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SOME NEW APPROACHES TO INVESTMENT COMPANY AND INVESTMENT ADVISOR REGULATION

REMARKS BY

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I am in the awkward position of delivering a so-called keynote speech at the tail end of the program, and this despite the fact that Syd Mendelsohn has already delivered an excellent keynote speech. In the words of the beer commercial, he "has said it all." I cannot even purport to sum up the conference because, unfortunately, I was not able to be here for the first two days.

Under the circumstances, all I can do is to elaborate, from my own perspective, on some of the themes which Syd has described.

In the first place, in describing the Investment Company Act Study Group and recent rulemaking, he referred to the general philosophy of deregulation or re-regulation or whatever you want to call it. This is a genuine objective of the Commission as well as the Division in the investment company area. I suspect that when Harold Williams came to the Commission, with his extensive business background, he was somewhat dismayed by the elaborately detailed structure of the Investment

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Company Act and by all of the pervasive and sometimes obscure regulations and doctrines which have grown up around it over nearly forty years.

As Syd said, we do intend to simplify this scheme and, to the extent possible and consistent with the Act, to reduce the day-to-day involvement of the Commission with many aspects of the operation of funds, transferring more responsibility to the funds themselves and particularly to their independent directors.

The Investment Company Act of 1940 was a recognition that this industry needed regulation, the record of what went on in the '20's and early '30's was deplorable and the structure of the funds was fraught with conflicts of interest. The Act, however, has a rather peculiar history. The proposed legislation, as originally drafted by the Commission and introduced in the early spring of 1940, was a very tough regulatory statute. The industry agreed that regulation was needed and supported the idea, but objected strongly to the draft. Some months of argument went on before the Congress. In the meantime, World War II exploded in Europe and Congress suddenly had other things to do than to wrangle about investment companies. Accordingly, the

Commission and the industry were told that they would have to come up with a bill acceptable to both within five weeks or there would be no Act. They complied, but it was not easy and some rather mysterious concepts, such as a transaction which is "joint or joint and several" emerged to perplex future generations.

The framers of the proposed Federal Securities Code at one time cherished the idea that they could rationalize the Investment Company Act without basically changing the balance of the 1940 compromise. After giving it a try, they concluded that this was not feasible given limited time and resources and many disagreements. I was a part of that effort and the experience makes me less optimistic about a legislative solution. But a good deal can be done administratively and by rule and we are working on this, as Syd has pointed out.

This process of reexamination of our regulatory practices does not merely reflect the currently fashionable interest in deregulation; the economic environment within which funds operate has also changed and we are responding to that. During the first thirty years of the Investment Company Act, the industry was growing at a tremendous rate.

The total assets of investment companies increased from about two billion dollars in 1941 to seventy-eight billion in 1971. Naturally, growth of this magnitude was accompanied by certain growing pains. Fund shares were sold to many people who had never invested in securities before. Of course, there was, and is, no objection to this, but the Commission was concerned about the selling practices which were addressed to this less sophisticated clientele, and hence the supervision of advertising that Syd referred to. Costs to fund investors did not appear to be effectively controlled by competition, investment advisory fees clustered around 1/2 of 1 percent although it does not cost ten times as much to manage a 500 million dollar portfolio as to manage a 50 million dollar one, and the Commission was troubled by that situation.

As you all know, the environment has changed. The fund industry has matured and the stock market does not always go up. Competition from other financial institutions such as banks and insurance companies has become keener; there are a lot of people who would like to get in on a good thing. While, as a matter of law as well as policy, we are in favor of competition,

we are concerned with the possibility that the fund industry may be placed at a competitive disadvantage by unequal regulation, but, in the interest of investor protection, we cannot settle for the lowest common denominator.

The question of bank involvement in what might be called the fund business is extremely complicated, involving as it does issues of banking regulation and policy and of undue economic concentration, as well as equal regulation. I think that only the Congress can settle these issues, so I am not going to try to do so here.

With respect to insurance companies, it has been our consistent position that to the extent they offer a product which is primarily an investment vehicle rather than a means of providing against or sharing mortality or other risks, offerings of that product should be fully subject to the federal securities laws. The problem is to identify such products, since many insurance contracts have an investment element and the ingenuity of the insurance industry in coming forward with new products is well known.

Our latest effort in this field, proposed Rule 154 dealing with the optional annuity contracts, does not appear to have been a great success. The commentators perceived numerous problems with it, and many of their objections were well taken. We will have to go back to the drawing board, and I suspect that we will come forward with an interpretive statement.

Another issue, which Syd mentioned, that of whether investment companies may bear distribution expenses, seems to me to be a good example of the impact of a changing economic environment. Back in the 1960's and earlier, it was Commission doctrine that funds could not bear distribution expenses on the theory that these expenses conferred no benefits on existing shareholders. I said things like that, in my then capacity as the Commission's general counsel, and have had them cited back to me in our current consideration of the question. In those days funds were growing rapidly and it appeared that possible benefits to existing shareholders, such as some economies of scale, should the fund grow a little faster, seemed to be offset by a possible loss of flexibility in managing the portfolio.

The present environment is quite different, equity funds have quite often been in a net redemption status. Consequently, the earlier theory may well be no longer viable. This does not mean that there are no problems with funds bearing distribution expenses, there are still quite a lot of problems and difficult issues. Since the Vanguard case will in due course come before the Commission, I had better not comment further on this matter, except to say that I personally think that there is no longer an adequate basis for saying that the answer is obviously no.

I would now like to turn for a few minutes to the area of disclosure and in that connection I ask your indulgence to register a complaint or two. I have for some time been troubled by investment company prospectuses. Generally speaking, they make full disclosure, but they are so long, so complicated and so dull that I doubt that the average investor ever takes the trouble to read them. To a degree this is true of all prospectuses, but in the case of business corporations we can say that the analysts read them and that their judgments are acted on by investors and are reflected in market prices, so that the prospectuses, indirectly, serve their purpose even if investors do not read them. I doubt that this is true to the same extent in the case of mutual fund prospectuses. Investors should be encouraged to read them.

It may well be that the Commission's requirements are a principal cause for the length and complexity of mutual fund prospectuses and, to the extent that such is the case, I solicit your advice as to how we can remedy the situation. I suspect, however, that part of the problem is that prospectuses are written by lawyers whose primary objective is to insure their clients against being sued, however dubious the possible plaintiff's case might be.

I do not know exactly what can be done about this but I would hope that management would exercise their editorial prerogative with a view to making the prospectus readable. Perhaps the boiler plate could be relegated to the rear or even incorporated by reference.

My other complaint relates to our corporate disclosure activities. We are reviewing this area as well and proposing changes. When we come out with a new disclosure requirement, we hear, sometimes at length, from the preparers of these documents. They complain about how much the new requirement would cost, which is entirely proper, and they express their opinions as to the value of the information, which is also proper -- if not necessarily unbiased. But we do not hear from

the users of the information. Investment companies and investment advisors are an important segment of such users. It would be very helpful if you would tell us whether you want the information or whether you don't, and whether you are getting the information you need and, if not, what you would like to see. You might also tell us about information you are getting which you do not think is worth much.

We rely a good deal on the comments we receive on such proposals, and if we hear both sides of the question everybody is likely to be better off.

Finally, I would like to turn to the area of investment advisor regulation. I have been involved with this process, off and on, for some twenty years and more and conclude that the investment advisory function is very hard to get a handle on for regulatory purposes. The principal difficulty is the diversity both in how advisors are organized and staffed and in what they do. They range from large and sophisticated organizations which manage multi-million dollar portfolios to one man operations with a handful of clients. What they do, ranges from the work of expert portfolio managers, to publishers of factual data, to issuers of market letters based on a great variety of theories of investment.

Many are engaged in other business as well as in advising. It is not too difficult to identify or understand, at least generally, what a broker does or what a mutual fund does, but that is not true of investment advisors.

This diversity creates at least two significant problems for a regulator. In the first place, aside from a prohibition against fraud and deceit, it is difficult to devise any regulatory scheme which fits all advisors. You need a variety of schemes. Moreover, owing to the intangible nature of their work and the varying degrees to which investors rely on them, it is difficult to determine exactly what type of regulation of advisors, again aside from antifraud, is needed and cost justified. For example, should their fees be regulated? The answer is generally no, but the Act does restrict performance based fees, because of the conflict of interest that these can create. Should minimum capital be required? The insolvency of an advisor does not endanger investors to the same extent that insolvency of a broker does; advisors do not usually owe money to their clients, while brokers almost always do. But advisors can have possession of client's securities. In addition the Commission has worried about the fact that some advisors, particularly publishers of advice, are usually paid in advance for

services to be rendered later. Should their ability to deliver be assured in some way? But, on the other hand, is this really different from newspapers and magazines whose solvency is unregulated? Should advisory personnel be subject to specified standards of training, experience and competency? Brokerage personnel have been subject to such requirements since 1964 by law, and before that by exchange and NASD rules. Should not an advisor know as much as a broker, particularly where he exercises discretion? But, again, the diversity creates problems. Advisors use a variety of techniques, some rely on fundamental analysis, others use charts or timing and subscribe to the efficient market theory. I am tentatively of the view that we should have some such requirements if only to protect investors against the wholly unqualified and ignorant and to support the concept of professionalism in this field.

Another principal problem arising from this diversity is the obstacle it creates for self-regulation. The Commission, of course, relies very heavily on self-regulators in most of the other areas of its jurisdiction and, since the 1975 Amendments, this reliance has increased. Back when I was in the old Trading Division

in the late '50's and early '60's, we tried to see if some self-regulatory organization for investment advisors could be devised. We got nowhere. The investment counselors were not about to get in bed with the publishers. More recently, the Financial Analysts Federation has seriously considered self-regulation, as a part of their generally successful effort to upgrade the profession. But the idea of a self-regulatory body composed of employees of companies engaged in a variety of businesses raises problems. More significantly, the existing self-regulatory organizations such as the stock exchanges and the NASD are sustained by a strong economic incentive to membership. A brokerage firm has to be an NASD member if it wants to participate in most underwritings. A seat on the New York Stock Exchange is valuable. That enables these organizations to require adherence to their standards and to impose burdens on members in order to make the system work. No such incentives in the investment advisory area now exist. Moreover, you have the antitrust laws which inhibit purely voluntary self-regulatory organizations.

In view of these problems, we are presently emphasizing improved disclosure in the investment advisory area. Syd has mentioned the brochure rule and the revised Form ADV. We think that disclosure can

accomplish quite a lot, particularly by enabling investors to make their own informed decisions with respect to investment advisors. To the extent that this makes more substantive regulation unnecessary, that is clearly desirable.

This morning I have discussed briefly quite a number of different things. I don't know exactly what that proves, except that we live in changing times and that yours is a dynamic industry. Your industry cooperated with the Commission to develop the Investment Company Act and to get it enacted. We have been cooperating ever since, with some adversary interludes. As I think you will notice from Syd's remarks and from mine, we are inclining towards giving you greater responsibilities for investor protection but subject to improved oversight by the Commission. More frequent and meaningful inspections are an example. This reflects an increased confidence in your ability and willingness to do the job. I believe that this confidence will not prove to be misplaced.