THE "MUTUAL" FUND

An Address By

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Before the 1968 Conference on Mutual Funds

Palm Springs, California

March 1, 1968

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The basic idea of a "mutual" fund is deceptively simple. A large number of investors, each with a small amount of capital to invest, pool their capital so that it can be jointly invested on their behalf by a manager who will decide what investments to make and when to make them. The asset value of shares in the fund is normally calculated on the basis of the market value of the portfolio securities, usually twice a day. The fund stands ready to sell an unlimited number of its shares at asset value plus a sales charge which may be reduced for very substantial sales. Outstanding shares may be redeemed at approximately net asset value.

This appearance of simplicity - combined with the substantial rewards to salesmen - account, at least in part, for the great increase in popularity of these funds over the past two decades. But you know and I know that "mutual" funds are not simple - that they are in fact an aspect of a very complicated business which is growing more complicated all the time. (If that were not the case, I am sure that a group of men as busy as you must be would not have journeyed to such an unattractive place under such trying conditions to devote yourselves to monastic contemplation of the legal and business complexities with which you must deal.)

In fact, very little about these funds is simple. Even the method of computing the net asset value for the entering or departing shareholder is not as mechanical or as simple as it might first appear. In this connection, we are now reviewing certain aspects of "backward pricing" which may lead to undesirable sales practices and unfair discrimination among investors. We have also received expressions of concern by investors about the different methods by which their interests in a fund can be terminated; the difference between redemption and repurchase, and the fact that they may receive different prices under these alternative procedures, is not always completely understandable to them.

A second area of complexity relates to the objectives of the fund. An investment in a particular fund is not an investment in any market average; nor is it a guarantee of equaling or beating any market average. Investment policies differ in basic, and sometimes more subtle, ways. Funds go by such designations as "income", "growth", and "balanced", but the prospectus description of investment policy--drawn so as to preserve maximum flexibility for the fund managers--often provides only a hazy idea of what specific mix of securities may be held from time to time. The fact that information is provided several times a year as to the securities actually held on a previous date is some help.

A third area of complexity is the legal structure of the fund. Many investors do not understand the complex interrelationships among the fund, the advisor, the underwriter, the custodian, the broker and the various supporting players. We continue to receive letters from investors asking us to explain the roles of the various persons or organizations listed in the prospectus. These relationships are not always easy to describe in terms that can be readily understood.

Closely related to the rather complicated legal structure is the complexity of the charges and costs that are involved in the acquistion and maintenance of shares in such a fund. One part--the sales charge--is paid by the investor at the time of purchase. It is usually based on the amount of the purchase, and may vary depending upon the amount and manner of the purchase. Another part--the management fee--is levied against the fund periodically - usually quarterly - and is based ordinarily on the total size of the fund. The third major part--brokerage commissions--is charged against the fund every time portfolio securities are bought or sold for it--including the investment of the proceeds derived from the sale of fund shares--and is based on the commission rate structures of the various securities exchanges. Additional charges may be levied for custodian fees, insurance and other miscellaneous services at levels based on a variety of factors. About all that can be said concerning the charges borne by the funds, and indirectly by their investors, is that they are substantial; yet it is difficult for the average investor to compute them with any accuracy or even to determine how substantial they are in relation to the gain he has achieved or hopes to achieve from his investment, since some of the charges are reflected in changes in the net asset value of his shares while others are not. Also, because of the unique external management structure of most of these funds, the investor has great difficulty in measuring the managers' compensation against generally accepted community standards regarding the compensation of individual corporate managers.

This brief recitation of the salient characteristics of "mutual" funds raises a serious question whether the word "mutual" is appropriate in describing this investment medium. That term is usually reserved for a situation where costs and profits are shared equally by all participants in the enterprise. Thus, according to my dictionary, the term "mutual" as it is used in relation to insurance is described as: "Designating or pertaining to the method or plan (mutual plan) in which the policy holders constitute the members of the insurance company electing their own managers and directors and sharing the profits." The same dictionary defines a mutual savings bank as: "A savings bank without capital, the depositors of which share in the profits." Some of you may say that these definitions aptly describe what we colloqually call a "mutual" fund. And to a point, it does. But you and I know that there is a most significant difference which springs primarily from, and usually manifests itself in, external management of the fund. It may also be significant that the term "mutual" is not found in the Investment Company Act of 1940. Nevertheless, I will continue to use that term tonight as I address this sophisticated and knowledgeable group.

The complexities which I have described--and the over-reaching and other abuses they permit--are principal reasons why the Congress in 1940, after more than five years of experience with disclosure statutes, decided that public and investor interests required more protection in connection with the organization, sale and management of investment companies than disclosure alone can provide. Given the argument--which has frequently been made--that "mutual fund shares are sold, not bought", disclosure plays a limited, albeit an important, role in the statutory scheme of protection of mutual fund investors.

It was clear to the Congress in 1940, as I believe it is clear today, that adequate protection of fund investors requires substantive controls in the promotion, management and sale of mutual funds. The regulatory scheme devised in 1940, when the industry was in its infancy, reached the grosser forms of abuses, such as embezzlement and the more obvious form of overreaching. It seems evident that it is now important to deal with more subtle abuses which may flow from over-charging and overreaching which traditional disclosure techniques are ineffective to reach.

One problem--or group of problems--that the Congress foresaw in 1940 was in the area of size. The hundredfold growth of investment companies in the past twenty-seven years has greatly magnified the problem of assuring a fair sharing of the economies of that growth in size between the fund managers and the shareholders they serve. The Commission, as you know, has suggested the enactment of an explicit court-enforced standard of reasonableness to assure this fair sharing. We suggested this as an alternative to true "mutualization" which is implied by the name under which these funds are sold.

Size has produced other problems for the managers in their operation of the funds. Indeed, there is a current trend, still minor but growing, for fund promoters to place a voluntary limit on the size of the funds they manage to preserve greater flexibility and maneuverability in portfolio transactions. While this development may answer some problems for certain fund managers, it raises fundamental questions about the nature and quality of changes wrought by large institutional investors in our securities markets and elsewhere.

Thus far, I have been talking about the complexity of the traditional "mutual" fund. But more complicated "mutual" funds have been developed in recent years, as promoters have exercised their ingenuity to attract more and more investors to this medium.

Most of you are familiar with the so-called "swap funds" which enjoyed a great popularity a few short years ago. We now have mutual funds which invest in other mutual funds. These funds add another layer of uncertainty--and frequently another layer of costs. Others propose to engage in complex securities transactions which were formerly considered the exclusive province of individual traders--puts, calls, straddles, short selling, short term trading and similar techniques. These practices, their risks and other consequences are difficult to explain or to describe adequately to investors. They also harbor potential dangers to investment companies, as the important vehicles they are for the allocation of public savings, and to our public market places for securities.

In the area of fund structure, while unduly leveraged capital structures were prohibited by the Investment Company Act, the recent development of the "dual" fund, offering both income and capital shares, creates complexities the ramifications of which may not be fully understood by investors. Another recent development which underlines the difficulties of disclosure, is the "multi-adviser fund" in which the investment manager assigns varying portions of fund assets to different and often unrelated sub-investment advisers to provide an element of competition among them. While this arrangement is capable of producing benefits for fund shareholders, it has the potential for stimulating excessive portfolio activity in a race among these sub-investment advisors to establish higher performance ratings.

This recitation is not intended to exhaust the possibilities since the ingenuity of fund promoters continues to produce new forms with which to entice the investor.

The fee structure has provided a real opportunity for the exercise of the ingenuity for which fund managers have established an enviable reputation. After all, that is where the money is, and despite the common use of the term "mutual", the principal reason these funds are created and sold is to make money for the people who sell, and those who manage or otherwise act for, them.

A current and developing fashion seems to be the performance fee. An appealing case can be made for the proposition that the man who does well for the fund he manages is entitled to extra compensation measured by the quality of his performance. But, apart from the problem of establishing appropriate yardsticks against which to measure performance, a difficult problem which has not as yet been resolved, we must not overlook the dangers inherent in certain types of incentive fees which led the Congress in the Investment Advisers

Act of 1940 to prohibit compensation for investment advisers based on a percentage of the gains achieved by their clients. These considerations are equally matters of concern in the investment company area today.

But it is in the area of sales compensation that the ingenuity of fund managers has had its greatest flowering. There are contests and other types of special incentives for dealers who sell a certain quota of the shares of a particular fund. Apart from the bias this introduces, and the manner in which it affects the dealer's or salesman's judgment in advising his customer, it is almost impossible to disclose the nature and amount of these incentives adequately and effectively.

While self-regulatory agencies have devoted and continue to devote some attention to certain of these practices, it has appeared at times that there was greater concern about the forms of compensation made possible by the managers of no-load funds than with the distortions produced by these practices in the load fund area.

I might say that in the course of our Congressional hearings last year, a fund dealer informed a Committee that he received extra compensation when he sold more than a certain amount of shares of a particular fund, and that this fact was fully disclosed in the prospectus. The Committee asked us afterwards whether this was the case. We advised that the general framework of the compensation scheme was disclosed in the prospectus -- but that the scheme was so complicated it was extremely difficult for the ordinary investor to understand its general workings and impossible for him to determine how much extra compensation his dealer or salesman would receive for steering his investment into that fund rather than another. As all of you know, the Commission's staff has never hesitated to insist upon the most informative disclosure that can reasonably be achieved. While it is probably true that we have not exhausted all the possibilities, this incident emphasizes that disclosure has not proved to be the answer to these problems.

Of course, the most complex technique of all for compensating the dealer who sells fund shares involves the use of part of the commission dollars paid by the fund on portfolio transactions. Fund managers have developed a variety of ingenious devices to channel excess commission dollars to dealers who perform various services for the managers. In connection with recent proposals for change in the New York Stock Exchange commission structure, we published a proposed rule based on the proposition that fund managers have a duty to use these procedures to return the excess dollars to the fund--a practice, incidentally, which a number of large fund complexes initiated voluntarily some time ago.

In our release discussing these proposals, we described some of the existing practices and indicated that they raised serious questions under accepted concepts of fiduciary responsibility. We do not believe, based on our present understanding of the situation, that disclosure of these practices is likely to benefit the average investor or to redress any grievances in this area, even assuming that he could understand from the prospectus description how the system worked, exactly how much compensation was being directed to dealers and salesmen generally, and to his dealer specifically, and how much of it constituted a charge against his interest in the fund. Paradoxically, disclosure may even lead a fund shareholder to believe that these practices raise no legal or ethical questions, since the disclosure is found in a document which, as the salesman advises his customer, has been filed with a government agency having certain responsibilities with respect to the practices of investment companies.

My cataloguing of these complexities of mutual funds does not indicate any desire on my part to return to a simpler era in all the areas mentioned. I wish only to point out that we must have an adequate system of regulation to assure that unsophisticated investors are fairly treated and that public confidence, so essential to continued growth of our securities markets, is not impaired.

As if all this were not enough, these increasingly complex investment vehicles are being combined, at an accelerating pace, with other techniques or contracts in even more complicated interrelationships. For confirmation, I refer to the program you have scheduled for tomorrow morning under the general heading "Combinations of Mutual Funds and Insurance." The individual topic headings are "The Variable Annuity", "Financing of Insurance Premiums Through Equities", "Life Insurance Sold in Connection with Investments", and finally (and I must assume this title was deliberately chosen to help me make my point) "The Contractual Plan -- A Study in Ingenuity". I am sure you gentlemen will be able to master these topics with little difficulty, but I am afraid I do not have as much confidence in the ability of the people to whom you will sell these combinations to understand the nature and implications of some of the packages.

The new tax provisions applicable to self-employed retirement plans which became effective at the beginning of this year, combined with the mass entry of insurance companies into the mutual fund field through the establishment or purchase of mutual fund advisory organizations, greatly increases the urgency of finding an adequate scheme of statutory regulation. The 50,000 securities salesmen now selling mutual fund shares will over the next few years be joined by a substantial number of the 200,000 life insurance salesmen around the country. Legislative proposals have been made which, if enacted, may authorize a broadening of activities of commercial banks in this area. Other types of financial and non financial institutions with different sales techniques have already entered or are considering entering the field. I understand that it has been suggested by an industry spokesman that the influx of other financial institutions into the mutual fund business, particularly the insurance companies, will inaugerate a new era of price competition that will lower costs to investors and render the Commission's basic recommendations unnecessary. I can only say that if that spokesman really believed anything of the sort was going to happen, he would not be crowing about it--he would probably be running to the Commission and the Congress for protection against it. As a matter of fact, we recently reviewed our records concerning seventeen insurance companies that are offering or planning to offer mutual fund shares through their sales agents. We found that twelve of the seventeen were charging the standard 8.5%--really 9.3% of the amount invested. The fact is that the insurance companies, for all their resources and ingenuity, will be subject to the same stimuli which have, over the past twenty-seven years, resulted in a steady increase in costs to investors as more and more "competitors" have entered the field.

The managers of all the institutions now operating, or which hope to operate in this field, have a vital stake in the passage of adequate and appropriate legislation by the Congress, as do the millions of existing and prospective owners of interests in funds. I believe that all of you will recognize your interest in a solution that will, on the one hand, avoid competitive imbalances among different groups of institutions and, on the other, assure a measure of public protection which is essential to the continued health of the funds as important investment vehicles and of the related investment advisory and securities industries.