United States market is such that any enhanced propensity to invest cannot fail to enhance foreign investment in American markets. Cooperation with foreign governments will also help to end the use of foreign nominees for trading in stolen securities or hiding the illegal gains of organized crime. We hope that the United States will draft and sign treaties with a number of foreign governments over the next couple of years to establish reciprocity in enforcement actions involving securities. This kind of intergovernmental cooperation will become more and more necessary as time goes on.

Now I want to say a few words about a product I know many of you are becoming more and more familiar with -- interests in oil and gas drilling ventures. These companies are in many ways structured like investment companies. In almost every case, they are managed externally much like the garden variety mutual fund. In this way they are similar to real estate investment trusts, farming ventures and the like. As we have observed over the years in the case of investment companies and, more recently, specifically in the case of oil and gas offerings, externalized management is frequently accompanied by a pattern of abuses.

The Commission recognized this problem in the case of oil and gas offerings and originally, as part of the legislative program for the amendment of the Investment Company Act, we proposed that such offerings be brought under 1940 Act review. This proposal was not adopted but the Congress did direct the Commission to submit by June 14, 1972, a reasonable regulatory statute dealing with oil and gas drilling funds. The drafting of such a statute, in view of the complexity of the industry, is not a simple undertaking, but we are well along in this project. Our staff has also received a very helpful draft of a proposed statute from the Oil Investment Institute and I understand that this has greatly facilitated our efforts. Pending the development of our legislative proposal, I would only suggest following some simple rules. First, don't sell it unless you can understand it. Second, in selling it, describe it fairly. Third -- and perhaps most importantly for the promoter -- structure it fairly at the outset.

I wish to close by discussing some recent developments which are likely to have an impact on domestic mutual fund distribution practices. The following panel on your program, consisting of the senior people of our Division of Corporate Regulation, will discuss some of these developments in more detail but let me briefly highlight them for you.

For a number of reasons, it seems likely that mutual fund distribution practices are likely to undergo substantial changes in the near future. The shift from fixed commissions to competitive rates on orders of $500,000 and over is likely to diminish the amount of brokerage commissions directed in reciprocity for fund sales. The recent decision of the Court of Appeals for the First Circuit in Moses v. Burgin, involving the Fidelity Fund complex, is likely to push this development along even faster.

In addition, the Commission is now well under way in a study requested by Congress to determine the impact of the elimination from the Investment Company Act of Section 22(d), the so-called retail price maintenance provision. Although any such change would require legislation, the possibility of the elimination of the provision - if as a result of the study we submit, the Congress concludes that such a change is warranted -- must be kept in mind.

As I am sure you all know, the NASD is now conducting its own study of sales charges to enable them to adopt, subject to our oversight, under a new provision of the Investment Company Act to become effective June 14, 1972, rules to provide for sales loads to investors which are not excessive but which, at the same time, allow for reasonable compensation to sales personnel, broker-dealers, and underwriters. It is, premature to speculate now as to what the NASD rules are likely to be, but I do want to stress the importance of the NASD study and the corresponding importance of your providing to the NASD the full and complete data requested by them and of the NASD's evaluating it in the light of all the changes which are occurring and those which are likely to occur in our markets.

Another change that is likely to evolve more quickly -- before the conclusion of the NASD sales load study -- is in the advertising and sales literature area. For some time now the Commission and its staff, as well as the investment company industry, have been concerned about the restrictive nature of the Commission's rules and policies governing investment company advertising.

In an exchange of correspondence which the NASD initiated in February 1971 concerning the scope of their sales load study, the staff emphasized how important it is that they consider other distribution methods, including the possibility of wider use of advertising.

Following closely, in the March 10 letter of transmittal for the Institutional Investor Study Report, the Commission mentioned the need for developing lower cost mutual fund distribution systems and noted that the study of mutual fund distribution now being conducted by the NASD should examine not only costs of existing methods of distribution, but also ways in which those costs can be reduced and the savings passed on to investors.

Subsequently, representatives of the Investment Company Institute and other members of the industry have been meeting with our staff to discuss specific proposals the ICI has submitted for relaxation of current restrictions. In fact, just last week our staff received the ICI's revised submission.

The ICI proposals deal with three areas -- tombstone advertising, sales literature, and the use of the summary prospectus and so-called institutional advertising. While the Commission has not yet had the opportunity to focus on their proposals, I am hopeful that when we do, if we conclude that we have adequate authority under the statutes, we will implement in large part the proposed changes. I believe it is important to your own sale efforts and to the increased availability of the investment management and diversification which investment companies offer American families that proper advertising make its contribution to identifying those who want and need these services, so that the essential educational, planning and selling mission which you perform is properly concentrated on them. I believe this can significantly improve the overall efficiency of investment company selling and performance.