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THE ADMINISTRATION OF THE INVESTMENT COMPANY ACT

The Investment Company Act presents the Commission with the most difficult problems which it faces at the present time. This is so for a variety of reasons.

1. The Act was approved on August 22, 1940, and went into effect on November 1, 1940 -- almost exactly midway between the outbreak of World War II and Pearl Harbor. By the time this regulatory measure was formulated, interest in investor protection and reform of the securities markets was on the wane.

2. The Act as enacted was admittedly a compromise, as a result of the pressure to present a non-controversial bill to a Congress absorbed with the defense program and the world-wide situation. Consequently, the powers of the Commission are not as broad as its sweeping powers under the Public Utility Holding Company Act of 1935.

3. It is fair to state, without critical intent, that none of those who participated in the drafting of the legislation, either on the side of the industry or of the government, envisaged the proliferation of investment companies which has since taken place or the shift in importance from closed-end to open-end companies. The total assets of the companies then in existence amounted to about two and one-half billion dollars. The average size was less than six million dollars. There were no giants by today's standards; the largest of the trusts was $120,000,000 and the next was $. Today, on the other hand,

the total assets of registered investment companies approximate twenty-five billion dollars; the average size is more than $40,000,000; and there are several with assets of over a billion dollars each.

4. There is no indication that a plateau has been reached. On the contrary, there have been a series of record-breaking years which may well continue for many more The trend of personal savings alone is likely to sustain this form of investment which has been marketed so successfully. In addition, new types of investment trusts are coming into being. There were on June 30 last 42 companies registered which were formed under the Small Business Investment Company Act. The sales potential of the variable annuity is still to be tested but may reach large dimensions, especially if the life insurance companies should enter the field on a large scale. In the past year a type of investment company, commonly referred to as a "swap" fund, has been devised; this offers to exchange stock of a newly formed investment company for securities rather than for cash, and is attractive to large investors who are reluctant for tax reasons to sell their holdings because of the extremely low cost at which they are acquired. With a medium as flexible as the investment company has proved to be, there is no doubt that other forms will be developed or old ones revised; for example, periodic payment plans are adding many new investors.

5. Even without these newer developments a continuing increase in total investment company assets is to be expected. The present magnitudes have been achieved in large part as a result of the creation

of a highly-developed distribution system, with thousands of salesmen and skillfully designed and effective campaigns. Regular sales forces are augmented by large numbers of part-time salesmen. Arrangements with life insurance companies add the latter's sales forces as mutual fund salesmen. Their numbers are being steadily augmented, and begin to reach almost every community in the country. There is no reason to think that their success in the future will be less than in the past.

6. The rewards for management and distribution have exceeded the wildest dreams of those who were engaged in the business when the Act was passed. The commissions to be earned for the purchase and sale of securities in the investment company portfolio also represent a sizeable plum. The effect of this is already apparent in the appearance of some of our best-known investment banking firms, as well as others, as promoters of investment companies. Such opportunities will no doubt continue to exert their attracting force. While much of this effort may result in competition for the same investor's dollar, a good deal will no doubt result in larger numbers of purchasers.

The preceding sketch of the background of the present and prospective situation in the investment company field suggests that there may be problems without indicating their character. This will be attempted in the succeeding sections.

General Supervision

For various reasons, initially because the Act was adopted on the eve of our participation in World War II, little was achieved under it

for many years. The inspection program was first instituted in 1957, and a rule prescribing the records that must be kept was first adopted this year. To date (June 30) there have been a total of 113 inspections and, at the present rate, the approximate cycle of inspections is 9-1/2 years. The Commission has set an ultimate inspection goal of a 1-1/2 year cycle. Since the average number of inspections is only seven per man-year, such a goal would call for a force of about 85, plus the necessary clerical and other help and supervisory structure. Even if it were possible to obtain the appropriation for such a force, its recruitment and training would present a formidable problem. The Commission is seeking to increase its staff in other directions, and is constantly faced with a loss of manpower due to attractive opportunities in private industry for its trained personnel. Under the circumstances it seems unlikely that its inspection goal or anything like it can be realized.

It by no means follows that adequate information and policing must be abandoned. I have reviewed a number of inspection reports and I am satisfied that most and perhaps all of the objectives of the inspections can be achieved by placing appropriate reporting and certifying responsibilities upon the companies and their auditors. This may enlarge in some respects the normal scope of an audit but it should not prove objectionable from the standpoint of the auditors since compliance reports are in use by at least one federal agency. From the standpoint

of the companies it is reasonable to assume that they would prefer so far as possible to have information verified by their own auditors rather than by a team of Commission inspectors. With such a program in effect the Commission's own efforts may be in the nature of flying inspections or such other supervision as circumstances may dictate. The force likely to be available should be adequate for the purpose.

One other operating matter should be mentioned. In accordance with uniform practice all filings under the 1933 Act are processed by the Division of Corporation Finance, and also the proxy statements filed under the 1934 Act. In addition, where the company in question is subject to regulation under a separate act, the document is also reviewed by the Division specially concerned with that Act. Thus, the Division of Corporate Regulation, which supervises investment company activities, will review these filings and make such comments as seem appropriate, to the Division of Corporation Finance.

Many have suggested that efficiency would be promoted if all of the processing were done by the regulatory division, and the suggestion is indeed plausible. However, the problems are more complex than would appear on the surface. In the first place, the processing of disclosure requirements in two divisions may create a difficult problem of coordination to ensure that reasonably uniform standards are applied. In the second place, where disclosure and regulation are combined in a single operating unit there is the danger that one function will be emphasized at the expense of the other. This, in my opinion, was the

effect of the earlier combination which was terminated in 1953. While the combination in a division which had no other disclosure responsibilities may present fewer hazards in this respect, the risk here involved must be carefully appraised.

Other considerations weigh heavily against effecting such a change at the present time. Both divisions are severely taxed as a result of the enormous volume of financing on the one hand and, on the other hand, the creation of new investment companies often with novel features. The suggested change would require shifts of personnel, new procedures, and other administrative adjustments. At the present time the Commission can ill afford the disruptions which the process of change would necessarily entail. I conclude therefore that consideration of such a change be postponed to a time when the pressures on the Commission have diminished.

Substantive Problems

On the substantive side, the Commission's actions have lacked direction and consistency. This must be corrected to achieve effective regulation. The examples to be considered involve either statutory construction or specific application.

1. One of the major abuses which the Act was designed to eliminate is the management of an investment company, or the selection of its portfolio securities, in the interest of affiliates rather than in the interest of its security holders (Section 1(b)). Among the means designed to end this abuse is Section 17. The first subdivision of that section makes it unlawful for any affiliate of an investment company to sell securities

or other property to, or purchase them from, that company. The second subdivision provides for applications for exemption, which are to be granted if the terms of the proposed transaction are reasonable and fair, and if the proposed transaction is consistent with the general purposes of the Act. The structure of the Act and its legislative history make it clear that the exemptive provision was intended as a safety valve, to permit the consummation of exceptional transactions where special circumstances compel the company to deal with an affiliate. The Commission has, instead, treated this provision as if it were a license for transactions with affiliates. Not only has it approved transactions which were not within the intended exemption; it has engaged considerable time and effort of itself and of its staff on transactions which should never have been submitted to it.

2. The problems which the Commission has encountered in connection with the "swap funds" should have led it to a bolder and sterner conclusion. "Swap fund" purports to be an open-end management company. Despite this, it may not be permitted to sell to the general public, it charges fees for management when its objective is to avoid portfolio turnover, and it must redeem in kind to achieve the object of its creation. Its sponsors have made it clear that it is simply a device for investment diversification with tax avoidance. Such devices are at variance with the structure and objectives of the Act.

When the first such company registered the Commission ruled that the contributors were promoters of the company and therefore

affiliates, and that the transactions required exemption under Section 17, just discussed. The Commission then granted the exemption under its loose interpretation of that section. After two such grants of exemption, the Commission reversed its position that exemption is required and permitted these companies to be formed without exemptive orders. This resolved the dilemma of approving transactions that did not satisfy Section 17, at the price of holding that the section was not applicable. While the Commission is not the guardian of the Treasury, it does have the duty to see that the instrumentalities under its care are not abused. The statutory powers are adequate, and if the Commission had applied them properly when the matter first came before it, these funds would have been found not to satisfy the Act.

The Commission's problems with these funds -- which are by no means at an end -- illustrate one of the recurrent lessons of regulation, namely, the multiplication of regulatory difficulties when undue complexities are permitted to be introduced in the area to be regulated.

3. Another practice highlighted by the "swap funds" raises questions under the Securities Act. Examination of these funds disclosed that with a single exception they had accepted large quantities of stock from controlling persons of the issuers, and claimed the right to dispose of such holdings freely whenever they determined that such holdings should not be retained. This emphasizes the second aspect of the "swap funds," namely, that they have been used for evasion of the requirements of the 1933 Act. Restricted stock has no place in the

portfolios of open-end companies. Since all of their outstanding shares are redeemable at the option of the holders, the portfolio of such a company is as much subject to call as if the shares were convertible. Hence shares acquired for the portfolio must be considered as acquired with a view to distribution and offered to the stockholders of the fund. This presents no problem in the usual acquisition, but, if the stock is restricted, there is a violation of Section 5 of the Securities Act. Punitive action would not be desirable or warranted but the Commission should take steps looking toward the liquidation of the situation that has been created.

The Investment Adviser

The operations of investment advisers of investment companies are currently receiving considerable attention, principally as a result of a spate of lawsuits brought by shareholders of investment companies. The situation attacked by these lawsuits is not new, although intensified in character in recent years. Unlike any other form of business enterprise, industrial or financial, investment companies -- especially open-end companies -- are not managed by their nominal managers but by investment advisers. The typical compensation is a percentage of the assets of the investment company, ordinarily at the rate of 1/2 of 1% per annum. This of course means that any purchase of a share or any rise in the market level automatically results in an increase in the advisory fee. With the long-continued bull market and the increasing success of mutual fund salesmen the advisory fees have grown to astronomical proportions.

The result of this has been that in the large funds today the fees paid to investment advisers have no substantial relation to the cost of performance of the service or to its results, they do not reflect the economies of scale, and are obviously not the product of arm's-length bargaining. They sometimes resemble a toll levied on the investment company as a result of the strategic position occupied by the investment adviser.

The Commission has been cognizant of this situation. In a speech delivered last year, its then Chairman referred to "the anomaly presented by the management contracts which delegate to another entity many of the functions normally performed by the corporate board of directors." He further said:

> "It is rarely asked whether another adviser might be able to render equally competent services at lower cost. Control of investment advisers has been transferred and non-voting stock issued at prices obviously based on the expectation that the adviser will continue its services to a particular fund at what might be termed monopoly prices....
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> "These phenomena of the investment company would have raised a question in the minds of some observers as to whether mutual funds have become captives of particular advisers, and whether directors of or investment advisers to the funds are fully acquitting their duty to shareholders."

Unfortunately, these sagacious words have not been accompanied by action designed to prevent the exaction of monopoly prices or to require directors to discharge their duty to shareholders. There is doubt whether any satisfactory solution can be found short of forbidding investment companies to enter into the present form of advisory contract, except possibly in the case of the no-load funds. Whether the Commission could forbid these contracts while affiliates of such advisers are permitted to constitute a majority of the board of an investment company presents a difficult question. On the other hand, a statement by the Commission outlining the responsibilities imposed upon directors of investment companies and the actions required of them in discharging these responsibilities should produce, at the least, drastic revision of the usual type of advisory contract. It should also lead to changes in the internal organization of investment companies designed to enable the directors to discharge their functions faithfully. The Commission will then be in a better position to determine what further changes should be included in its legislative program.

A more rational form of investment advisory service should also result in curbing further sales to the public of securities of investment adviser companies. In the first place, these sales have been made at such high multiples of assets and earnings as to presuppose an assurance that the adviser cannot be ousted and that it will continue to enjoy the current scale of compensation. Such an assurance

is inconsistent with the statutory requirement of annual approval and the statutory protection of the freedom of the investment company to terminate the advisory contract on short notice. A power to terminate can be used as such or as a tool in bargaining for terms. It was on this basis that Congress sanctioned the making of advisory contracts. The sales which have taken place strongly imply that the advisers can render these provisions futile. If that is so, the basic scheme of the Act is defeated and amendment is indispensable. In the second place, bringing the public in as stockholders intensifies the already dangerous conflict of interest between the stockholders of the investment company and the management of the investment adviser. When the latter are forced to consider, in addition to their own welfare, that of the public securityholders of their company, the relationship becomes well-nigh intolerable. Moreover, the capitalization of compensation to be derived from personal services to a single enterprise is difficult to reconcile with traditional concepts which forbid the sale of corporate offices. Finally, the capital structure which many of these companies created for the purpose of public sale is too reminiscent of a period when corporate standards were laxer than can be tolerated. The typical structure consists of some small amount of voting stock, retained by the insiders, and a large amount of non-voting stock which is sold to the public. It would be unfortunate if this concept of corporate structure were used in selecting the securities to be acquired for the investment company itself.

Representation on Portfolio Companies

There is a wide difference of views and practice as to membership on boards of portfolio companies by representatives of the investment companies. This question has become acute in view of the recent Cady, Roberts decision with respect to the use by directors of inside information. Prior to that decision a number of investment company managers had expressed the view that no representative of an investment adviser should serve on the board of a portfolio company, and that an unaffiliated director who was also a director of a portfolio company should not participate in any discussion of that company.

Marketing

The marketing of investment company shares presents problems fully as acute as those already considered. While there are situations that need exploring in the closed-end area, the heart of the problem is in the open-end field. It has a mushroom character. Under the present typical method of compensating the investment adviser any increase in the number of outstanding shares automatically increases the advisory fee. This creates a great incentive to secure increased sales. There also seems to be universal agreement that open-end shares are sold rather than bought.

This combination of circumstances puts enormous leverage in the hands of the sellers, and the results are manifest. There has been a continuous increase in the sales load for open-end shares and an increase

in the percentage of the sales load going to the retailer. There is also constant pressure by the latter for compensation in addition to the portion of the spread. Reciprocal business is almost universal. But retailers now seek additional benefits such as warrants or cheap stock of the distributor or investment adviser, and additional sources of compensation will no doubt be found.

This is of course a two-way affiar. The seller seeks maximum compensation; the investment company and its distributor seek to have the salesman push their product in preference to the products of others. The salesmen do sell, and apparently emphasize those funds which offer them the largest reward, but the standards of the securities market suffer in the process. A cursory examination of training programs for salesmen and selling aids increases one's uneasiness, especially when it is borne in mind that a salesman addressing his prospects may not show even those restraints which have been pointed out to him in his training course. The investigation directed by the Congress and currently under way affords an opportunity for a thorough study of selling practices.

Another cause for concern in this area is that a large segment of the industry does not accept the concept of self-policing, even in theory. Four of the largest distributors of investment company shares have refrained from joining the National Association of Securities Dealers and are therefore not bound by the Rules of Fair Practice of that organization, nor the eligibility requirements for salesmen. This entails a dual system of supervision in certain areas, such as the review of selling literature, and leaves a serious gap in other areas. This state of affairs must be

corrected. If self-policing is to remain on a voluntary basis, the Commission must have corresponding powers over non-members. The choice between compulsory membership or additional powers for the Commission may be a difficult one; but it must be made.

The competitive pressure to achieve greater sales raises large questions of policy. It has been assumed all along that the selling of securities required different standards from those used in the selling of cigarettes or shoe polish. However, the current set-up in some organizations with a highly-geared selling system, high-pressure selling techniques, and quotas for salesmen raises a question as to which standards are higher.

One area requiring reconsideration is the load on periodic payment plans. The statutory maximum has in practice also been the minimum. Since this permits deduction of half of the payments made in the first year as sales load it produces obvious hardship for persons who discontinue the plan in early years. On the other hand, it creates a strong incentive for the salesman, with the result that the sales in this area have been increasing faster than outright sales of mutual fund shares. It is difficult for the type of purchaser who is the usual prospect for these sales to comprehend the consequences of the contractual arrangement. This was recognized in setting the present maxima. In the light of experience, it is difficult to see why the load should not be spread uniformly, with an additional bookkeeping charge, as is now the case with so-called voluntary accumulation plans.

The load for regular sales of mutual fund shares is increasingly approaching the permitted load for the so-called "front end load" offerings. This is difficult to reconcile with the size of the respective sales. An NAIC study made in 1959 showed that the median payment on an accumulation plan was $58 whereas the median payment on a regular purchase was close to $1,000. At least one state had until recently refused to qualify funds with a sales load exceeding 7-1/2%. Both this Commission and the NASD have responsibility in this area and should ascertain whether the economics of distribution warrant the sales loads now commonly charged.

As to the other forms of compensation, a prohibition against such compensation would be feasible and warranted, except for the practice of reciprocal business. The latter is a practice that extends beyond the present field and a prohibition, even if warranted, would be extremely difficult to police. The only solution that seems feasible is to recognize that the practice exists and to treat it as part of the regular compensation. Where, for instance, the investment adviser is a securities dealer it may be appropriate to require that all or the greater portion of the commissions generated by portfolio turnover should be credited against the advisory fee. Where, on the other hand, the commissions are used to further the sales of the fund's shares, a similar credit should be given against the selling charge. The use of brokerage as compensation for statistical and investment advice is permitted by the rules of the New York Stock Exchange.

Miscellaneous Problems

1. One of the difficult questions now confronting the Commission is the variable annuity. This has been the subject of a separate study by Professor Francis W. Coker, Jr., of the Yale Law School. I believe that substantial progress has been made toward formulating a program for workable federal-state regulation of these instrumentalities. The variable annuity problem illustrates a type of situation that frequently confronts the Commission. Basic structural questions, such as those presented by the variable annuity, are difficult to resolve intelligently by the process of passing on individual exemption applications. The individual application presents the question whether, in a particular case, departures from a norm are warranted. It is not a suitable instrument for ascertaining what the norm itself should be. For that purpose there is required the kind of inquiry used for rule-making or legislative purposes. It will add greatly to the efficacy of administration if matters of this character are recognized early and suitable steps taken for their resolution.

2. When the Act was passed, considerable hope was entertained that the investment companies would prove to be a source of capital for equity financing, particularly for smaller enterprises. It was recognized that such investments would be more suitable for closed-end companies, but to provide the largest possible latitude even open-end diversified companies were permitted to invest as much as 25% of their assets without being subject to the limitations applicable to the rest of their portfolios.

With the benefit of more than twenty years of experience, it is evident that almost all the open-end companies have shunned the role of entrepreneurs, and the few who have made such investments appear to have been more interested in control, with discouraging investment experience. Even the closed-end companies have played a wholly insifnificant role in this area until the advent of the small business investment company. There is no reason why the other closed-end companies should be prohibited from participating in this field if they choose. But there are substantial objections to having open-end comp anies acquire control of other companies. The Act should require all open-end companies to be diversified, with the investment limitations extended to the entire portfolio.

3. The Act made a great advance in the reduction of leverage in investment companies by limiting senior debt securities to 50% of the equity capital. Over the years, a number of companies have eliminated senior securities from their structure. Others retain such securities and those who are free of them today are also free to establish or re-establish a leverage situation. While the limit may appear to be severe, it is higher than the margin requirement in force today for listed securities. With the present market values of portfolio securities there should be little, if any, hardship if all leverage were required to be eliminated. This would still permit the use of short-term bank loans to take care of temporary situations.

4. Another problem facing the Commission is whether it should ask the Congress to extend the investment company regulation to the real estate trusts. These were recently accorded flow-through tax treatment similar to that granted to the regulated investment companies many years ago. In organization and operation, the real estate trusts differ little from the regulated companies except for the absence of the limitations upon, and supervision of, the latter. Indeed, since they are adopting the words "investment trust" in their business titles, it takes a degree of sophistication to realize that they are not regulated under the 1940 Act. The legislative history does not suggest that organizations of this type were envisaged when the "real estate" exemption was included in the Act, and the considerations which underlie the regulation of investment companies generally would indicate that the real estate trusts which qualify for the special tax treatment should be subject to this regulation.

5. The Alleghany decision reached the anomalous result that a company which was only incidentally a railroad holding company is by that fact alone exempt from regulation under the 1940 Act, although it is not thereby subjected to comparable regulation elsewhere. It is clearly not desirable to have this Commission regulate railroad holding companies and in a recent legislative program it proposed a division of regulation between itself and the Interstate Commerce Commission. This seems to me far less desirable than a prohibition against an investment company becoming a railroad holding company or the latter extending its activities into the investment company field. Alleghany, the only

company presently affected, should be required to choose the field of its future activity.

6. Somewhat similar problems exist both in the insurance and the banking field, and perhaps other areas of regulated enterprise. Whether holding companies should be permitted in these fields, and under what circumstances, lies outside the Commission's responsibility. In the banking field, for example, licensing of such companies has been entrusted to the Federal Reserve Board. Apart from such special cases, it seems advisable to limit exemption to true holding companies; they should not be permitted to spread their holdings by minority interests over a large field so that they come within the definition of an investment company. In general, the exemptions in Section 3, put together largely on an ad hoc basis, need overrhauling and clarification.

Some General Considerations

It is appropriate to point out that the present background differs from that portrayed in the Investment Trust Study. The grosser excesses disclosed there have, with few exceptions, not been repeated since. On the other hand, the phenomenal growth of the investment companies since World War II has demonstrated that they are not in danger of being stifled by strict regulation. An investment medium which already has some three million shareholders imposes great responsibilities on both its managers and its regulators. Care and zeal on the part of both in the protection of these investors will help retain the confidence reposed in them by the investing public.

Problems related to the size of investment companies have not been considered since that is the subject of the Wharton School study.