MEMORANDUM

March 12, 1965

To: The Commission

From: Office of the General Counsel

Re: References in Congressional Hearings Which May Be Pertinent in Connection With the Investment Company Report

Pursuant to the Commission's request, we have examined the Congressional Hearings both in the House and Senate held in 1962, 1963 and 1964 to see if there is any discussion there which might in some way be pertinent to the subject of the investment company report. We did not think that hearings in 1961 and earlier years before the Wharton Report was issued would be likely to contain material pertinent to the present matter.

Attached hereto are all the references we found which may be of some significance. We do not believe that any of this testimony extends the scope of the Commission's commitment with respect to its investment company report beyond that expressed in the Commission's letter transmitting the Wharton School Report to the Congress.

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I. HEARINGS ON 1964 AMENDMENTS ACT

The Senate Hearings contain no pertinent references.

1. House Hearings, pt. 1 (1963) p. 16

"Mr. Keith. A lot of your spadework with reference to the mutual funds has been done by the Wharton School report. I gather that, after studying that report, you didn't find it imperative to treat mutual funds either in an early chapter in your report or in an early legislative proposal.

"Mr. Cary. That is correct. We have the Wharton School report that we feel we have to give very thoughtful study to; we have a group in the staff that is doing that, quite apart form [sic] the Special Study.

"Secondly, the Special Study itself has undertaken only one segment of the matter of mutual funds and that is largely selling practices.

That is the major area with which they are dealing."

2. House Hearings, pt. 1 (1963) p. 159 (Statement of Mr. Cary)

"Finally, Mr. Chairman, I would like to make a brief reference to mutual funds.

"Any discussion of the study report would be incomplete without reference to mutual funds. By way of background, as the subcommittee is aware, on August 27, 1962, the Commission transmitted to the Congress "A Study of Mutual Funds," representing a factfinding survey of certain aspects and practices of open-end investment companies. This study was prepared by the Wharton School of Finance and Commerce.

"At approximately the same time, the Commission requested its Division of Corporate Regulation to undertake a detailed analysis of the Wharton School study and conduct a thorough study of various mutual fund complexes in order to more fully understand the structural problems of the industry. The examination is scheduled to be submitted to the Commission in the near future.

"The Commission has not received any of the division's recommendations and so we obviously are not in a position to comment on possible proposals. After we have reviewed them, it is anticipated that conferences will be held with industry representatives respecting those areas where the Commission ascertains a need for action.

"Meanwhile, chapter XI of the study report, dealing with selected aspects of mutual funds, represents an important contribution to the overall picture That chapter covered selling practices, insider trading in portfolio securities, reciprocal business patterns, and contractual

plans. The former topics are under consideration. The reciprocal business question is tied in with our review of the New York Stock Exchange minimum commission rate schedule and is also being analyzed in the staff study.

"The Special Study report raised serious questions about contractual plans, which involve the purchase of mutual funds on an installment basis, with a substantial portion of the first year's payments -- generally 50 percent -- taken out for sales load. The questions raised by the study revolve basically around the size of the initial load. The Commission has not arrived at any conclusions with respect to the study report's recommendations on contractual plans. We are now awaiting a presentation by the Association of Mutual Fund Plan Sponsors, a trade association representing the major sellers of contractual plans. In a sense, it is a response to the chapter XI analysis that was made available. No judgments will be reached until we have completed our analysis of the sponsors' evidence.

"Upon completion of our review of the staff study, we shall be in a responsible position to inform the Congress whether any amendments are required to the Investment Company Act of 1940. We shall also have a sound basis for major rule changes, where necessary.

3. House Hearings, pt. 1 (1963) p. 237

"Mr. Staggers. We will go into that a little more fully a little later. I would like to get into these different recommendations that have been made by the committee.

"Mr. Chairman, we have your legislative recommendations before us which grow out of the Special Study. I understand that you may have some further recommendations coming from your study of the effect of the Silver case, which has been mentioned, on self-regulation.

"Mr. Cary. We mentioned that there might be a possibility of that. We are not sure at this particular time whether or not we will find it necessary. It is a matter that we are considering and, of course, we have been discussing the implications of the Silver case with the exchange.

"Mr. Staggers. And a study of the investment companies, too?

"Mr. Cary. In the investment companies it could conceivably be. Once we get the recommendations from the Division and from the studies that are presently in process, it could conceivably be that we might be here for legislation. I cannot speak to that as far as actually knowing at this moment."

3. House Hearings, pt. 1 (1963) p. 237

"Mr. Harris . . . What is a thin market?

"Mr. Cary. A thin market is a market in which there are relatively few buyers and sellers and, as a consequence, although there is a market price, it might be applicable only, to say, a maximum of 100 shares. Therefore, if it were found that you were offering 500 shares, the

spread would immediately be much wider. In other words, you cannot be sure of selling your shares at a fixed price if there is a thin market and you have a large number of shares.

"Mr. Harris. Did your Wharton School of Finance & Commerce raise some questions in this field?

"Mr. Cary. No, sir; not that I know of. This would be primarily the mutual fund study, the Wharton School.

"I will check that with Mr. Conwill, the director of our division of corporate regulation, but he doesn't indicate that there is anything on that point.

"Mr. Conwill. No, sir.

"Mr. Harris. It is recognized that one of the great problems of maintaining a market in a given security is the number of shares of that security which may be outstanding and might enter such market. Do you agree to that?

"Mr. Cary. Yes, sir; there may be this problem -- and this is something that you might have reference to, Chairman Harris -- in connection with mutual fund purchases of shares. There has been a very substantial movement toward the purchase of shares which are listed on exchanges off the exchange -- of buying them through broker-dealers who are not members of the exchange.

"This trend has developed in recent years. I think it was mentioned in the Wharton School report and analyzed in the Special Study.

"Mr. Harris. I had understood that in that report there was instance after instance of large proportions of issues held by investor companies, pension funds, bank trusts, fiduciary institutions, and groups of that kind.

"Mr. Cary. That is correct; yes, sir.

"Mr. Harris. In other words, as was pointed out in the report, that was the trend that was being accentuated quite a lot.

"Mr. Cary. Of course, one of the great purchasers in the securities market today is these investment companies. Another important area of purchasing today, institutional, is through pension trusts and the like. You do find, as you have indicated, very substantial holdings of the leading securities in the portfolios of investment companies today.

"Mr. Harris. Do you think the rules for the protection of investors in situations of this kind are adequate today?

"Mr. Cary. In that field? That raises several questions. First, looking at it from the standpoint of the institutions, that is, the investment companies; and second, looking at it from the standpoint of the exchange.

"From the standpoint of investment companies, they are frequently purchasing and selling off the exchange, even though they are exchange-listed securities. They do that in large part to reduce the commission which they have to pay. That is one of the reasons. And perhaps because they may, in some instances, get a better price.

"Mr. Harris. Is there any protection where large blocks are disposed of by such an institution?

"Mr. Cary. Mr. Conwill, would you speak to this?

"Mr. Conwill. I think I now understand Chairman Harris' reference to the thin market in the context of the Wharton School report.

"As the chairman has indicated, investment companies, because they do, or many of them, hold large blocks, if you should have a thin market in the stock in which they hold a large block that they wanted to dispose of, that would accentuate the thin market problem; that is, their disposition of that block would have more of an impact upon the price fluctuation of that issue. That was observed by the Wharton School study.

"As to the existing rules on the subject, I way be wrong on this, but I don't believe we have any that provides protection in that area.

"Mr. Cary. Mr. Whitney might want to add to this.

"Mr. Whitney. Chairman Harris, any distribution, whether by an institution, such as a mutual fund or anyone else, is subject to the anti-manipulative section of the Exchange Act and our rules and regulations thereunder. We have quite a few rules, and the stock exchanges themselves have rules relating to so-called secondary distributions, special offers that are effected on the floor of the exchange.

"If the offering is effected on the exchange, it is under those rules. If it is off the exchange, it is under our rules, and I would say that generally our experience has been that those rules are adequate."

5. <u>House Hearings, pt. 1 (1963) pp. 320-321</u>

"Mr. Staggers. I just want to go back to the history of this legislation for a moment. Yesterday I asked you whether legislative proposals contained in these bills represent all of the legislation you felt necessary for the protection of investors. You indicated that this was so except for the possibility of additional legislation on investment companies. I believe that is correct.

"Mr. Cary. I said we thought, as we went over it, that we had no intention of asking for immediate legislation in other areas, except possibly, as I said, in the investment company [sic] field if our study should reveal the necessity for it."

II. APPROPRIATIONS HEARINGS

House Appropriations Committee

"Mr. Thomas What is the biggest headache you have in this whole investment company picture?

"Mr. Cary One area that comes before us frequently is in matters involving conflicts of interest

"Mr. Thomas Spell that out

"Mr. Conwill As you know, Mr. Chairman, there is ordinarily a very close relationship between the investment adviser and the mutual fund he serves. We are very concerned that this extremely close relationship might --

"Mr. Thomas Can you seek legislation in that field?

"Mr. Conwill We have not as yet.

"Mr. Thomas Do you contemplate seeking any?

"Mr. Conwill We have a report which should be forthcoming shortly, the Wharton report

"RELATIONSHIP OF INVESTMENT ADVISER AND INVESTMENT COMPANY

"Mr. Thomas Spell out the relationship generally between the advisers and the underwriters with the crust itself

"Mr. Cary I shall be glad to do that, and then Mr. Conwill can add to it

"Mr. Thomas Point out the weaknesses that might exist and how they should be corrected.

"Mr. Cary Frequently, the pattern is this: A particular firm is a sponsor of an investment company. In many cases therefore, they will act as an underwriter of its securities and therefore derive one segment of profit through the commissions on the sales of mutual funds shares

"Secondly, that firm may at the same time organize an affiliated company which is an investment adviser. It enters into a contract with the mutual fund which that firm has organized for normally a flat fee of one-half of 1 percent. sometimes that is reduced when the amount under their control gets up into fabulous sums, but not always. Therefore, there are these two elements of profit involved to the firm. Then there is a third element: namely the brokerage of the fund itself. Besides the sales of the shares it involves the sale of securities which that fund had.

"In many cases, the same entity may be investment adviser, principal underwriter, and a broker for the investment company. This is not in all cases, because some of those functions may be divided among several persons. But where one firm participates in all three facets of profitability from that particular mutual fund you wind up with considerable possibilities of conflict of interest and potential abuse "
House Hearings, Feb. 1, 1962, pp. 608-609.

"Mr. Cary. As you recall, I was referring to investment companies. As I said a moment ago, our discussion is quite pertinent to the work of the Division of Corporation Finance, but this is something over which we do not have jurisdiction through the Investment Company Act. However, as Mr. Conwill pointed out a moment ago, we have about 700 investment companies which are under our jurisdiction and in which we must have an inspection program.

"Recent events have required a broad reexamination of industry practices in the investment company industry. As you may know, 50-odd private lawsuits have focused our attention on the relationship of investment companies to their managers. The Wharton School of the University of Pennsylvania has completed, at the direction of the Commission, an extensive study of various aspects of mutual funds. Therefore, the Division of Corporate Regulation and the Special Study are at the present time reviewing the industry problems."
House Hearings, Jan. 31, 1963, pp. 524-525.

"Mr. Thomas. What is the history of them? How many of them issued stock in the same amount or approximately the same amount as the original capitalization?

"The studies show all this. You have all this information. Your study of a year or a year and a half ago showed all that.

"Mr. Cary. That is right. We are continuing that.

"Mr. Conwill and Mr. Henderson are engaged in this entire study. The reason the investment companies have grown is that the public has been anxious to buy these shares representing other companies, and as values have risen it has made it more attractive for people to buy. The shares are also aggressively sold. The records of the investment companies have not been generally favorable during the period of rising markets, and as a consequence it has been a major medium of investment.

* * *

"Mr. Thomas. You are being criticized to some extent now by certain quarters. Whether or not it is justified I do not know. Certainly as a result of your studies the report you issued 6 to 8 months ago was well treated. It did not create any panics nor any sizable repercussions. Good judgment was used.

"Are you planning some now regulations on these investment funds? If so, what has been the reason for the delay in not coming forward with them? The financial community is getting a little worried about it, wants to know what is happening. Will you address yourself to that a moment?

"Mr. Cary Yes, sir. I can understand they would like us to come forward with any recommendations which we are proposing to make. This area, by the way, poses some very complicated legal and financial problems on which any answer is difficult to reach. As a consequence, I am sure the financial community would rather have us approach this matter in a very practical and in a very conservative way rather than coming out with a conclusion of which we are not convinced.

"There are areas on which we have focused. For instance, there is a special study focused on the so-called contractual plan way of selling securities."
House Hearings, Feb. 17, 1964, pp. 690, 613.

Senate Appropriations Committee

"Senator Allott. I didn't intend to get off of the subject Mr. Chairman, but while we are on this, what became of your investigation which you started a year or more ago I guess and what is the status of it on the loading charges on these funds?

"Mr. Cary. Yes, sir. As you recall, we finished our Special Study of the Securities Markets about a year ago, and one chapter of that, I think that it was chapter 11. Senator Allott, related to the so-called question of front-end load. Now as you know, when they sell mutual funds, the normal load of the normal charge is roughly around 8 percent. It has maximum of 8. There is also a plan by which you enter into a contract to buy shares over an extended period of time that is called the contractual arrangement to buy shares. In that case you can have what they call a load or in other words a charge of 50 percent of the first year payments. Now it was in that area that we found a particular problem. For instance, if a person entered into a contract and he had to pay 50 percent in that first year, and then his contract lapsed, he would never get back 50 percent of what he put in, whereas if he had kept on throughout until the end of his contract, let's say 10 years, then the average load or charge would have been about 8 percent.

"Now it was in that area --

"Senator Magnusen. You mean 3 percent is charged by the company to handle it?

"Mr. Cary. That is the selling charge. It is paid the people who sell and distribute the shares, but in general that is the amount that the buyer has to pay overall as an average if the contract were completely fulfilled, Senator, that is over say a 10-year time.

"Senator Magnusen. Yes.

"Mr. Cary. The arrangement is also that although it can only be 8 or 9 percent over a 10-year period let's say or an extended period, it may be 50 percent in the first year and then a smaller percentage in later years. Do you see the point? Under those circumstances it poses a particular problem if a person buys one of these contracts, and then he is not able to pay in say the second year, the contract lapses, so he had to pay 50 percent in that first year and he never gets it back.

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"Mr. Cary. The problem that we were particularly worried about was this extra sales load in the so-called contractual plan, where it was a 50-pecent bite in the first year. That was the principal problem. Now we exposed this problem to the public. I mean we presented it in the special study. We probably believed that any actual final solution of that problem would require legislation rather than just action on our part. After the problem had been posed, the question is: What can you do about it?

"We recognize that we really can't do anything about it basically without legislation. However, by bringing the problem to public attention, certain factors seem to be taking place.

"One, some of the companies are stretching out their load. It is not going to be in many cases as much as 50 percent in the first year.

"Secondly, there are other firms that are thinking of going into the mutual fund industry that really will have no front end load at all. So as a consequence, we think that the exposure has been of considerable help in meeting the problem, although it doesn't meet it all the way.

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"Senator Allott. I would like to ask one further question. What limitations or regulations are there upon the management investment advisory fees, et cetera, within these open-end mutuals?

"Mr. Cary. By and large very little if any. The average investment advisory fee, as you may know, is one-half of 1 percent. That is about the standard that is charged against the fund annually. There are certain technical limitations, but by and large if there is full disclosure, I would say that there is relatively little limitation. I would like to check with Allan Conwill to see if he would want to add anything to that?

"Mr. Conwill. We have not solicited any price-fixing powers in this regard. The only limitation would be that the directors of the fund are doing their duty in making the best deal that they can conscientiously for their stockholders."

Senate Hearings, May 6, 1964, pp. 584, 586-87, 590.

We found no pertinent references in the Senate Hearings in 1962 and 1963. The Senate Hearings in those years were quite brief.

Most of the references in the House Hearings came up in the context of budget estimates for the investment company inspection program. The references in the Senate Hearings originated mostly from Senator Allott's apparent interest in the investment company field.

III. HEARINGS ON POSTPONEMENT OF THE SPECIAL STUDY REPORT

1. House Hearings (1962) p. 11*

Mr. Cary. "Finally, I should like to comment on the Commission's study of investment companies. At present, the special study and the Division of Corporate Regulation are examining various problems in the mutual fund area. Fifty-odd lawsuits involving mutual funds and their affiliates inevitably so direct our attention.

"Moreover, under section 14(b) of the Investment Company Act of 1940, which generally authorizes the Commission to study investment companies, the Commission 3 years ago requested the Wharton School of Finance of the University of Pennsylvania to do a study of the investment company industry. Final disposition of this study can be expected in the near future.

"We expect the market study and the Division of Corporate Regulation will analyze and report to the Commission on the following problems among others:

(1) Sales practices of mutual funds.

(2) Investment company relationships with their investment advisers, brokers, and underwriters. Sometimes one group may perform all three functions.

(3) The participation by underwriters and dealers in investment advisory fees.

(4) Joint transactions by the investment companies and affiliated persons.

(5) Industry practices, such as "reciprocal business." This recitation of only certain of the projects undertaken by the study indicated the scope and ambitiousness of our undertaking. I have omitted discussion of some very basic projects, such as industry self-regulation through the registered exchanges and the NASD, which will entail considerable examinations [sic] and analysis. And I am hopeful that practically all of our projects can be completed in a meaningful manner."

2. House Hearings (1962) p. 19-20

Mr. Cary. "I did not plan to make this statement unless I was asked these questions. I know that several of you have asked questions in this area of fee litigation. I wanted to present an integrated statement of what positions we have thus far taken.

"As I stated earlier, we have not taken a position on the merits in any of the approximately 50 lawsuits alleging excessive advisory fees and other collateral matters. We

* Note: A similar statement is contained in letter from Mr. Cary to Senator Robertson which is reprinted in S. Rep. No. 1703, 87th Cong. 2d Sess. (1962) pp. 8-9.

have, however, appeared amicus curiae in two of the cases which reached the appellate level -- and this I have mentioned already in answer to Congressman Keith's question -- strong support of the proposition that private individuals as well as the Commission have the right to bring lawsuits under various provisions of the investment company act. We have not got into the factual merits of these cases for several reasons:

"First of all, the focus of these suits is in large part upon the question of the fee scale, which is a subject of a broad study of the industry that we have been undertaking, as I mentioned before. The thrust of these suits goes to the structure and organization of mutual funds and the related responsibilities and duties of directors and other affiliated persons. These matters warrant and are receiving careful study by the Commission in a far more comprehensive way than would be possible to develop from the evidence in individual lawsuits. In other words, if we got in one lawsuit we would get into the individual problems there rather than looking at it as a whole.

"Secondly, the act with exceptions not relevant to the existing lawsuits, confers no specific authority upon the Commission to regulate directly the size of advisory fees or to superimpose the Commission's judgment upon that of management. We do not really have that direct power.

"Thirdly, as to intervening on the factual issues, the Commission cannot possibly participate effectively in 50 more lawsuits. There are obvious limitations on our available legal personnel. [sic] If we attempted to get into them, our own direct litigation and our general enforcement program would be seriously impaired. This is not to say that we are ignoring the fee litigation. To the contrary, we are actively and carefully watching the progress of each case. In recent weeks we have been concerned with and studied the terms of settlement of three of the lawsuits prior to trial of factual issues. Particularly arresting our attention is the fact that several have already resulted in modification of future fee schedules but counsel's fees for plaintiffs attorneys are to be paid by the mutual fund rather than by the active defendants.

"Finally, it is clear to us that the prevailing contractual investment advisory arrangements and the payment of fees based upon a percentage of assets are an inherent part of the investment company structure contemplated at the time of the adoption of the act. It is possible that this and other elements of the industry structure, which may have been reasonable in the context of conditions 20 years ago require reexamination. Consequently, we are conducting a thorough study of the entire structure to determine what is realistic and reasonable in the light of present conditions. The Wharton School study soon to be available, will afford a general picture of mutual funds and further case study will supplement that by concrete example. I think that states generally the posture of our work and the general approach which we are taking to this as a problem -- arrested to our attention, in substantial part by the existence of these 50-odd lawsuits."