



SPECIAL REPORT

TO NASD MEMBERS

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., 1700 K STREET, N.W., WASHINGTON, D. C.

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Special Report To NASD Members, Branch Offices, and Registered Representatives

On December 2, the Securities and Exchange Commission transmitted to Congress, to the press and the public its long-awaited report on investment companies, entitled "Public Policy Implications of Investment Company Growth." The report has been in preparation for several years and has been the subject of a great deal of interest and speculation throughout the securities business.

To assist NASD members and registered representatives in gaining a working knowledge of the content of this major study, the Association has prepared this Special Report summarizing the Commission's recommendations chapter-by-chapter. The Commission's recommendations "... should not," in the words of the SEC, "impair public confidence in investment companies." Nevertheless, if enacted in full, they would seriously affect the future operations of virtually all firms in the securities business.

At the end of the outline of SEC recommendations, we have included excerpts from a statement made by the Association to the SEC Commissioners after we had the opportunity to briefly review page proofs of the Report prior to its publication.

The NASD will continue to make every effort, both before the Commission and the Congress, in representing the best interest of its members and the public as they are affected by these SEC recommendations. We suggest that Association members carefully study the full text of the report before making public comment.

Association members are urged to obtain copies of the SEC Report from the U.S. Government Printing Office, Superintendent of Documents, Washington, D. C. 20402, price \$1.00; and we would welcome any comments you may have to guide us in our future discussions with the Commission.

Outline of Major Recommendations in the SEC Investment Companies Report

Chapter I—Background, Scope and Summary

In this chapter, the SEC states, before summarizing its recommendations to the Congress, that:

"... on the whole the investment company industry reflects diligent management by competent persons. The flagrant abuses which prevailed prior to 1940 and prompted the enactment of the Act have to a significant extent been eliminated. Under the guidelines established by the Act the investment company industry has acted responsibly to provide a useful and desirable means for investors to obtain diversification of investment risks and professional investment management. Thus, this report should not impair public confidence in investment companies."

Chapter II—Regulatory Background of the Investment Companies Act of 1940

This chapter gives the legislative history of the 1940 Act and refers to the various problems associated with the growing importance of mutual funds.

Chapter III—Management Cost

SEC Recommendations:

1. The Investment Company Act of 1940 should be amended to provide an express statutory standard of reasonableness toward management costs.
2. Reasonableness of such costs would be judged by the SEC on the basis of those which prevail in similar institutions such as pension plans, bank common trust funds and internally managed investment companies. Shareholders' or directors' approval would raise no presumption of reasonableness.
3. SEC seeks statutory authority to institute suit on its own behalf or in behalf of shareholders to recover claimed excesses in management fees. All papers involved in prospective shareholder suits would be required to be filed with the Commission.
4. The '40 Act should be amended to prohibit any sale or transfer of investment adviser responsibilities when it appears affirmatively that they are likely to impose additional burdens on the investment company involved.

Chapter IV—Portfolio Transactions, Including Reciprocal Business

SEC Recommendations:

1. Securities exchanges should adopt plans to provide volume discounts for large investors.
2. Any give-ups or other concessions directed by Fund underwriters and management companies to dealers of their choosing should be prohibited.
3. Commissions received by brokers affiliated with mutual fund management companies should be included in judging the reasonableness of management costs.
4. SEC wants authority to require all management companies and investment advisers to adopt Codes of Conduct, meeting a specified minimum standard, that would require reporting of all employees' securities trading activities.
5. Prohibit capital gain distributions more than once per year.

Chapter V—Distribution and Cost

SEC Recommendations:

1. The '40 Act should be amended to limit sales charges on fund shares to 5 percent of net asset value. This would be equivalent to $4\frac{3}{4}$ percent of the offering price and contrasts with the present level of approximately $8\frac{1}{2}$ percent of offering price.
2. The '40 Act should be amended to give SEC authority to adjust maximum sales charges as it deems appropriate.
3. All dividends should be required to be reinvested at net asset value rather than at the public offering price, thus eliminating any sales charge on dividend reinvestment.
4. Contractual plan "front end loads" should be abolished and total sales charges on contractual plans and Face Amount Certificates would be limited to 5 percent of net asset value, or $4\frac{3}{4}$ percent of the offering price.

Chapter VI—Size of Funds and Investment Performance

The SEC recommends no size standards should be set, beyond the present minimum requirement in the Act. The report states that the Commission will continue to observe the effects of size on performance.

Chapter VII—Investment Company Growth and Market Impact

SEC Recommendations:

1. The Commission seeks authority to require the availability to the SEC of information on transactions and other statistical data of all financial institutions including mutual funds, pension plans, banks, insurance companies and charitable foundations.

Chapter VIII—Investment Company Relationships With Portfolio Companies

SEC Recommendations:

1. Mutual fund holding companies should be prohibited. This would eliminate mutual funds' purchasing shares of other mutual funds.

Chapter IX—Administration of the Investment Company Act

This chapter contains recommendations for numerous technical changes in the Act and in the Investment Advisers Act of 1940. A few of these are:

1. The registration of a series of funds under one registration statement should be prohibited; rather, each fund in a "series" should be registered separately.
2. Sales charges on exchanges of funds within a group or "family" should be prohibited.
3. The Act should be amended to bar any of the persons now specified in section 9 of the Act, who have violated any provisions of the 1933, '34 or '40 Acts, from being affiliated with a management company or fund.
4. The Act should be amended to give the SEC authority to bar any person from certain affiliations with investment companies for "abuse of trust" and to seek to enjoin any such affiliation for "breach of fiduciary duty," as determined by the Commission.
5. The Investment Advisers Act should be amended to give the Commission authority to proceed directly against individuals without the necessity of joining the employing firm.
6. The Investment Advisers Act should be amended to eliminate management compensation based on fund performance, such as those based on comparison with a market index or on appreciation of net asset value per share.

**Excerpts from NASD Statement
to the
Securities and Exchange Commission
After a Brief Pre-publication Review on November 17 of the
Page Proofs of the SEC's Investment Companies Report**

". . . We believe that the release of the SEC's Investment Companies Report will have a highly negative impact upon our member dealers and their representatives and will seriously impair public confidence in investment companies, in spite of the cautionary language in the introduction.

"The NASD is in a unique position to view the consequences and impact on the securities business as a whole, on retail dealers both large and small and of the regulatory scheme that would emerge should the Congress accept and enact all of the recommendations proposed in this study. In spite of certain relatively minor proposals obviously in the public interest, the more significant of the Commission's legislative proposals, if enacted, would appear to invite further erosion of the securities business, which this Commission and our Association by law are obligated to foster and to promote.

"The proposals for the drastic curtailment of economic incentive to organize, develop and manage open-end investment companies and to sell their shares cannot fail to have a disrupting effect upon the investment company business and the securities business as a whole . . .

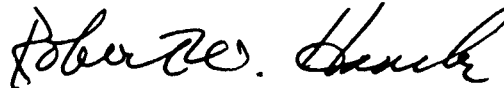
"The proposals in this report for reducing the economic incentive and reward of the dealers who sell mutual fund shares cannot be viewed in the context of this report alone. On the contrary, they must be looked upon as a part of the total fabric of actions recently taken and proposed by the Commission to alter drastically nearly every phase of the mechanism of the securities markets and to reduce the profitability of nearly every branch of the securities business.

"In summary, we would not perform our assigned function should we fail to point out that the sum of these recommendations would remove much of the incentive from this important phase of the securities business without any substantially overriding benefit to the investing public whose best interests the Commission and this Association are charged by law with protecting. The net result as we see it, therefore, could be only a very material lessening of public investment opportunity.

"We do not pretend that the rapid growth of the investment company business has created no problems, regulatory and otherwise, or that all elements of this business are operating as they should. But recognition of the need for sensible correctives need not be accompanied by proposals to dismember an industry that we feel, and that Congress evidently felt, was worthy of Federal statutory sanction."

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Sincerely,



Robert W. Haack
NASD President

Note: Quantity copies of This Special Report are being sent to all NASD members for distribution to registered representatives.