PROBLEMS IN THE SECURITIES INDUSTRY

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

U.S. Cong. Senate.

OF THE

COMMITTEE ON BANKING AND CURRENCY

UNITED STATES SENATE

NINETY-FIRST CONGRESS

FIRST SESSION

TO ASCERTAIN THE VIEWS OF HAMER H. BUDGE, CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION, ON PROBLEMS IN THE SECURITIES INDUSTRY

MARCH 6, 1969

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PROBLEMS IN THE SECURITIES INDUSTRY

THURSDAY, MARCH 6, 1969

U.S. SENATE,
COMMITTEE ON BANKING AND CURRENCY,
SUBCOMMITTEE ON SECURITIES,
Washington, D.C.

The subcommittee met at 10:15 a.m., in room 5302, New Senate Office Building, Senator Harrison A. Williams, Jr., presiding.

Present: Senators Sparkman, Williams, McIntyre, Cranston, Bennett, Brooke, and Packwood.

Senator WILLIAMS. We certainly welcome the new Chairman of the Securities and Exchange Commission to this meeting of the Subcommittee on Securities of the Senate Banking and Currency Committee.

This is not a confirmation hearing but a hearing which will allow the members of this committee to meet and become acquainted with the new Chairman of the SEC. Mr. Budge—the new Chairman of the SEC—has been kind enough to voluntarily appear before our subcommittee and talk over some of the aspects of his new responsibilities.

Over the past 5 years, the Securities and Exchange Commission has initiated new and innovative steps designed to provide improved investor protection. Mutual fund reform legislation, the regulation of insider trading, full disclosure in corporate takeover bids, volume discounts and elimination of customer directed giveups are but a few of the Commission's constructive actions.

Regretfully, however, as soon as tentative solutions to one set of problems are found, new and more serious problems arise. This is due in great measure to the rapid growth and trading activity which is now taking place in our Nation's securities markets.

The back office paperwork logjam has resulted in hardships to many small investors—some of whom are unable to find brokers willing to execute their orders. Surely such a situation cannot and should not be tolerated.

The recent rapid growth of conglomerate corporations makes it imperative for the SEC to implement regulations requiring division-by-division financial reporting. Such measures will go a long way toward providing full and complete financial disclosure for all investors. If we can get a man to the moon by 1969, we can certainly devise methods to provide for full disclosure in conglomerate reporting.

The growth of institutional investors such as mutual funds and insurance companies is to a point where they now account for 50 percent of the New York Stock Exchange's total volume.

This makes stock exchange access and volume discounts issues which must be resolved. In solving these problems, the economies of size must be passed on to the many millions of small institutional shareholders. Recent comments by the Department of Justice also raise questions as to the implied antitrust exemptions currently enjoyed by the New York Stock Exchange. Within the near future, this problem must also be dealt with in a realistic and equitable manner.

This rapid growth in institutional investors has also caused unprecedented delays of up to 6 months in the processing of mutual fund registration statements—a situation which should and must be eliminated—if new capital is to continue to flow into our securities markets.

Our witness today is the Honorable Hamer H. Budge, Chairman of the Securities and Exchange Commission. Chairman Budge brings with him 5 years of experience as an SEC Commissioner as well as extensive judicial experience and 10 years of service in the House of Representatives.

Mr. Chairman, we trust that your personal opinions and observations concerning these pressing problems will do much to guide our committee's actions in the years to come.

The chairman of our Banking and Currency Committee is Senator Sparkman. Senator Sparkman.

Senator SPARKMAN. Mr. Chairman, just let me say this. I am not a member of this subcommittee, except, I suppose, in an ex officio capacity. But I was pleased when you invited Judge Budge to come up here, and I was pleased when he consented to do so.

As you pointed out, he has had a long, distinguished, and able career. I am most happy to have him here to talk about the problems in the securities industry. We do have some real problems, as you have pointed out, in the securities field. Thank you very much.

Senator WILLIAMS. Thank you, Mr. Chairman.

Senator BENNETT. Mr. Chairman.

Senator WILLIAMS. The Senator from Utah.

Senator BENNETT. As a member of the minority and citizen of the State which borders on the State of Idaho from which Judge Budge comes, I want to express my great satisfaction at his appointment to the chairmanship.

I have known him all the years since he has been in Congress. His family is one of the pioneer families of Idaho that has supplied many members particularly to the legal profession and the judicial bench in Idaho and slopped over a little into Utah, provided us with some prominent members of the Budge family.

I know he is going to do an excellent job in his new assignment, as he has done as a member of the Commission, and I am sure he is prepared to supply the committee with very wise, intelligent answers to the questions we have today.

Senator WILLIAMS. Thank you very much.

Are there any other words of welcome? I am sure all members of the committee welcome you, Mr. Chairman.

Will you proceed? We all have copies of your statement.

Mr. BUDGE. Thank you, Mr. Chairman.

STATEMENT OF HAMER H. BUDGE, CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION

Mr. BUDGE. I am, of course, most grateful for the comments which have been made here this morning. I wish to thank the chairman and Chairman Sparkman and Senator Bennett for the comments, for which I am most grateful.

I consider this to be a most important undertaking into which I am entering, and I assure you that I shall attempt to discharge it to the best of my ability.

Sitting with me at the table this morning, Mr. Chairman, is Mr. Philip Loomis, who is the General Counsel of the Commission and has been for some years.

I would like to say that the statement might appear to be quite lengthy, because I have attempted to cover the subjects which have been expressed to me as matters in which the committee is interested. There are some portions, rather major portions, which I will submit for the record.

Senator WILLIAMS. It will all be in the record.

Mr. BUDGE. Mr. Chairman and members of the subcommittee, I am happy to be here for the purpose of reporting to you with respect to certain matters which have arisen under the securities laws, particularly the Securities Exchange Act of 1934 and the Investment Company Act of 1940.

The staff of your subcommittee has indicated to me certain areas which they wish me to discuss, and I propose to proceed with those matters.

As the subcommittee is aware, I was called to testify on certain pressing problems confronting the Commission before a subcommittee of the House Committee on Interstate and Foreign Commerce last week. I have with me copies of my statement on that occasion, if the members of the subcommittee are interested in having them. Insofar as practicable, I propose to avoid duplicating today the matters covered in my statement of last week, although some overlap is inevitable.

Senator BENNETT. Mr. Chairman, I suggest that the statement he made before the committee in the House be included in our record here without his reading it.

Senator WILLIAMS. Is there objection to that? It will eliminate duplication, is that the point?

Mr. BUDGE. That is the point, Senator.

(The statement is reproduced as the appendix, see p. 127.)

Mr. BUDGE. The subjects I propose to touch upon today include the administration of Public Law 90-439, commonly known as the Williams bill; complaints from small investors about brokers being unwilling to execute their transactions; certain aspects of our investigation of the minimum commission rate structure on the stock exchanges and certain related problems; our position with respect to S. 34 and S. 296—I perhaps should say my position with regard to those bills, which are the mutual fund bills which have been introduced by Senator Sparkman and Senator McIntyre; recent developments with respect to insider trading and certain accounting questions, particularly product-line reporting by so-called conglomerates; and the backlog in the securities business, and so forth.

ADMINISTRATION OF PUBLIC LAW 90–439

Public Law 90–439, commonly known as the Williams bill because it was originated and sponsored by the distinguished chairman of this subcommittee, was signed into law on July 29, 1968. It provides for increased disclosure with respect to substantial acquisitions of securities registered under the Securities Exchange Act and in connection with tender offers for such securities, together with protections against fraud in such activities, permits Commission regulation of corporations' purchases of their own shares, and provides disclosure in connection with changes of a majority of the board of directors in connection with acquisitions of securities or takeover bids. It also provides for the regulation of solicitations or recommendations to accept or reject the tender offer and provide certain significant substantive protections for the investor to whom a tender offer is directed, such as a limited time in which tendered securities can be withdrawn, a limit on the time during which the tender offer can be held open, a limited period during which securities must be taken up on a pro rata basis rather than a first-come-first-served basis, and provides that if a person varies the terms of a tender offer by increasing the price, he must afford the benefit of that increase to persons who have already tendered their securities.

This subcommittee, and particularly Senator Williams, are certainly to be congratulated upon accomplishing this important reform and improvement in investor protection in an area which has become increasingly significant in recent years, and I may say even more so just in recent months.

Immediately upon the enactment of the legislation, we adopted temporary regulations thereunder governing the form and content of the disclosures to be required and related matters. This was necessary since certain provisions of the legislation were not self-executing but required Commission rules in order to implement them. Such rules are contained in regulation 13(d) and regulation 14(d), and I have copies available in case you wish them included in the record.

Senator WILLIAMS. Without objection.

(The following was submitted for the record:)

[Securities Exchange Act of 1934, Release No. 8510, Jan. 31, 1969]

ADOPTION OF RULE 13d–4 UNDER SECTION 13(d)

The Securities and Exchange Commission has amended its temporary rules under Section 13(d) of the Securities Exchange Act of 1934 by adding thereto a new Rule 13d–4. Section 13(d) requires certain disclosure with respect to the acquisition of more than 10 percent of a class of equity securities registered pursuant to Section 12 of the Act.

The new Rule 13d-4 provides an exemption from Section 13(d) of the Act with respect to purchases of securities by security holders pursuant to preemptive rights where the purchaser does not acquire more than his or its pro rata share of the securities offered.

It is contemplated that a similar rule will be incorporated in the permanent rules under Section 13(d) which are now under consideration.

The text of the new rule is as follows:

Rule 13d-4. Exemption of Acquisitions Pursuant to Pre-emptive Rights

An acquisition of securities of an issuer by a security holder who prior to such acquisition was the beneficial owner of more than 10 percent of the outstanding securities of the same class as those acquired shall be exempt from Section 13(d) of the Act if the following conditions are met:

(a) The acquisition is made pursuant to pre-emptive subscription rights in an offering made to all holders of securities of the class to which the pre-emptive subscription rights pertain;

(b) The purchaser does not, through the exercise of such pre-emptive subscription rights, acquire more than his or its pro rata share of the securities offered; and

(c) The acquisition is duly reported pursuant to Section 16(a) of the Act and the rule and regulations thereunder.

* * * * * * *

The Commission finds that the foregoing rule is appropriate in the public interest and is consistent with the protection of investors and that notice and procedure pursuant to the Administrative Procedure Act is not necessary. Since the rule provides an exemption from Section 13(d) of the Act, the Commission finds that it may be made effective immediately. Accordingly, the rule shall become effective upon publication January 31, 1969.

By the Commission.

ORVAL L. DUBOIS,
Secretary.

[Securities Exchange Act of 1934, Release No. 8392, Aug. 30, 1968]

ADOPTION OF AMENDMENTS TO TEMPORARY RULES AND REGULATIONS UNDER SECTIONS 13 (d) AND (e) AND 14(d)

On July 30, 1968 the Commission announced, in Securities Exchange Act Release No. 8370, the adoption of temporary rules and regulations to implement the recent amendments to Sections 13 and 14 of the Securities Exchange Act of 1934, effected by Public Law 90–439. The Commission has amended these rules and regulations by adding certain new rules thereto and amending some of the previously adopted rules and regulations. A brief description of the changes involved in the amendments follows.

Rule 13d–1 has been amended by deleting therefrom the reference to July 29, 1968, the effective date of the statutory amendments. The reference to that date has led some persons to construe the rule as being applicable only if more than ten percent of a class of equity securities is acquired after such date. The rule is intended to apply, in accordance with the statute, whenever any person acquires after that date any equity securities if after such acquisition the person is then the beneficial owner of more than ten percent of the class.

A new Rule 13d-3 has been added to Regulation 13D. This rule provides that for the purpose of determining whether a person is the beneficial owner of a specified percentage of a class of equity securities, he shall be deemed to be the beneficial owner of securities of that class which he has the right to acquire through the exercise of presently exercisable options, warrants or rights or through the conversion of presently convertible securities, or otherwise.

Rule 13e-1 provides that no issuer which is subject to Section 13(e) of the Act shall purchase any of its equity securities when a tender offer is being made unless a statement with respect to the proposed purchase has been filed with the Commission and the substance of the information contained therein has been sent to its equity security holders within the preceding six months. The rule has been construed by some persons to mean that an issuer may either file the information with the Commission or transmit it to its security holders. The intent of the rule is that the issuer must comply with both conditions prior to any such purchase and the rule has been amended to make this clear.

Rule 14d-1 of Regulation 14D specifies the information to be filed with the Commission and furnished to the issuer and security holders in connection with tender offers for equity securities of an issuer. The amendment provides that all tender offers for, or requests or invitations for tenders of, securities published or sent to security holders shall include, in addition to the information previously required, information with respect to the rights of security holders to withdraw their securities and with respect to the pro rata acceptance of tenders where all of the securities tendered are not accepted.

A new Rule 14d–2 has been adopted which provides that Regulation 14D does not apply to certain communications which in the absence of such a rule would be deemed to constitute tender offers, or solicitations in favor of or in opposition to such offers. The exclusions relate to matters such as offers to no more than ten security holders during any period of twelve months, the call or redemption of any security in accordance with the terms and conditions of the governing instruments and the furnishing of information or advice to customers or clients by attorneys, banks, brokers, fiduciaries or investment advisers.

Item 4 of Schedule 13D has been amended to require a statement of the purpose or purposes for which securities of an issuer have been or are to be purchased. Under the existing Item this information is not specifically required. The amended item would also require, where the issuer is a registered closed-end investment company, information with respect to any plans or proposals to change its fundamental investment policy.

Item 5 of Schedule 13D has been amended to require information with respect to recent transactions in the securities of the issuer. Under the existing item this information is not required.

Schedule 14D has been amended by adding thereto a new Item 5 which would require information with respect to recent transactions by insiders in securities of the issuer.

It is suggested that the applicable sections of the statute be read in connection with the temporary rules. The Commission's staff will endeavor to be as helpful as possible in connection with interpretive or other problems which may arise under the new legislation or the rules thereunder. The Commission will be glad to receive any comments or suggestions which interested persons may wish to make in regard to the temporary rules or these amendments thereto.

It should be noted that a "special bid" to purchase equity securities through the facilities of a national securities exchange ordinarily, under the regulations of such exchange, would constitute a "tender offer" or "request or invitation for offers" within the meaning of Sections 14(d) and (e) of the Act. Any such bid, therefore, can be lawfully made only in accordance with the provisions of those sections, including paragraph (5), withdrawal provisions, and paragraph (6), pro rata provisions, of Section 14(d), and the rules and regulations thereunder.

The text of the new and amended rules which were adopted pursuant to the Securities Exchange Act of 1934, particularly Sections 13(d) and (e), 14(d) and (e) and 23(a) thereof, is attached hereto.

The Commission finds that it is necessary in the public interest and for the protection of investors that additional temporary rules and regulations be adopted immediately to implement the recent amendments to Sections 13 and 14 of the Securities Exchange Act of 1934 and that notice and procedure pursuant to the Administrative Procedure Act is impracticable. Accordingly, the foregoing rules and regulations shall become effective immediately.

By the Commission.

ORVAL L. DUBOIS,
Secretary.

I. Rule 13d–1 as amended reads as follows:

Rule 13d–1. Filing of Schedule 13D

Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to Section 12 of the Act, or any equity security issued by a closed-end investment company registered under the Investment Company Act of 1940, is directly or indirectly the beneficial owner of more than 10 per centum of such class shall, within ten days after such acquisition, send to the issuer of the security at its principal executive office, by registered or certified mail, send to each exchange where the security is traded, and filed with the Commission, a statement containing the information required by Schedule 13D

II. The following new Rule 13d–3 has been aded to Regulation 13D:

Rule 13d–3. Determination of Ownership of Specified Percentages of a Class of Equity Securities

In determining, for the purposes of Section 13(d) or Section 14(d), whether a person is directly or indirectly the beneficial owner of securities of any class, such person shall be deemed to be the beneficial owner of securities of such class which such person has the right to acquire through the exercise of presently exercisable options, warrants or rights or through the conversion of presently convertible securities, or otherwise. The securities subject to such options, warrants, rights or conversion privileges held by a person shall be deemed to be outstanding for the purpose of computing the percentage of outstanding securities of the class owned by such person but shall not be deemed to be

outstanding for the purpose of computing the percentage of the class owned by any other person.

III. Rule 13e–1 as amended reads as follows:

Rule 13e–1. Purchase of Securities by Issuer Thereof

When a person other than the issuer makes a tender offer for, or request or invitation continues, purchase any equity securities of which it is the issuer Section 13(e) of the Act, and such person has filed a statement with the Commission pursuant to Rule 14d–1 and the issuer has received notice thereof, such issuer shall not thereafter, during the period such tender offer, request or invitation continues, purchase any equity securities of which it is the issuer unless it has complied with both of the following conditions:

(a) The issuer has filed with the Commission a statement containing the information specified below with respect to proposed purchases:

(1) The title and amount of securities to be purchased, the names of the persons or classes of persons from whom, and the market in which, the securities are to be purchased, including the name of any exchange on which the purchase is to be made;

(2) The purpose for which the purchase is to be made and whether the securities are to be retired, held in the treasury of the issuer or otherwise disposed of, indicating such disposition; and

(3) The source and amount of funds or other consideration used or to be used in making the purchases, and if any part of the purchase price or proposed purchase price is represented by funds or other consideration borrowed or otherwise obtained for the purpose of acquiring, holding, or trading the securities, a description of the transaction and the names of the parties thereto; and

(b) The issuer has at any time within the past six months sent or given to its equity security holders the substance of the information contained in the statement required by subparagraph (a).

Provided, however, that any issuer making such purchases which commenced prior to July 30, 1968, shall, if such purchases continue after such date, comply with the provisions of this rule on or before August 12, 1968.

IV. Rule 14d–1 has been amended as follows:

Rule 14d–1. Filing of Schedule 13D and Furnishing of Information to Security Holders

(a) (No change)

(b) (No change)

(c) All tender offers for, or requests or invitations for tenders of, securities published or sent or given to the holders of such securities shall include the following information:

(1) The name of the person making the tender offer, request or invitation;

(2) The exact dates prior to which, and after which, security holders who deposit their securities will have the right to withdraw their securities pursuant to Section 14(d)(5) of the Act, or otherwise;

(3) If the tender offer or request or invitation for tenders is for less than all of the outstanding securities of the class and the person making the offer, request or invitation is not obligated to purchase all of the securities tendered, the date of expiration of the period during which the securities will be taken up pro rata pursuant to Section 14(d)(6), or otherwise; and

(4) The information required by Items 2(a), (c) and (e), 3, 4, 5, and 6 of Schedule 13D, or a fair and adequate summary thereof.

(d) (No change)

V. The following new Rule 14d-2 has been added to Regulation 14D:

Rule 14-2. Certain Communications to Which Rules Do Not Apply

The rules contained in this regulaton do not apply to the following communications:

(a) offers to purchase securities made in connection with a distribution of securities permitted by Rule 10b-6, 10b-7 or 10b-8.

(b) the call or redemption of any security in accordance with the terms and conditions of the governing instruments.

(c) offers to purchase securities evidenced by a script certificate, order form or similar document which represents a fractional interest in a share of stock or similar security.

(d) offers to purchase securities pursuant to a statutory procedure for the purchase of dissenting shareholders' securities,

(e) the furnishing of information and advice regarding a tender offer to customers or clients by attorneys, banks, brokers, fiduciaries or investment advisers, who are not otherwise participating in the tender offer or solicitation, on the unsolicited request of a person or pursuant to a general contract for advice to the person to whom the information or advice is given.

(f) A communication from an issuer to its security holders which does no the unsolicited request of a person or pursuant to a general contract for admore than (1) identify a tender offer or request or invitation for tenders made by another person, (2) state that the management of the issuer is studying the matter and will, on or before a specified date (which shall be not later than 10 days prior to the date specified in the offer, request or invitation, as the last date on which tenders will be accepted, or such shorter period as the Commission may authorize) advise security holders as to the management's recommendation to accept or reject the offer, request or invitation, and (3) request security holders to defer making a determination as to whether or not they should accept or reject the offer, request or invitation until they have received the management's recommendation with respect thereto.

(g) offers to purchase securities in transactions exempt from registration under the Securities Act of 1933 pursuant to Section 3(a)(10) thereof.

VI. Item 4 of Schedule 13D has been amended as follows:

Item 4. Purpose of Transaction

State the purpose or purposes of the purchase or proposed purchase of securities of the issuer. If the purpose or one of the purposes of the purchaser or proposed purchase is to acquire control of the business of the issuer, describe any plans or proposals which the purchasers may have to liquidate the issuer, to sell its assets or to merge it with any other persons, or to make any other major change in its business or corporate structure, including, if the issuer is a registered closed-end investment company, any plans or proposals to make any changes in its investment policy for which a vote would be required by Section 13 of the Investment Company Act of 1940.

VII. Item 5 of Schedule 13D has been amended as follows:

Item 5. Interest in Securities of the Issuer

State the number of shares of the security which are beneficially owned, and the number of shares concerning which there is a right to acquire, directly or indirectly, by (i) such persons, and (ii) each associate of such person, giving the name and address of each such associate. Furnish information as to all transactions in the class of securities to which this statement relates which were effected during the past 60 days by the person filing this statement and by its subsidiaries and their officers, directors and affiliated persons.

VIII. The following new Item 6 has been added to Schedule 14D:

Item 6. Additional Information to be Furnished

(a) Furnish information as to all transactions in the class of securities to which this statement relates which were effected during the past 60 days by the issuer and its subsidiaries and their officers, directors and affiliated persons.

[Securities Exchange Act of 1934, Release No. 8370, July 30, 1968]

ADOPTION OF TEMPORARY RULES AND REGULATIONS UNDER SECTIONS 13(D) AND (E) AND SECTIONS 14(D) AND (F)

The Securities and Exchange Commission has adopted temporary rules and regulations to implement the recent amendements, effected by Bill S. 510, to Sections 13 and 14 of the Securities Exchange Act of 1934. These amendments, set forth in Sections 13(d) and (e) and Sections 14(d) and (f) of the Act, apply to classes of equity securities registered pursuant to Section 12 of the Act and classes of equity securities issued by closed-end investment companies registered under the Investment Company Act of 1940. They relate to the acquisition of more than ten percent of a class of such securities by any person, the purchase of securities by the issuer thereof, the making of tender offers or solicitations in favor of, or in opposition to, such tender offers, and the replacement of a majority of the directors of an issuer in connection with an acquisition subject to Section 13(d) or a tender offer subject to Section 14(d) of the Act. The statutory amendments became effective immediately when the President signed the Bill on July 29, 1968. The Commission adopted the temporary rules to put into operation the provisions of the amendments. This constitutes a first step in the development of comprehensive regulations to accomplish the full purposes of the statutory amendments.

The rules under the new Section 13(d) with respect to the acquisition of securities are set forth in Regulation 13D. That regulation provides that the information with respect to such acquisitions called for by Schedule 13D be filed with the Commission and sent to the issuer of the security and to each exchange where the security is traded. For the purpose of preventing fraudulent, deceptive or manipulative acts and practices, the Commission had adopted Rule 13e-1. The rule provides that no issuer which is subject to Section 13(e) of the Act shall purchase any of its equity securities when a tender offer is being made unless a statement with respect to the proposed purchase has been filed by it with the Commission, and the substance of the information therein has been sent or given to its equity security holders within the preceding six months.

The rules under Section 14(d) with respect to tender offers and solicitations to accept or to reject such offers are set forth in Regulation 14D. That regulation provides that the information called for by Schedule 13D or Schedule 14D shall be filed with the Commission. Certain of such information, or a fair and adequate summary thereof, is required to be included in all requests and solicitations.

Rule 14f-1 relates to the replacement of a majority of the directors of an issuer in connection with an acquisition subject to Section 13(d) or a tender offer subject to Section 14(d) of the Act. The rule requires that not less than 10 days prior to the time the persons elected or designated as directors of the issuer take office, or such shorter period as the Commission may authorize, the issuer shall file with the Commission and transmit to certain holders of securities of the issuer information required by certain items of the Commission's proxy rules.

Provisions are made for delay in compliance with the rules in regard to activities which had been commenced before the statutory amendments became effective.

It is suggested that the applicable sections of the statute be read in connection with the temporary rules. The Commission's staff will endeavor to be as helpful as possible in connection with interpretive or other problems which may arise under the new legislation or the rules thereunder. The Commission will be glad to receive any comments or suggestions which interested persons may wish to make in regard to the temporary rules.

It should be noted that compliance with these rules does not provide relief from other applicable provisions of the Act and rules and regulations thereunder.

The rules and regulations which were adopted pursuant to the Securities Exchange Act of 1934, particularly Sections 13(d) and (e) and Sections 14(d) and (f), are attached to this release.

The Commission finds that it is necessary in the public interest and for the protection of investors that temporary rules and regulations be adopted immediately to implement the recent amendments to Sections 13 and 14 of the Securities Exchange Act of 1934 and that notice and procedure pursuant to the Administrative Procedure Act is impracticable. Accordingly, the foregoing rules and regulations shall become effective immediately.

By the Commission.

ORVAL L. DUBOIS,
Secretary.

REGULATION 13D

Rule 13d-1. Filing of Schedule 13D

Any person who, after acquiring, subsequent to July 29, 1968, directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to Section 12 of the Act, or any security issued by a closed-end investment company registered under the Investment Company Act of 1940, is directly or indirectly the beneficial owner of more than 10 per centum of such class shall, within ten days after such acquisition, send to the issuer of the security at its principal executive office, by registered or certified mail, send to each exchange where the security is traded, and file with the Commission, a statement containing the information required by Schedule 13D.

Rule 13d–2. Filing of Amendments

If any material change occurs in the facts set forth in the statement required by Rule 13d–1, the person who filed such statement shall promptly file with the Commission and send to the issuer and the exchange an amendment disclosing such change.

Rule 13e–1. Purchase of Securities by Issuer Thereof

When a person other than the issuer makes a tender offer for, or request or invitation for tenders of, any class of equity securities of an issuer subject to Section 13(e) of the Act, and such person has filed a statement with the Commission pursuant to Rule 14d–1 and the issuer has received notice thereof, such issuer shall not thereafter during the period such tender offer, request or invitation continues, purchase any equity securities of which it is the issuer unless:

(a) The issuer has filed with the Commission a statement containing the information specified below with respect to proposed purchases:

(1) The title and amount of securities to be purchased, the names of the persons or classes of persons from whom, and the market in which, the securities are to be purchased, including the name of any exchange on which the purchase is to be made;

(2) The purpose for which the purchase is to be made and whether the securities are to be retired, held in the treasury of the issuer or otherwise disposed of, indicating such disposition; and

(3) The source and amount of funds or other consideration used or to be used in making the purchases, and if any part of the purchase price or proposed purchase price is represented by funds or other consideration borrowed or otherwise obtained for the purpose of acquiring, holding, or trading the securities, a description of the transaction and the names of the parties thereto.

(b) The issuer has at any time within the past six months sent or given to its equity security holders the substance of the information contained in the statement required by subparagraph (a).

Provided, however, that any issuer making such purchases which commenced prior to July 30, 1968 shall, if such purchases continue after such date, comply with the provisions of this rule on or before August 12, 1968.

REGULATION 14D

Rule 14d–1. Filing of Schedule 13D

(a) No person, directly or indirectly, by use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, shall make a tender offer for, or a request or invitation for tenders of, any class of any equity security which is registered pursuant to section 12 of the Act, or any equity security issued by a closed-end investment company registered under the Investment Company Act of 1940, if, after consummation thereof, such person would, directly or indirectly, be the beneficial owner of more than 10 per centum of such class, unless, at the time copies of the offer or request or invitation are first published or sent or given to security holders, such person has filed with the Commission a statement containing the information and exhibits required by Schedule 13D: *Provided, however*, that any person making a tender offer for or a request or invitation for tenders which commenced prior to July 30, 1968 shall, if such offer, request or invitation continues after such date, file the statement required by this rule on or before August 12, 1968.

(b) If any material change occurs in the facts set forth in the statement required by paragraph (a) of this rule, the person who filed such statement shall promptly file with the Commission an amendment disclosing such change.

(c) All requests or invitations for tenders or advertisements making a tender offer or requesting or inviting tenders shall contain the name of the persons making such requests, invitations, or advertisements and the information required by Items 2(a), (c) and (e), 3, 4, 5 and 6 of Schedule 13D, or a fair and adequate summary thereof, and shall be filed with the Commission as part of the statement required by paragraph (a) of this rule.

(d) Any additional material soliciting or requesting such tender offers subsequent to the initial solicitation or request shall contain the name of the persons making such solicitation or request and the information required by Items 2(a), (c) and (e), 3, 4, 5 and 6 of Schedule 13D, or a fair and adequate summary thereof: *Provided, however*, that such material may omit any of such information previously furnished to the persons solicited or requested for tender offers. Copies

of such additional material soliciting or requesting such tender offers shall be filed with the Commission not later than the time copies of such material are first published or sent or given to security holders.

Rule 14d–4. Filing of Schedule 14D

(a) No solicitation or recommendation to the holders of a security to accept or reject a tender offer or request or invitation for tenders subject to Section 14(d) of the Act shall be made unless, at the time copies of the solicitation or recommendation are first published or sent or given to holders of the security, the person making such solicitation or recommendation has filed with the Commission a statement containing the information specified by Schedule 14D: *Provided, however*, that this rule shall not apply to (1) a person required by Rule 14d-1(a) to file a statement, or (2) a person, other than the issuer or the management of the issuer, who makes no written solicitations or recommendations other than solicitations or recommendations copies of which have been filed with the Commission pursuant to this rule of Rule 14d–1: *And, provided further*, that any person making a solicitation or recommendation to the holders of a security to accept or reject a tender offer or request or invitation for tenders which solicitation or recommendation commenced prior to July 30, 1968 shall, if such solicitation or recommendation continues after such date, file the statement required by this rule on or before August 12, 1968.

(b) If any material change occurs in the facts set forth in the statement required by paragraph (a) of this rule, the person who filed such statement shall promptly file with the Commission an amendment disclosing such change.

(c) Any written solicitation or recommendation to the holders of a security to accept or reject a tender offer or request or invitation for tenders subject to Section 14(d) of the Act shall include the name of the person making such solicitation or recommendation and the information required by Items (1)b, 2(b) of Schedule 14D of a fair and adequate summary thereof: *Provided, however*, that such written solicitation or recommendation may omit any of such information previously furnished to the persons to whom the solicitation or recommendation is made.

Rule 14f–1. Change in Majority of Directors

If, pursuant to any arrangement or understanding with the person or persons acquiring securities in a transaction subject to section 13(d) or 14(d) of the Act, any persons are to be elected or designated as directors of the issuer, otherwise than at a meeting of security holders, and the persons so elected or designated will constitute a majority of the directors of the issuer, then, not less than 10 days prior to the date any such person take office as a director, or such shorter period prior to that date as the Commission may authorize upon a showing of good cause therefor, the issuer shall file with the Commission and transmit to all holders of record of securities of the issuer who would be entitled to vote at a meeting for election of directors, information substantially equivalent to the information which would be required by Items 5(a), (d), (e) and (f), 6 and 7 of Schedule 14A of Regulation 14A to be transmitted if such person or persons were nominees for election as directors at a meeting of such security holders.

SCHEDULE 13D. INFORMATION TO BE INCLUDED IN STATEMENTS FILED PURSUANT TO RULE 13D 1 OR 14D-1

NOTES.—A. The item numbers and captions of the items shall be included but the text of the items are to be omitted. The answers to the items shall be so prepared as to indicate clearly the coverage of the items without referring to the text of the items. Answer every item. If an item is inapplicable or the answer is in the negative, so state.

B. If the statement is filed by a partnership, limited partnership, syndicate, or other group, the information called for by Items 2 to 6, inclusive, shall be given with respect to (1) each partner or any partnership or limited partnership (2) each member of such syndicate or group and (3) each person controlling such partner or member. If a person referred to in (1), (2) or (3) is a corporation or the statement is filed by a corporation, the information called for by the above-mentioned items shall be given with respect to each officer and director of such corporation and each person controlling such corporation.

Item 1. Security and Issuer

State the title of the class of equity securities to which this statement relates and the name and address of the issuer of such securities.

Item 2. Identity and Background

State the following with respect to the person filing this statement:

(a) Name and business address;

(b) Residence address;

(c) Present principal occupation or employment and the name, principal business and address of any corporation or other organization in which such employment is carried on;

(d) Material occupations, positions, officers or employments during the last 10 years, giving the starting and ending dates of each and the name, principal business and addres of any business corporation or other organization in which each such occupation, position, office or employment was carried on; and

(e) Whether or not, during the last 10 years, such person has been convicted in a criminal proceeding (excluding traffic violations or similar misdemeanors) and, if so, give the dates, nature of conviction, name and location of court, and penalty imposed, or other disposition of the case. A negative answer to this sub-item need not be furnished to security holders.

Item 3. Source and Amount of Funds or Other Consideration

State the source and amount of funds or other consideration used or to be used in making the purchases, and if any part of the purchase price or proposed purchase price is represented or to be represented by funds or other consideration borrowed or otherwise obtained for the purpose of acquiring, holding, or trading the securities, a description of the transaction and the names of the parties thereto.

Item 4. Purpose of Transaction

If the purpose of the purchases or prospective purchases is to acquire control of the business of the issuer of the securities, describe any plans or proposals which such person may have to liquidate such issuer, to sell its asset to or merge it with any other person, or to make any other major change in its business or corporate structure.

Item 5. Interest in Securities of the Issuer

State the number of shares of the security which are beneficially owned, and the number of shares concerning which there is a right to acquire, directly or indirectly, by (i) such person, and (ii) each associate of such person, giving the name and address of each such associate.

Item 6. Contracts, Arrangements, or Understandings with respect to Securities of the Issuer

Furnish information as to any contracts, arrangements, or understandings with any person with respect to any securities of the issuer, including but not limited to transfer of any of the securities, joint ventures, loan or option arrangements, puts or calls, guaranties of loans, guaranties against loss or guaranties of profits, division of losses or profits, or the giving or withholding of proxies, naming the persons with whom such contracts, arrangements, or understandings have been entered into, and giving the details thereof.

Item 7. Persons Retained, Employed or to be Compensated

Where the Schedule 13D relates to a tender offer, or request or invitation for tenders, identify all persons and classes of persons employed, retained or to be compensated by the person filing this Schedule 13D, or by any person on his behalf, to make solicitations or recommendations to security holders and describe briefly the terms of such employment, retainer or arrangement for compensation.

Item 8. Material to be Filed as Exhibits

Copies of all requests or invitations for tenders or advertisements making a tender offer or requesting or inviting tenders, additional material soliciting or requesting such tender offers, solicitations or recommendations to the holders of the security to accept or reject a tender offer or request or invitation for tenders shall be filed as an exhibit.

Signature

I certify that to the best of my knowledge and belief the information set forth in this statement is true, complete and correct.

________________ (Date) ________________ ________________ (Signature)

If the statement is signed on behalf of a person by an authorized representative, evidence of the representative's authority to sign on behalf of such person shall be filed with the statement.

SCHEDULE 14D

Item 1. Security and Issuer

(a) State the title of the class of equity securities to which this statement relates and the name and address of the issuer of such securities.

(b) Identify the tender offer or request or invitation for tenders to which this statement relates and state the reasons for the solicitation or recommendation to security holders to accept or reject such tended offer, request, or invitation for tenders.

Item 2. Identity and Background

(a) State the name and business address of the person filing this statement.

(b) Describe any arrangement or understanding in regard to the solicitation with (i) the issuer or the management of the issuer or (ii) the maker of the tender offer or request or invitation for tender of securities of the class to which this statement relates.

Item 3. Persons Retained, Employed or to be Compensated

Identify any person or class or persons employed, retained or to be compensated, by the person filing this Schedule 14D, or by any person on his behalf, to make solicitations or recommendations to security holders and describe briefly the terms of such employment, retainer or arrangement for compensation.

Item 4. Material to be filed as Exhibits

Copies of all solicitations or recommendations to accept or to reject a tender offer or request or invitation for tenders of the securities specified in Item 1 shall be filed as an exhibit.

Signature

I certify that to the best of my knowledge and belief the information set forth in this statement is true, complete and correct.

________________ (Date) ________________ ________________ (Signature)

If the statement is signed on behalf of a person by an authorized representative, evidence of the representative's authority to sign on behalf of such person shall be filed with the statement.

Mr. BUDGE. These temporary rules were amended in August of 1968 and January 1969 to allow certain exemptions therefrom and to provide necessary clarification. We propose to adopt permanent and comprehensive rules as soon as possible based on our experience with the temporary rules.

During the period from the effective date of the bill through February 28, 1969, filings with us have been made with respect to 54 tender offers and 167 acquisitions of securities subject to new section 13(d). The dollar amount of the tender offers was approximately \$1,424 million. In this connection, it is interesting to note that of this sum, approximately \$1,135 million was financed by means of bank loans and another \$97 million by the prior sale of securities.

I think for the sake of completeness I should also point out that during the period from the effective date of the bill through January 31, 1969, 104 offerings of securities in exchange for other securities were registered with the Commission. The dollar amount of the securities so registered was approximately $9 billion.

It will thus be noted that these offerings, which are exempt from most provisions of the Williams bill, somewhat exceeded in number and far exceeded in dollar value, the cash tender offers with respect to which filings were made under the Williams bill. I do not believe this trend toward the offer of securties rather than cash in tender offers is motivated to any significant extent by a desire to avoid compliance with the requirements of the Williams bill. I suspect the principal reason for this change in emphasis was economic, particularly in view of the tight-money conditions in the last few months.

Also, there has been an increasing tendency to attempt to take over large corporations, and it would be very difficult to finance a cash tender offer in a transaction which may approach a billion dollars.

Our experience with the Williams bill has been very satisfactory. Anyone who reads the financial press can see the vast improvement in the disclosure made available to investors by reason of the Williams bill and, as I pointed out, that bill also provides important protections for shareholders with respect to the substantive terms of tender offers.

I should like to mention two other rulemaking proceedings of the Commission, which are related to the Williams bill. In the course of consideration of the Williams bill, we directed the attention of Congress to the practices of so-called short tendering, which we thought unduly favored certain investors, particularly securities firms, as compared with the other shareholders to whom a tender offer was directed. The committee in its report suggested that the Commission could deal with this problem under its existing rulemaking power under the Exchange Act, and we proceeded to do so, adopting rule 10b-4 on May 28, 1968. This rule, in effect, prohibits the practice of short tendering.

On August 30, 1968, we published for comment a proposed rule 10b-13 dealing with open-market purchases involved in a tender offer by a person making the offer. After reviewing the numerous and useful comments received from the public with respect to this proposal and giving the matter further consideration, I understand our staff has concluded the proposed rule was probably unduly complex and they intend to recommend to the Commission a simplified rule which will be published for further comments. Basically, the problem is that such purchases by a person making a tender offer could have a manipulative effect and could result in unfair discrimination between investors who tender their shares and investors whose shares are purchased in the open market.

There already has been certain significant litigation under the Williams bill. The most important case is the decision of the Court of Appeals for the Second Circuit in *Electronic Specialty Co. v. International Controls Corp.*, decided January 24, 1969. In this case plaintiffs contended that the statements in a tender offer were misleading and therefore violated section 14(e) of the act, as added by the Williams bill. The decision of the court of appeals established the important proposition that a target corporation has standing to complain of a violation of 14(e) and further suggested that an application for a preliminary injunction is the time when relief can best be granted,

rather than attempting to unscramble the eggs after the tender offer has been completed.

At the early stage, the court can require a correction of the material if necessary, as in fact occurred in this particular case. The court of appeals, however, concluded that the material was not in fact misleading and reversed the decision of the district court to the contrary.

I understand that the subcommittee is interested in knowing whether or not, upon the basis of our experience with the Williams bill, we believe that any amendments to that statute would be desirable. The Commission has not developed a legislative program in this area. We do believe, however, that in the light of the great increase in takeover activity, which I discussed in my statement before the House subcommittee, consideration should be given to certain perfecting amendments to the legislation.

In the first place, I think it might be desirable to reduce the 10-percent figure in section 13(d)(1), which requires that a report be filed if a person has acquired 10 percent of the outstanding stock of a company, to 5 percent. The reason for this is that it is common for a person proposing to make a tender offer, either with cash or with securities, to first accumulate a position in the open market and, as takeover efforts are increasingly directed toward larger corporations, very substantial positions can be accumulated without reaching 10 percent.

Thus, in one case involving a registered exchange offer, the proposed offeror acquired, before the offering, securities of the target company having a value of about $30 million without coming anywhere near 10 percent.

We have also been told that persons accumulating stock prior to a tender offer have in some instances ceased buying just short of 10 percent in order to avoid the disclosure required by section 13(d).

Another possible change would be to amend section 14(e) to give the Commission a greater degree of rulemaking power with respect to purchases of shares of the target company. Now section 13(e) gives the Commission substantial rulemaking authority with respect to purchases by an issuer of its own shares, but section 14(e) merely prohibits fraud and manipulative practices.

As the law has developed, this adds little to the protection afforded by other antifraud provisions of the securities laws such as section 10(b) and rule 10b-5, except as it may affect the question of standing to sue, which I mentioned in connection with the *Electronic Specialty* case. Section 14(e) might therefore be amended to grant to the Commission rulemaking authority over purchases by a potential tender offeror and his associates comparable to that provided in section 13(e) for purchase by the issuer.

As I mentioned, the Williams bill, as enacted, contained an express exemption for tender offers registered under the Securities Act of 1933. This was no doubt introduced with the thought that registration would provide adequate disclosure and, indeed, more comprehensive disclosure, than was contemplated by the Williams bill, and that consequently application of the bill would be unnecessary and would involve some duplication.

As far as disclosure is concerned, this conclusion is correct. This exclusion, however, has the effect of depriving investors to whom a registered tender offer is directed of the important substantive protections provided by subparagraphs 5, 6, and 7 of section 14(d) dealing with the terms and conditions under which tender offers can be made, including the right to share in an increase in the offer price, and it may also have the effect of leaving solicitations in opposition to a registered tender offer regulated only by the fraud provisions, while the offeror is restricted by the registration requirements of the Securities Act of 1933.

If this exemption were eliminated, we could easily avoid any duplication of disclosure administratively. Indeed, such offers could be exempted from the disclosure requirements of section 14(d)(1), since that information will almost inevitably be contained in the registration statement.

There is one omission in the Williams bill which may have been inadvertent, since it is not mentioned in the legislative history. If it was inadvertent, we must bear much of the responsibility, since we did not suggest it.

The Williams bill applies only to securities registered pursuant to section 12 of the Exchange Act and to closed-end investment companies. The securities of most insurance companies are not registered pursuant to section 12(g), because of the exemption contained in section 12(g)(2)(G) for insurance company securities which are subject to specified State regulation.

We would not wish to disturb the congressional decision in 1964 to leave reporting, proxy solicitation, and regulation of insider trading with respect to the securities of insurance companies to the State insurance commissioners.

We believe, however, that the considerations which led to this decision by the Congress in 1964 may well be inapplicable to tender offers. Tender offers are frequently made on a nationwide basis and are not presently regulated by the State insurance commissioners; indeed, it might be very difficult for a State insurance commissioner to regulate a tender offer made from outside the State.

We have not had an opportunity to obtain the views of the insurance industry on this suggestion, and it would undoubtedly be necessary to ascertain their views before proceeding with any such legislation.

Some insurance companies have, however, written to us suggesting that such an amendment be adopted in order to give them and their shareholders the protections afforded by the Williams bill. Insurance companies in recent periods have been the target of tender offers, although I do not recall any such situation which occurred during the consideration of the Williams bill, although there may have been some.

In my statement before the House subcommittee, I discussed certain serious problems of public policy which may be presented by the rise of conglomerate corporations and the use of complex securities, particularly debt securities, in connection with takeover efforts. I will not repeat that discussion at the present time, particularly as these problems relate to matters of national policy rather than to disclosure, and the prevention of fraudulent, deceptive, or manipulative activities which are the primary thrust of the Williams bill.

Before leaving this subject, I want to take this opportunity again to congratulate the chairman and the members of the subcommittee for originating and being instrumental in the passage of this valuable and important legislation.

THE BACK OFFICE PROBLEMS AND THE SMALL INVESTOR

The brokerage community today is beset with a number of problems, one of which is its inability to process the paperwork involved in the execution of securities transactions. This has caused hardships to many investors. They have been inconvenienced by the late receipt of securities and funds due them and are plagued by an inability to obtain correct statements of their accounts. Moreover, their complaints may go unanswered for long periods of time and some firms are refusing to accept orders if below certain minimum amounts.

That these are problems of some moment is amply demonstrated by the increasing number of complaints the Commission has been receiving from dissatisfied and in some cases bewildered investors. In 1968 alone, investors' complaints increased fourfold and in recent weeks we have been receiving an increasing number.

The ability of the industry to process transactions has not kept pace with the rise in market trading activity. In 1962, the New York Stock Exchange was experiencing an average daily volume of 3.8 million shares and estimated that volume would double by 1975. This forecast was outstripped as early as 1967 when the average New York Stock Exchange volume rose to 10.1 million shares. By the end of December 1968 average daily volume had increased to 14.9 million shares.

Two major factors in the development of this situation have been (1) the failure of management of individual firms to regard the increase in activity as a permanent fixture of the business, and (2) the absence of facilities for clearing over-the-counter transactions, which involve the greatest number of firms and issues, and which have been estimated to equal or surpass, at least in number of shares, the total volume of all transactions effected on the national securities exchanges.

In the past year and a half the Commission, the self-regulatory organizations, and individual firms have taken a number of steps designed to restrict activity, to strengthen financial safeguards, and to improve procedures for the clearance, transfer, and delivery of securities. I would like to add that last Thursday and Friday the Commission sponsored a conference attended by representatives of the exchanges, National Association of Securities Dealers, and other interested parties for the purpose of expanding existing over-the-counter clearing facilities and expediting efforts to develop national over-the-counter clearing facilities. The conference marked the broadest representation of clearing experts at a meeting of this kind and was most helpful in coordinating the efforts of all concerned.

As you know, I appeared before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce last week. That material has been presented and accepted.

Senator WILLIAMS. That is correct.

Mr. BUDGE. Where individual firms have been found to have operational difficulties or to be violating applicable recordkeeping and financial responsibility requirements, the exchanges, the National Association of Securities Dealers, and the Commission have imposed restrictions on the activities of such firms through informal measures or where warranted by the formal institution of proceedings. In some cases, firms have voluntarily forgone expansion or cut back from prevailing levels of activity by self-imposed restrictions.

One such voluntary restriction has been the refusal of certain firms to accept customers' orders below a fixed minimum amount. Although we recognize the urgent need for firms, with difficulties to impose voluntary restraints, we are firmly opposed to the imposition of restrictions that would deny small investors an access to our securities markets.

This is particularly so in view of the minimum commission rate structure which the stock exchanges have justified, in part, on the ground that it enables members to accommodate small transactions by the public. Whatever the validity of this claim, and my remarks here are in no way intended as a value judgment respecting it, serious questions are raised when the exchange members who previously solicited small orders now refuse them.

The president of the New York Stock Exchange has spoken out against this practice. He has also discussed this matter before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce.

We have written to the New York Stock Exchange expressing our concern with this practice and have asked for a full report. Upon receipt of that report, our staff will meet with officials of the exchange to determine what action is required. In the interim we will continue to make suitable inquiry when an investor complains about the refusal of a pariteular firm to handle his order. Our staff does this in an attempt to determine the reason for such action, as well as whether there are other firms which are willing to accept such business.

Mr. Chairman, in this connection, we were pleased to note yesterday in one of the local newspapers a full-page advertisement by one of the investment companies that they will accept orders for 10 shares or 10,000.

Mr. Chairman, as you know, the Commission has had for some months a hearing underway, investigative hearing with regard to commission rate structure of the exchanges, particularly the New York Stock Exchange. The order for that hearing sets forth the following seven broad areas to be explored in the course of the investigation: (1) Commission rate levels for nonmembers and for exchange members (including intramember rates); (2) the services for which commission rates pay and the costs allocated thereto; (3) giveups and reciprocal practices among different categories of members and nonmembers; (4) membership for financial institutions on exchanges; (5) economic access to exchange markets by nonmember broker-dealers; (6) competition among exchanges and other markets; and (7) the necessity for restrictions on access of exchange members to the "third market" (the over-the-counter market in listed securities in which market there is no minimum commission rate).

Pages 12 through 25 of my statement discuss the presentation which has been made in that investigatory hearing in quite some detail. A lot of it is technical, and with the permission of the chairman, I would like to submit pages 12 through 25 of my statement for inclusion in the record without reading it.

Senator WILLIAMS. Speaking for myself, that would be acceptable. Your statement was given to us this morning and I have not had the opportunity to read it in advance. Mr. Chairman; therefore, I obviously will not be able to intelligently ask any questions which I might have in this area.

We have a lot of fast readers on this committee, and perhaps they can skip-read while I give you my undivided attention. Therefore, without objection, those pages will be included in the record.

(Pages 12 through 25 of Mr. Budge's statement follows:)

STRUCTURE AND LEVEL OF COMMISSION RATES

Since formation of the NYSE in 1792, members have adhered to a schedule of fixed rates of commission charges to the general public. The system at present has three essential characteriscies: (i) members must charge all non-members a fixed minimum rate for executing transactions; (ii) members are charged a considerably lower preferential rate of commission; and (iii) members are required to bring to an exchange market all their transactions, including prearranged trades, whether as principal or as agent, however with exceptions which vary among the exchanges.

At the time the Exchange Act was passed, the institutional investor was a relatively unimportant factor in the exchange market for common stocks, and the exchange rate structure was oriented to the concept that the normal unit of trading is 100 shares. This structure has continued except for limited "interim" changes effected December 5, 1968. Thus until that date, exchange commission rates contained no provisions for economies of scale. For a 10,000 share order the minimum commission was 100 times that on a 100 share transaction.

One consequence was that mutual fund managers, whose advisory fees rise as the amount of assets they manage increases, found that the increasingly large volume of stock exchange portfolio commissions paid by the funds they managed could be used to supplement the sales load earned by broker-dealers for the sale of mutual fund shares. They negotiated with the funds' portfolio brokers the portion of the minimum commission the latter were to retain for effecting the funds' transactions. The balance of the minimum commissions was distributed or given up, at the direction of the fund managers, primarily to the many broker-dealers who sold fund shares and, to a lesser extent, to those who supplied research or statistical services. As a result, executing brokers would give away or "give up" most commonly 50–60 percent but as much as 80–90 per cent of the fixed commissions. The give-up rates generally were lower if the executing broker was a substantial seller of fund shares or had supplied research.

Give-up techniques were complicated by varying restrictions imposed upon their respective members by the different exchanges. The New York Stock Exchange, which is the primary market for most of the securities dealt in by the mutual funds, purported to permit commission sharing—or give-ups—only to its own members. If a mutual fund manager wished to make use of its control over portfolio brokerage to reward a fund seller who was not a member of the New York Stock Exchange, there developed a variety of techniques to accomplish this. A New York member who gets business from a regional member has traditionally been permitted to reciprocate by bringing business to the regional exchange and sharing commission earned on such business with the regional member. This practice was expanded to include reciprocation at the direction of the mutual fund manager who was responsible for originating the business done on the New York Stock Exchange. Under the rules of the regional exchanges, commission could be shared with their members and also to a limited extent with brokerage firms which were only members of the National Association of Securities Dealers, Inc. Placing of business on a rgional stock exchange was relatively easy to accomplish where a member of both the NYSE and a regional exchange had negotiated a trade between the fund and one or more institutional buyers. This trade (commonly known as a "cross") could be taken to any exchange where the firm was a member and the commissions could then be shared accordingly.

Accordingly, these practices cast considerable doubt on the appropriateness of rate levels and on the very existence of a minimum stock exchange commission rate structure.

On May 28, 1968, the Commission moved to correct some of the rate inequities produced under the then existing rate schedule. We formally requested the NYSE to adopt one of two interim rate structures. One proposal incorporated a volume discount as well as changes in commission rates which have narrowed the then existing discrepancies between orders which involve the same amount of money but different priced shares. Alternatively, the NYSE was requested to eliminate fixed rates of commission for the portions of transactions in excess of $50,000. In addition, it was suggested that an appropriate review be made of existing intramember minimum rate charges. These requests were character- ized as interim because at the same time, the Commission announced that it would institute public hearings to give more extensive consideration to various aspects of the commission rate structure of the exchanges. The hearings com- menced on July 1, 1968.

On August 8, 1968, the NYSE advised the Commission that its Board of Gov- ernors agreed in principal with a need for an interim volume discount on large transactions. However, because of certain operational difficulties, the Exchange proposed a somewhat different schedule incorporating a quantity discount and providing a 7% reduction in intra-member rates.

The estimated overall reduction in commissions paid by investors were ap- proximately the same as under the Commission's proposal. The NYSE also proposed to amend its constitution to bar customer-directed give-ups. The Com- mission agreed to the NYSE proposal and it went into effect December 5, 1968. The American Stock Exchange and the major regional exchanges have effected similar changes.

The New York Stock Exchange estimated that on the basis of 1967 trading volume, the interim schedule would result in a yearly commission saving to in- vestors of approximately $150,000,000 or over $600,000 per trading day. These savings will accrue to the tens of millions of persons who invest in our securi- ties markets through institutional media—mutual funds, insurance companies, pension funds—which are aggregates of small investors. The ban on give-ups was subject to the understanding that traditional reciprocal practices between the regional and primary exchanges would not be disturbed. Whatever ques- tions there may be as to the ultimate desirability of these practices, the Com- mission believed they should not be altered as part of the interim change.

The public hearing on the commission rate structure which began on July 1, 1968 is investigatory in nature. Its purpose is to develop evidence from inter- ested persons on the following seven broad areas to which the Commission order of investigation refers: (1) commission rate levels for non-members and for exchange members (including intra-member rates); (2) the services for which commission rates pay and the costs allocated thereto; (3) give-ups and reciprocal practices among different categories of members and non-members; (4) member- ship for financial institutions on exchanges; (5) economic access to exchange markets by non-member broker-dealers; (6) competition among exchanges and other markets; and (7) the necessity for restrictions on access of exchange mem- bers to the "third market" (the over-the-counter market in listed securities in which market there is no minimum commission rate).

Testimony and statements on some of these issues have been received from num- erous interested persons—the New York, American, Midwest, Philadelphia- Baltimore-Washington and Pacific Coast Stock Exchanges; the National Asso- ciation of Securities Dealers, Inc.; broker-dealers that are exchange members, third market makers, and representatives of trade associations; the Anti-Trust Division of the Department of Justice and economists who testified at its invita- tion.

MINIMUM COMMISSION RATES

In the course of the hearing, basically conflicting positions have been pre- sented by the national securities exchanges and the Anti-Trust Division of the Department of Justice. In brief, the Justice Department has taken the position that a minimum commission rate structure on national securities exchanges—particularly as applied to large volume business—is inconsistent with the national policy found in the anti-trust laws. Its position is that in pass- ing the Exchange Act the Congress did not mandate fixed rates for stock ex- changes; that minimum rates are not necessary to make that Act work; that since workable standards of reasonableness of rates have not been developed and are difficult or, perhaps, impossible to develop for so diverse an industry, competition rather than regulation should prevail.

The exchanges, in their presentations, have sought to establish that a minimum rate structure is necessary for the proper operation of the exchange markets and that if fixed rates were abolished, the centralized market would be impaired; brokers would no longer have the incentive to remain or become members and submit to the expenses of regulation by the exchanges; many firms could not remain in business, and that Congress, when it passed the Securities Exchange Act of 1934, mandated or permitted the existence of a fixed minimum commission rate structure for national securities exchanges. In addition, the NYSE has stated

its intention of conducting a study of what services may reasonably be included within a minimum rate structure, of the standards for determinging the reas- onableness of rate levels, and to suggest specific rate levels under those stand- ards.

The Justice Department, in its January 17, 1969, filing with the Commission, has submitted a plan for the gradual introduction of negotiated exchange com- mission rates.

ACCESS

I now turn to the problem of access to exchanges and other markets for ex- change-listed securities. For Commission rate purposes, NYSE rules recognize only two types of entities, members and non-members. Non-member broker-dealers must pay the full public rate to execute trades on that Exchange. To make a profit on transactions in NYSE listed securities, broker-dealers that are not mem- bers of that Exchange must either utilize the regional exchanges, the third market or rely upon reciprocity from member firms to recoup some of the minimum com- missions paid.

Many broker-dealers have joined regional exchanges which trade in securities listed on the NYSE, so called dually traded issues. Over the years, the regional exchanges' trading in such securities has come to account for all but a very small portion of their volume. To the extent that orders in dually traded securities can be executed on the regional exchange, sole members (that is firms which are members only of the regional exchanges) have the same advantages as they would obtain by membership on the primary exchange. Where an order or part of it cannot be executed on the regional exchange, it is forwarded to the primary exchange market. Though the sole member of the regional exchange pays the dual member (i.e., a firm which is a member both of the regional and primary exchanges) the full non-member NYSE commission, reciprocal practices of long standing enable him to recoup 40–50% on other trades effected by the dual mem- ber on the regional exchange. Unlike the NYSE, some regional exchanges also provide reduced commissions for orders off non-member broker-dealers which can be executed on the regional exchange.

Non-member broker-dealers also may execute in the third market customers' orders in several hundred of the most commonly traded exchange-listed securi- ties. The broker-dealer buys or sells stocks at prices competitive to those on the Exchange and charges the customer a commission. If the security is not traded in the third market, the non-member will have to pay a full exchange commission, although we understand that some broker-dealers manage, through reciprocal practices, to recoup part of the commissions thus paid.

The New York Stock Exchange has argued that the diversion of any business from the NYSE market is undesirable. They call it "fractionalizing" the central- ized auction market. On the other hand, testimony has been received from the regional exchanges and third market makers that these market places have produced competition which is in the public interest. Competition from the re- gional exchanges has included innovations such as centralized bookkeeping services and improved clearance methods for member firms which have enabled them to compete more effectively. The third market makers have offered price competition. Resolution of the commission rate structure questions may well require an assessment of the actual and potential benefits of competition from these market places.

Unlike fund managers who look to independent broker-dealers for the sale of fund shares, fund managers that rely on their own "captive" sales organizations have not had the need to utilize exchange commissions to reward broker-dealers for fund sales. Other institutions such as insurance companies, pension funds and college endowments also have not needed to use portfolio brokerage for such purposes.

Some of these institutions have indirectly joined regional exchanges through membership of their broker-dealer affiliates. They have thereby succeeded in returning to the small investors who comprise the institution all or part of the profits directly or indirectly obtained by the regional exchange affiliate from the institutions' portfolio brokerage.

The regional members affiliated with such institutions have in some cases limited their activity to obtaining reduced commissions on the fund's portfolio brokerage. In other cases such members have increasingly engaged in various aspects of the exchange brokerage business in competition with other member firms. Other institutions have been content to invest in an established regional exchange firm in the hope of realizing profits from business unrelated to the parent company's portfolio brokerage. Still other institutions have indicated that they prefer not to enter the brokerage business provided they obtain concessions as to commissions on exchange portfolio transactions.

Reduced to its simplest terms, the question of non-member access is whether there should be preferential reduced commission rates for orders from broker-dealers who are not already members of an exchange. As I have previously noted, a few of the exchanges permit such access. The New York Stock Exchange does not. Moreover, the New York Stock Exchange, like other exchanges, has a fixed number of seats or memberships available for sale. Thus, the broker-dealer who desires to obtain the benefits of the reduced rates of commissions for members has to buy a seat from another member at the going rate. Seats on the New York Stock Exchange recently have sold in the neighborhood of $500,000.

Since the NYSE is the primary market for most securities listed on it, a non-member broker-dealer cannot—though he may resort to the regional exchanges, the third market and various reciprocal techniques—obtain direct access to the primary market. Whether or not the indirect approaches are fully satisfactory from the standpoint of the public and the industry is one of the matters to be further considered during the course of the hearings. The regional exchanges and others have pointed out that if the New York Stock Exchange permits a substantial professional discount to broker-dealers who are not members of the Exchange, this could have a substantial effect on the attractiveness of membership on the regional exchanges.

The access problem has another aspect to it. So far, I have been discussing the issue of access of professionals to the exchange markets. In 1954, the New York Stock Exchange adopted Rule 394 which restricted access by its members to the third market. The Rule in effect required all members to execute all of their trades on the New York Stock Exchange or another exchange of which they were a member. Members were prohibited from dealing with third market makers unless they charged such market maker the minimum New York Stock Exchange rate. This provision made it impossible for the member firm to obtain for its public customers benefits from dealing in the third market. In 1966, at the Commission's request, the Exchange adopted Rule 394(b) which allows members to go off-board and deal net with certain qualified third market makers, when they can thereby obtain a better price for their public customer. However, there has been testimony in the commission rate structure hearing by certain non-member firms that this new rule has not been achieving its objective because of the complex and cumbersome procedures required under it.

INSTITUTIONAL MEMBERSHIP

The issue of access also is related to the subject of institutional membership on exchanges. Simply speaking, the question is whether financial and other institutions such as mutual funds and insurance companies should be permitted directly, or through broker-dealer affiliates, to become members of national securities exchanges. There are at least two types of institutional membership. One is the case where the financial institution desires to use the seat to benefit from the reduced cost of commissions on its own transactions. The second is the acquisition of a seat by an institution for the purpose of engaging in the traditional brokerage business for others. A number of institutions through broker-dealer affiliates already have seats on some of the regional exchanges and use these seats for one or both of these purposes. Among them are some of the largest mutual funds, as well as insurance companies and other financial institutions. The NYSE prohibits such membership through a rule requiring that all partners or voting shareholders of a member firm be engaged full time in the securities business. However, there are certain members of the NYSE which are investment advisers to affiliated investment companies, some of which obtain indirect benefits in the form of reduced management fees as a result of the member firm handling their exchange transactions.

In one sense, institutional membership is purely a commission rate issue. In other words, an institutional member of an exchange may obtain the benefit of a discount in commission rates when executing transactions in its portfolio of commission stocks. In another sense, the question of institutional membership bears upon the future structure of the securities industry.

The objections to institutional membership are stated in terms of an inability of exchanges to regulate institutional members or their affiliates and a concern that a loss in commission revenue will impair the ability of the traditional brokerage community to service public investors. On the other hand, proponents of

such institutional membership point to the values of permitting increased competition in the securities industry resulting from the entry of new firms.

A very closely related issue concerns public ownership of member firms. I refer to a New York Stock Exchange requirement which has the effect of preventing ownership of member firms by the public or by publicly-owned corporations. There are less sweeping restrictions in the rules of other exchanges. By way of background, I should point out that it has only been in recent times that the question of the public ownership of firms, stock and bonds assumed significance. Not until 1953 were New York Stock Exchange firms permitted to incorporate their organization. Until then the Exchange took the position that corporations, with their ability to spread their ownership among numerous stockholders, would be less susceptible to Exchange control than would partnerships. In permitting incorporation, the Exchange specifically retained control over who could qualify as a stockholder.

In the past year or so, the New York and American Stock Exchanges, recognizing the need for more long-term capital to handle expanded business, have begun to reconsider their provisions on the question of public ownership. Removal of the restrictions on public ownership would force these exchanges to deal directly with the question of institutional membership since financial institutions are publicly owned. Institutional membership as such is, in turn, closely intertwined with the question of commission rates for institutional business since the prospect of commission savings is a major incentive to some institutions to seek Exchange membership.

The issues I have discussed are still being developed in our current commission rate structure hearings. Other issues which I have not discussed today are related to the matter of commission rate structure and will be the subject of further testimony in the hearing. These include the matter of intra-member commission rates, access to transaction and floor information by competing markets, the impact of automation on competition between markets in exchange-listed securities, the determination of what practices are developing under the interim rate structure that became effective on December 5, 1968, and related matters.

I wish to make clear that the Commission intends to proceed as expeditiously as possible with the commission rate structure hearing. While issues which are the subject of the hearing are interrelated in varying degrees and while some of them may of necessity be the subject of long term studies, we shall give the complex issues our most careful consideration and we shall deal promptly with those issues which we find susceptible of separate and prompt resolution.

While we intend to deal with these matters promptly, I do not believe it would be appropriate for me or for any other member of the Commission now to attempt to reach conclusions concerning the issues as to which the record is incomplete and as to which we have not had the benefit of staff recommendations or the views of all interested persons.

Senator BENNETT. Mr. Chairman, may I ask questions for the record at this point?

Senator WILLIAMS. Surely.

Senator BENNETT. Mr. Chairman, do you have any impression as to when this hearing may be concluded and the report might be available?

Mr. BUDGE. Senator Bennett, I asked that question of the officer of the Commission who is conducting the hearing, presiding over the hearing and also of the Director of the Division of Trading and Markets this morning. They cannot give me an estimate as to the closing of the evidentiary hearing because of the nature of the seven elements that are imposed in the order of investigation. Some of those, obviously, are going to take quite some time. However, we do not intend to wait until we can wrap up the entire package, we intend to proceed with the commission rate structure and such other matters as we can determine in the relatively near future. Some of the other conclusions regarding some of the seven investigatory areas obviously will take some time, but we don't intend to wait for the completion of all seven before we attempt to resolve the individual ones numbered one through seven.

I should say, regarding the back office problem, Mr. Chairman, that I have been furnished this morning, just before entering the committee room figures indicating that the picture on the fails situation as represented in the back office problem has improved considerably just in the last week. On the New York Stock Exchange, the figures given me by the staff this morning, staff of the Commission, fails to deliver are minus 6.81 and fails to receive are minus 8.95 percent.

On the American Stock Exchange they are minus 7.34 percent on the fails to deliver; minus 12.85 percent on the fails to receive.

The figures for the preceding week and the dollar figures which are represented by this change in the *fails* are set forth, and I can give you the figures which I have, and I can furnish them for the record, should the chairman so desire.

Senator BENNETT. Mr. Chairman, I think that we should ask that it be furnished for the record.

Senator WILLIAMS. If that is possible.

Mr. BUDGE. Thank you.

(The figures referred to follow:)

(Memorandum, May 5, 1969)

Subject: Back Office.

We have today received the report of fails from the New York Stock Exchange based on its 54 member weekly sample. The figures are as follows:

NEW YORK STOCK EXCHANGE

Fails to deliver (three zeros omitted)	*Fails to receive* (three zeros omitted)
Week ending 2/28/69 1,050,000	Week ending 2/28/69 1,388,000
Week ending 2/21/69 1,127,000	Week ending 2/21/69 1,524,000
Decrease in fails from 2/21–28/69 —77,000 (Minus 6.81%)	Decrease in fails from 2/21–28/69 —136,000 (Minus 8.95%)

AMERICAN STOCK EXCHANGE

Fails to deliver (three zeros omitted)	*Fails to receive* (three zeros omitted)
Week ending 2/28/69 390,759	Week ending 2/28/69 401,439
Week ending 2/21/69 417,401	Week ending 2/21/69 460,621
Decrease in fails from 2/21–28/69 —30,642 (Minus 7.34%)	Decrease in fails from 2/21–28/69 —59,182 (Minus 12.85%)

MUTUAL FUND LEGISLATION

Mr. BUDGE. The mutual fund legislation which we proposed in the last session of Congress and the background of that proposal, including the Commission's Report on the Public Policy Implications of Investment Company Growth, are in our last two annual reports to the Congress. This committee, of course, is very familiar with this legislation, since the full committee held extensive hearings at the last session of Congress and developed a bill which was reported out and passed the Senate on July 26, 1968. Consequently, I will not repeat that

background here but will merely discuss the differences between the legislation we proposed and the mutual fund legislation now pending in the Senate.

This, as I see it, is represented by S. 34, introduced by Chairman Sparkman on January 15, and S. 296, introduced by Senator McIntyre on January 16. S. 34 is identical with the legislation which passed the Senate at the last session. These two bills differ in certain respects which I will mention later.

Turning now to S. 34, I would like to say at the outset that in proposing legislation in this area, the Commission recognized that the Investment Company Act of 1940 is very important legislation and had worked very well in dealing with the specific abuses at which it was aimed, but that the dramatic growth of the industry and the changes which accompanied that growth created certain situations which were not anticipated in 1940.

While most of the changes in the statutes which we proposed and which are embodied in S. 34 were accepted, or even welcomed by the industry, they took exception to certain recommendations of the Commission, and S. 34 modified the Commission's proposals in those respects.

The principal changes are in four areas: management compensation, sales charges generally, the so called front end load, and finally, provisions dealing with certain bank-administered funds under the Federal securities laws and other laws, together with corresponding provisions relating to the employee plans funded by group variable annuities issued by insurance companies.

MANAGEMENT COMPENSATION

The Commission's proposals would have required that investment advisory and management compensation paid by a registered investment company shall be reasonable, would have specified certain criteria for determining reasonableness, and would have made this standard enforceable in the Federal courts. The principal modifications of this requirement contained in the corresponding provisions of S. 34 are that—

(1) Compensation shall be presumed reasonable if it has been approved or ratified by the affirmative vote of the owners of a majority of the outstanding voting securities and by a majority of the directors of the investment company, who are not interested persons;

(2) If the court determines that the board of directors of the investment company acted with due care in approving the compensation, then there may be no monetary recovery for any period prior to the institution of the action, or, in the case of an investment advisory contract, prior to the termination date of such contract;

(3) No action may be maintained by a security holder under these provisions unless the Commission refuses or fails to bring such action within 6 months after written request by the security holder.

SALES LOADS

The Commission's proposals would have limited the sales load for investment company shares to 5 percent of the amount received and invested by the investment company, subject to authority in the Commission to grant exemptions from this provision.

Section 12(a) of S. 34 would replace this provision with a grant of jurisdiction to the National Association of Securities Dealers, Inc., to adopt rules designed to prevent "excessive sales loads" but allowing for reasonable compensation for sales personnel, broker-dealers, and underwriters and for reasonable sales loads to be charged to investors.

The Commission would be authorized, after the expiration of 18 months from the enactment of the bill, to alter or supplement such rules of the NASD in the manner provided in section 15A(k)(2) of the Securities Exchange Act and would also be granted authority, comparable to that of the NASD, with respect to sales loads charged by dealers who are not members of that association, but such nonmember dealers would have an election to be governed either by the Commission's rules or by the NASD's rules.

FRONT-END LOADS

The Commission proposed to eliminate the so-called front-end load whereby 50 percent of the first year's payments on a periodic payment plan may be deducted for sales charges and would have required that the charges be spread equally over each installment. Section 16(a) of S. 34 would spread the front-end load over a 4-year period, permitting not more than 20 percent of any 1 year's payments to be deducted for sales charges.

BANK-ADMINISTERED FUNDS AND GROUP VARIABLE ANNUITIES

S. 34 contains provisions to deal with certain questions as to the status under the Federal securities laws, and certain other laws, of bank-administered, collective managing agency accounts, and bank-administered pension and welfare plans, including H.R. 10 plans.

Whether banks should be allowed to enter the field of collective managing agency accounts, which resemble mutual funds, is a matter of national policy within the primary jurisdiction of the Congress and agencies of the Government other than the Commission. The Commission does not consider that its responsibility extends to this question and it neither expresses nor implies any views thereon. In his testimony before the House and Senate committees with respect to these provisions, former Chairman Cohen expressed certain reservations with respect to the treatment accorded bank-administered funds of various types under the Securities Act of 1933 and the Securities Exchange Act of 1934. In general, S. 34 does not adopt these suggestions.

With respect to group variable annuities administered by insurance companies, we recognize and understand the reasons which led the insurance industry to advance these proposals. Basically, they seek exemptions comparable to those afforded to banks, both under the existing provisions of the Investment Company Act and under the proposals relating to bank-administered funds contained in S. 34.

There are, however, differences, both in method of operation and in existing regulation, between banks and the insurance companies, and at the last session of Congress, the Commission expressed a preference for dealing with the problems of the insurance industry, including its competitive problem, administratively.

As we then mentioned, we have been conducting extensive discussions with representatives of the insurance industry in an effort to arrive at a satisfactory solution, and just this week we published for comment a proposed set of rules which would deal with the status of group variable annuities under the Investment Company Act and under the Securities Act. Problems under the Securities Exchange Act have been largely resolved by administrative action. We recognize, of course, that the insurance industry would prefer the broader exemptions contained in S. 34, particularly if the banks are to expressly receive comparable exemptions.

Senator BENNETT. Mr. Chairman, I would ask that those proposed rules be included in the record.

Senator WILLIAMS. I would think that there would be no objection. Is it strictly a matter of practice for the committee to receive those proposals as they come forward, and the rules that you have issued?

Mr. BUDGE. If that has not been done, Mr. Chairman, I will see that it is done.

Mr. LOOMIS. I will see if I have them.

Senator BENNETT. I think you need not take time now.

Mr. BUDGE. They will be furnished at this point in the record.

Senator WILLIAMS. And we will include them.

Mr. BUDGE. Thank you, sir.

(The rules referred to are as follows:)

(Investment Company Act, Release No. 5628, and Securities Act of 1933, Release No. 4954, Mar. 6, 1969)

NOTICE OF PROPOSALS TO (1) ADOPT RULE 6e–1 UNDER THE INVESTMENT COMPANY ACT OF 1940 RELATING TO CERTAIN SEPARATE ACCOUNTS OF INSURANCE COMPANIES IN WHICH EMPLOYER OR EMPLOYEE CONTRIBUTIONS UNDER QUALIFIED PENSION AND PROFIT-SHARING PLANS ARE HELD AND INVESTED AND (2) AMEND RULE 156 UNDER THE SECURITIES ACT OF 1933 RELATING TO TRANSACTIONS INVOLVING SUCH SEPARATE ACCOUNTS

Notice is hereby given that the Securities and Exchange Commission has under consideration the adoption of Rule 6e–1 under the Investment Company Act of 1940 ("Investment Company Act") which would exempt from the registration requirements of the Investment Company Act certain separate accounts established by life insurance companies upon the condition that such accounts comply with all but certain designated provisions of the Act and meet other requirements set forth in the proposed rule. The proposed rule would be adopted pursuant to the authority granted to the Commission in Sections 6(c), 6(e) and 38(a) of the Investment Company Act.

Notice is also given that the Commission has under consideration an amendment to Rule 156 under the Securities Act of 1933 ("Securities Act"), relating to the proposed Rule 6e–1. Rule 156 defines "transactions by an issuer not involving any public offering" in Section 4(2) of the Securities Act to include certain transactions involving separate accounts which are now exempt from Rule 3c–3 under the Investment Company Act. The proposed amendment would extend that definition to certain transactions involving separate accounts which meet the conditions set forth in proposed Rule 6e–1 and would also provide that no "sale," "offer," "offer to sell," and "offer for sale" would be deemed to be involved, for purposes only of Section 5 of the Securities Act, in certain defined circumstances. The amendment would be adopted pursuant to the authority granted to the Commission in Section 19(a) of the Securities Act.

On January 7, 1963 the Commission adopted Rule 3c–3 (Investment Company Act Release No. 3605) under the Investment Company Act exempting from the provisions of that Act certain transactions of insurance companies involving group annuity contracts which provide for the allocation of employer's contributions to separate accounts established and maintained pursuant to state legislation which permits the income, gains and losses, whether or not realized, from assets allocated to such account to be credited to or charged against such account without regard to other income, gains or losses of the insurance company. Transactions so exempt from the Investment Company Act by Rule 3c–3 were also given the status of "transactions by an issuer not involving any public offering" in Section 4(2) of the Securities Act, provided certain conditions were met, by the adoption by the Commission on August 1, 1963 of Rule 156 under the Securities Act (Securities Act Release No. 4627).

On July 2, 1964, the Commission amended Rule 3c–3 (Investment Company Act Release No. 4007) to extend the exemption provided by that rule to group annuity contracts which met all the conditions of the original Rule 3c–3 other than the requirement that benefits be payable only in fixed-dollar amounts. Thus, under the amended Rule 3c–3, certain transactions involving group contracts which provide for retirement benefits that vary to reflect the investment experience of a separate account are also entitled to exemption, provided those benefits derive solely from contributions of the employer. The amended rule continued the condition of the original rule that the contract must prohibit the allocation to the separate account of any payment or contribution made by an employee.

Since the adoption and amendment of Rules 3c–3 and 156, the Commission has continued to consider the appropriateness of new rules which would permit certain exemptions from the Investment Company Act and the Securities Act for insurance company separate accounts to which employee contributions may be allocated, subject to appropriate restrictions for the protection of investors.

Proposed Rule 6e–1 would apply to separate accounts which hold assets attributable only to pension and profit-sharing plans which meet the requirements for qualification under either Section 401 or 404(a)(2) of the Internal Revenue Code. These are commonly referred to as "qualified plans." They include plans established for self-employed persons pursuant to the provisions of the Self-Employed Individuals Tax Retirement Act of 1962 ("Smathers-Keogh plans"), since those plans also meet the requirements of Section 401 or 404(a)(2). Unlike Rule 3c–3, the proposed rule does not condition the exemption by requiring a prohibition against the allocation of employee contributions to the separate account. Thus, separate accounts which meet the more restrictive conditions for exemption under Rule 3c–3 will continue to enjoy the much more extensive exemption from the Investment Company Act provided by that rule while, on the other hand, a wider variety of pension and profit-sharing plans will be able to be funded through contracts participating in separate accounts which qualify for the narrower exemption under proposed Rule 6e–1.

Proposed Rule 6e–1 provides that certain separate accounts are exempt from Section 7, which effectively prohibits an unregistered investment company from operating, and Section 8, which provides for the method of registration and the content of the registration statement. In place of the notification of registration provided for by Section 8(a), an insurance company may file a notification of claim of exemption under Rule 6e–1 on Form N–6E–1 to be promulgated. In place of the registration statement required by Section 8(b), the insurance company will file a report on Form N–6E–2 to be promulgated.

The proposed Rule 6e–1 would also provide that such separate accounts must comply with every provision of the Investment Company Act as if they were registered open-end investment companies, except for a number of specified sections of the Investment Company Act. In addition to Sections 7 and 8, exemption would be granted from Section 18(i) so that persons who hold participating interests in the separate account will not be required to be given any voting rights. In consequence, and since such separate accounts will not have a separate board of directors, exemption would also be granted from the other provisions of the Act which, broadly speaking, provide the opportunity for shareholder participation in the management of registered investment companies. These provisions include Sections 10 (other than subsection (f) thereof), 15, 16, 20 (a) and (b), and 32 (a) and (b). A conditional exemption would be granted from Section 13(a) which requires majority shareholder approval of

any change in the fundamental investment policy of a registered investment company. Instead, the Commission must be notified in writing at least 60 days prior to any proposed change in the investment policy of a separate account. The change may then be made unless the Commission, within 30 days of the receipt of such notice, conditions or limits the exemption provided by the rule.

A partial exemption from Section 9 is proposed which would make the restrictions of that section applicable only to officers and directors of the insurance company and to other employees who participate either in the administration of the separate account or in the sale of participating contracts.

A limited exemption from the provisions of Section 14(a) is provided in order to afford separate accounts claiming exemptions from the provisions of the Investment Company Act under Rule 6e–1 with the same treatment which the Commission has proposed in Investment Company Act Release No. 5586 (January 24, 1969) for registered separate accounts having assets derived solely from pension and profit-sharing plans meeting the requirements of Sections 401, 403(b) or 404(a) of the Internal Revenue Code. That is, exemption from the minimum capital requirements of Section 14(a) would be afforded by Rule 6e–1 where the insurance company has a combined capital and surplus or an unassigned surplus of at least $1,000,000.

A narrow exemption from Section 17(d) is proposed. Most life insurance companies currently invest some portion of their general funds in common stocks and it is anticipated that many companies will establish more than one separate account that will qualify for exemption under Rule 3c–3 or the proposed Rule 6e–1. While the investment policies of these separate accounts may differ, there will be times when an insurance company will wish simultaneously to purchase the same security or sell the same security, on behalf of its general accounts and one or more of its separate accounts. Proposed Rule 6e–1 would grant exemption from Section 17(d) to permit contemporaneous purchases or contemporaneous sales of the same class or series of securities of the same issuer on behalf of separate accounts and the general account of the insurance company. Except to the extent provided by this exemption, Section 17(d) will be applicable to transactions of separate accounts claiming exemption under this rule exactly as if such accounts were registered investment companies.

The proposed rule would grant an exemption from Section 17(f) to allow securities held in a separate account claiming exemption under the rule to be held in the custody of the insurance company. Exemption from Section 19 is proposed since separate accounts do not pay dividends in the sense in which the term is used in this section.

Because of the manner in which insurance companies negotiate and sell contracts respecting interests in separate accounts for funding pension and profit-sharing plans, the Commission believes that it is not necessary to impose all the requirement of Section 22 on such separate accounts. Thus exemptions from Sections 22(a), (b), (d), (e) and (f) are proposed. No exemption is proposed, however, from Section 22(c), so that the Commission will retain jurisdiction to prescribe means of pricing of interests in such accounts and prevent the imposition of unconscionable or grossly excessive sales loads. Similarly, no exemption from Section 22(g) is proposed, since the Commission believes there is no reason why separate accounts should not observe the prohibitions of this section.

Since most contracts that participate in a separate account meeting the conditions of Rule 6e–1 will be exempt from the registration requirements of the Securities Act, under the amendment to Rule 156 that is simultaneously being proposed, the provisions of Section 24 of the Investment Company Act, other than subsection (b), would not be meaningful as applied to such accounts. However, exemption from the entire section is proposed, including Section 24(b), since the proposed rule, in paragraph (b), would impose separate specific filing requirements with respect to literature prepared by the insurance companies that relate to the operations of such separate accounts. These requirements are discussed below. Similarly, exemption is proposed from Sections 30 and 31(a), which require periodic reporting to the Commission and to stockholders and the keeping of prescribed records. In place of these requirements the proposed rule will require reports and records in a form which takes into account the nature of the contracts issued through such separate accounts and the manner in which such accounts are administered.

An exemption from Section 27(c) is proposed in recognition of the fact that annuity contracts with life contingencies are necessarily non-redeemable during the payout period.

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Paragraph (b) of proposed Rule 6e-1 sets forth the several report and record-keeping requirements that have already been mentioned. Subparagraphs (1) and (2) require the filing of initial reports which correspond to the notification of registration and the registration statement filed by investment companies. Subparagraph (3) requires the filing of such annual and other reports and the maintenance of such records with respect to separate accounts as the Commission shall prescribe as appropriate.

Subparagraph (b)(4) requires the insurance company to furnish a written statement to every employer to which a contract participating in the separate account has been issued, if the retirement plan provides for benefits which vary to reflect the investment results of the separate account. That statement must explain, to the extent applicable to the particular employer's retirement plan, that the benefits to be received by employees will not be paid in any fixed dollar amount but will vary to reflect the investment experience of the separate account, and that the assets held in the account will include common stocks and other equity investments. In addition, the statement must describe how the insurance company will determine the dollar amount of each periodic payment to be made to the covered employees pursuant to the plan. A copy of the statement must be filed with the Commission within 10 days after it is delivered to any employer.

The insurance company must recommend to the employer that this statement should be transmitted to each covered employee. While it appears desirable that each employee be given a copy of such a statement, it is the employer, rather than the funding agency, that controls what communications are delivered to its employees. Accordingly, it would not be feasible to impose such an obligation upon the insurance company. Although this section is not intended to impose any duty upon employers to transmit copies of this required statement to their employees, responsible employers will, of course, wish to be certain that their employees are given the information set forth in this required statement.

Subparagraph (b)(5) would also impose upon insurance companies claiming exemption under the proposed rule the requirement to file certain other documents with the Commission. Virtually every employer that establishes a pension or profit-sharing plan will provide its covered employees with a booklet or brochure describing the principal features of the plan. Sometimes a copy of the plan itself is distributed. In some cases this description is prepared entirely by the employer. In many cases the funding agency will participate in its preparation, supplying information for part of the brochure. In other cases the funding agency will be entirely responsible for the preparation and printing of this descriptive material. This subparagraph does not require any participation by the insurance company in the preparation of this explanatory literature. It does require, if the funding agency does furnish the employer with all or some portion of a document that is transmitted to employees, or if it provides the employer with material that may reasonably be expected to be transmitted to employees, that a copy of what has been furnished the employer, if it relates in any way to the separate account, be filed with the Commission within 10 days after it is first delivered to an employer.

Subparagraph (c) of the proposed rule sets forth two conditions that must be met by a separate account in order to be exempt under the rule. The first is that the separate account be legally segregated and not subject to claims which arise out of any other business of the insurance company. Because the value of the assets held in separate accounts will be related not only to investment performance but also to the longevity of covered employees, formulation of this condition has required the use of insurance terminology. The reserve and other contract liabilities under all contracts that participate in a separate account, which is the equivalent of the value of all present and future payments that the insurance company is obligated to make under the contracts, can be determined only by actuarial computations. This amount, moreover, will vary from time to time to take into account the deaths of persons who were entitled to payment of benefits under the contracts. To the extent that the market value of the assets in a separate account exceeds the reserve and other contract liabilities of the account, the excess is part of the surplus of the insurance company. Subparagraph (c)(1) of the proposed rule recognizes that this portion of the assets held in a separate account must be subject to claims arising out of other business of the insurance company. The subparagraph also provides that the value of the assets of the account must not be less than the reserve and other contract liabilities of the account. Thus the insurance company is free to transfer any or all of the excess from a separate account to its general funds. If, however, the value of the assets

should fall below the amount of the reserve and other contract liabilities, the insurance company is required to eliminate the deficiency by transferring funds to the account.

Under the laws of many of the states which authorize the establishment of separate accounts by life insurance companies, such accounts will either be legally segregated to the extent required by this subparagraph or can readily be made segregated through the addition of appropriate provisions in the participating contracts. Some states require legal segregation but other states do not require nor permit such segregation. This condition will be satisfied if an arrangement is made which will ensure, in the event of bankruptcy of the insurance company, that claims of creditors that arise out of other business of the insurance company will not be satisfied out of assets held to meet the separate account contract obligations. This might be accomplished, for example, through some form of insurance with a different insurance company, or by provision of a superior lien under applicable state law. Because insurance companies in some states may find it difficult to make the necessary arrangements to comply with this condition, it is provided that the condition need not be satisfied until six months after the effective date of the rule.

The second condition is that every contract which participates in a separate account claiming exemption under the rule must authorize the contract holder to direct that the assets held pursuant to his contract be withdrawn or transferred. This will enable a contract holder, if he chooses, to utilize a different funding agency for the investments of the funds supporting his plan. This withdrawal privilege would not, however, apply to funds allocated to provide benefits to the individual employees who have retired, since the insurance company would in such cases have assumed direct contractual obligations to pay those benefits. In some cases these benefits might be payable to persons other than employees, as in the case of a plan which provides for the payment of an annuity to an employee and his spouse so long as either shall live. Amounts held to provide for the payment of benefits to the spouse of a deceased employee under such an arrangement would also not be required to be made subject to this withdrawal provision.

Many existing contracts already contain such a provision. These usually provide for a limitation upon the amount that may be withdrawn in any one month. This is to protect against a large drain upon the assets of the account, causing a forced liquidation of some of the securities, to the possible disadvantage both to the withdrawing contract holder and to other contract holders. Such a limitation is authorized under the proposed rule, provided that the contract must permit the withdrawal of at least $1 million in any one month, or, where the value of the contract holder's interest in the separate account at the time the request for withdrawal or transfer is made is in excess of $20 million, at least 5 percent of the value of that interest.

The proposed rule also provides that no surrender charge in excess of 2 percent may be made in connection with any such withdrawal or transfer. Many contracts employed for the purpose of funding pension and profit-sharing plans impose no sales load at all in connection with purchase payments but do impose what would be the equivalent of a sales load in connection with withdrawals or the payment of benefits. In order to accommodate these arrangements, subparagraph (c)(2) permits a surrender charge in excess of 2 percent but only if the sales load and the surrender charge under the contract in the aggregate do not exceed 6 percent.

Section 6(c) of the Investment Company Act provides that the Commission by rule, regulation or order may conditionally or unconditionally exempt any person, security, or transaction, or any class of persons, securities, or transactions, from any provision or provisions of the Investment Company Act, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Investment Company Act. Section 6(e) of the Investment Company Act provides that if, in connection with any rule, regulation or order under Section 6 exempting any investment company from any provision of Section 7, the Commission deems it necessary or appropriate in the public interest or necessary for the protection of investors that certain specified provisions of the Investment Company Act shall be applicable in respect of such company, the provisions so specified shall apply to such company and to other persons in their transactions and relations with such company, as though such company were a registered investment company. Section 38(a) of the Investment Company Act authorizes the Commission to issue rules necessary or appropriate to the exercise of the powers conferred upon the Commission in the Investment Company Act.

RULE 156

Rule 156 under the Securities Act, as presently in force, defines as "transactions by an issuer not involving any public offering" in Section 4(2) of that Act transactions which are exempted from the Investment Company Act by Rule 3c–3 provided that certain additional conditions are met.

In connection with its proposal to adopt Rule 6e–1 the Commission also proposes to amend Rule 156. Paragraph (a) generally follows the present Rule but would cover transactions involving contracts which relate to separate accounts claiming exemption either under Rule 3c–3 or Rule 6e–1, instead of only under Rule 3c–3. This paragraph continues to cover only transactions with employers and has no applicability to any transaction whereby an employee acquires an interest in a separate account.

The present Rule 156 is applicable only to contracts which are negotiated with an employer for the benefit of at least 25 employees because this is one of the conditions for exemption under Rule 3c–3. Since the proposed Rule 6e–1 would not have any such condition, it is proposed to make such a requirement an explicit condition in subparagraph (a)(1) of the amended Rule 156.

The term "employer" is defined, as it is in the present Rule 156, to mean "an employer, employers or persons acting on their behalf." This would include within the definition of transactions not involving any public offering, the sale of group contracts to trustees or associations representing several employers in a single industry. In several industries, pension and profit-sharing plans are established in connection with collective bargaining between industry-wide management representatives and unions, and these plans permit covered employees to change from one employer to another while remaining eligible for benefits under the plan. A group annuity contract issued for the purpose of funding such a plan would not, under the amended rule, as it does not now under the present rule, have to be registered under the Securities Act, if the other conditions of the rule are met.

A different test would apply, however, to contracts issued for the purpose of funding Smathers-Keogh plans. Where a contract is to cover a sole proprietorship or a partnership involving 25 or more employees, the transaction would be regarded under the rule as a transaction not involving a public offering. But where a contract is issued covering the employees of several separate enterprises, as would be the case with a contract issued to a bar or medical association permitting participation thereunder by members of the association, this would be regarded as constituting a public offering if any member of the association employed less than 25 persons. As a practical matter it would therefore appear that virtually all Smathers-Keogh contracts would be subject to the registration requirements of the Securities Act.

Paragraph (b) of the proposed amendment to Rule 156 is new. Since Rule 3c–3 provides an exemption from the Investment Company Act only for transactions involving contracts which prohibit the allocation of employee contributions to a separate account, paragraph (b) would be applicable only where allocations of employee contributions are made to a separate account which is entitled to exemption under Rule 6e–1, as part of a transaction that is regarded as not involving a public offering under Rule 156(a).

Subparagraph (b) provides that no sale or offer shall be deemed to be involved where employee contributions are allocated to a separate account under the foregoing circumstances if two conditions are met. First, there must not be any individual solicitation of employees either to participate in the plan or to elect to participate in the portion that utilizes the separate account rather than in other aspects of the plan. Second, the employer must make a "substantial contribution" to the overall pension and profit-sharing program of which the contract participating in the separate account is a part. Each of these conditions is described more fully below.

The first condition is set forth in subparagraphs (b)(1) and (b)(2). It is recognized, of course, that employees who are offered an opportunity to make contributions under a retirement program must be told about the plan and about the terms and nature of their participation. Booklets describing the plan may be distributed by the employer or the insurance company. Regular employees of the employer, in its labor relations, personnel, or comparable divisions may meet with employees either in groups or singly, to discuss and explain the plan and to make whatever recommendations are thought appropriate. Where a pension consultant has been retained by the employer, he may participate in this activity.

It is common practice, when a retirement plan is first established or a significant change made, or new features added, to provide oral explanations to groups of employees at meetings arranged for that purpose. Representatives of the insurance company or, where an independent broker has participated in the sale of the contract, representatives of the broker, may appear at and participate in such meetings. If the provisions of subparagraph (b) are to be available, these representatives must be salaried employees and may not receive commissions based upon the extent of participation under the separate account contract. Such representatives may not, however, engage in discussions with individual employees for the purpose of inducing participation in or explaining the plan. Nor may the employer engage anyone for the purpose of inducing participation.

The "substantial contribution" condition is set forth in subparagraph (b)(3). The employer must make a contribution under the program, of which the plan funded by the separate account contract is a part, that can be expected, over the life of the plan, to be at least one-half that made by the employees. Because employers enjoy considerable flexibility in determining the amount and timing of their contributions under qualified pension and profit sharing plans, demonstration of satisfaction of this condition presents certain difficulties. For this reason the test set forth in subparagraph (b)(2) has been included.

It should be noted that the amended rule would continue to provide an exemption only from Section 5 of the Securities Act and would not, therefore, afford any exemption from the anti fraud sections of the Securities Act.

The text of proposed Rule 6e–1 under the Investment Company Act reads as follows:

"PROPOSED RULE 6e–1. EXEMPTION FOR CERTAIN SEPARATE ACCOUNTS OF INSURANCE COMPANIES

"(a) A separate account which issues only interests or participations in a fund of securities, pursuant to contracts made in connection with pension or profit-sharing plans which meet the requirements either for qualification under Section 401 of the Internal Revenue Code or for deduction of the employer's contributions under Section 404(a)(2) of said Code, shall, except for the following sections, be subject to all provisions of the Act as though such separate account were a registered open-end investment company:

"(1) Section 7;

"(2) Section 8 except to the extent made applicable by paragraph (b) of this Rule;

"(3) Section 9 but only to the extent that a company shall not be subject to the restrictions of Section 9(a)(3) by virtue of the status of persons who do not participate in any way in the operations of or sales of interests in the separate account;

"(4) Section 10 but not paragraph (f) thereof;

"(5) Section 13(a) provided that the Commission is notified in writing at least 60 days prior to any proposed change in investment policy, and the Commission does not in its discretion within 30 days of receipt of such notice condition or limit, in respect of the proposed change in investment policy, the exemption otherwise provided by this Rule;

"(6) Section 14(a) provided the insurance company of which the separate account is a part shall have (a) a combined capital and surplus, if a stock company, or (b) an unassigned surplus, if a mutual company, of not less than $1,000,000 at the time of the filing of the notification provided for by paragraph (b)(1) hereof.

"(7) Section 15;

"(8) Section 16;

"(9) Section 17(d), to the extent necessary to permit contemporaneous purchases or contemporaneous sales on behalf of the separate account and other separate accounts and the general account of the insurance company of the same class or series of securities of the same issuer.

"(10) Section 17(f);

"(11) Section 18(i);

"(12) Section 19;

"(13) Section 20(a) and (b);

"(14) Section 22 other than paragraphs (c) and (g) thereof;

"(15) Section 24;

"(16) Section 27(c);

"(17) Sections 30 and 31(a) except as provided by paragraph (b) of this Rule; and

"(18) Sections 32 (a) and (b).

"(b) Any insurance company which maintains or proposes to maintain a separate account with respect to which exemption from registration under this Rule is claimed shall:

"(1) file with the Commission, within thirty days after the effective date of this Rule or within thirty days after the establishment of such separate account, whichever is later, a notification on Form N-6E-1 which identifies such separate account.

"(2) file with the Commission, a report on Form N-6E-2 within three months after filing the notification referred to above; provided that if the fiscal year of the separate account ends within this three-month period, the Form N-6E-2 report may be filed within three months after the end of such fiscal year.

"(3) file with the Commission, such annual and other reports and shall maintain such records with respect to such separate account as the Commission shall prescribe by rules pursuant to Sections 30 and 31 of the Act as appropriate in view of the character of the separate account and its operations and as necessary or appropriate in the public interest or for the protection of investors; provided that, except as may otherwise be provided in either such rules or in this Rule or in the Forms for reports prescribed by the Commission, the provisions of *Regulation SX* under the Act shall be applicable. Records required to be maintained pursuant to such rules shall be subject to the requirements of Section 31(b) of the Act.

"(4) in the case of a contract that provides for the allocation of contributions to the separate account in connection with a pension or profit-sharing plan that provides for employee benefits which may vary to reflect the investment results of the separate account, such insurance company shall deliver to every employer to which such a contract has been issued a copy of a statement in writing setting forth, to the extent applicable, (A) that the benefits to be received by the employees will not be paid in any fixed dollar amount, and will vary to reflect the investment experience of the separate account; (B) that the investments held in the separate account will include common stocks and other equity investments which may be changed from time to time; and (C) the essential features of the procedure to be followed by the insurance company in determining the dollar amount of such variable benefits. The insurance company shall recommend to the employer that such statement should be transmitted to covered employees, and file such statement with the Commission within 10 days after delivery to any employer, and

"(5) file with the Commission, within 10 days after delivery to an employer, a copy of every document, or portion thereof, relating to the separate account or the interests or participations therein, that has been furnished by the insurance company to an employer for transmission or which may reasonably be expected to be transmitted to employees:

"(c) A separate account shall be entitled to the exemptions provided by paragraph (a) of this Rule only if:

"(1) the separate account is a legally segregated asset account, the assets of which have a value at least equal to the reserves and other contract liabilities with respect to such account, and that portion of such assets, which has a value equal to the reserves and other contract liabilities of such account, is not chargeable with liabilities arising out of any other business which the insurance company may conduct: provided that this condition need not be satisfied until six months after the effective date of this rule.

"(2) any contract which provides for allocation of contributions to the separate account, authorizes the contract holder to direct that assets held in the separate account applicable to the contract (other than amounts which, pursuant to the contract, have been allocated to provide retirement benefits to individual employees) be withdrawn or transferred, although such contract may (A) limit the amount that may be transferred in any one month to the greater of (i) $1,000,000 or (ii) 5% of the value of the contract holder's interest in the separate account at the time the original request for withdrawal or transfer is made and (B) impose a surrender charge not to exceed 2 percent of the amount transferred, provided that the surrender charge in excess of 2 percent of the amount transferred may be imposed if the sales load and surender charge, in the aggregate, do not exceed 6 percent.

"(d) 'Separate account,' as used in this Rule, shall mean a fund established and maintained by an insurance company pursuant to the law of any state or territory of the United States or the District of Columbia, under which income, gains, and losses, whether or not realized, from assets allocated to such fund, are, in accordance with the applicable contract, credited to or charged against such fund without regard to other income, gains, or losses of the insurance company.

"(e) 'Insurance company,' as used in this Rule, shall have the same meaning as that prescribed in Section 2(a)(17) of the Act."

The text of proposed amended Rule 156 under the Securities Act reads as follows:

"PROPOSED RULE 156, AS AMENDED

"PROPOSED RULE 156. DEFINITION OF 'TRANSACTIONS BY AN ISSUER NOT INVOLVING ANY PUBLIC OFFERING' IN SECTION 4(2) AND OF 'SALE,' 'OFFER,' 'OFFER TO SELL,' AND 'OFFER FOR SALE' FOR PURPOSES OF SECTION 5, IN CONNECTION WITH SEPARATE ACCOUNTS EXEMPTED BY RULE 3C-3 OR RULE 6E-1 UNDER THE INVESTMENT COMPANY ACT OF 1940

"(a) The phrase 'transactions by an issuer not involving any public offering' in Section 4(2) of the Act shall include any transaction with an employer, employers or persons acting on their behalf (herein called the employer') whereby an insurance company offers, pursuant to a contract, interests or participations in a separate account, which meets the conditions and limitations set forth in Rule 3c-3 or Rule 6e-1 under the Investment Company *Act of 1940*, provided that:

"(1) Such contract is negotiated with such employer for the benefit of at least 25 employees, provided further that, in the case of a contract which covers self-employed individuals and owner-employees some or all of whom are employees within the meaning of Section 401(c) of the Internal Revenue Code, each partnership or sole proprietor employs at least 25 employees including such self-employed individuals and owner-employees; and

"(2) Such contract is not advertised in any written communication which, insofar as it relates to interests or participations in a separate account, does more than identify the insurance company, state that it is engaged in the business of writing such contracts, sets forth a brief description of the nature of the separate account and of the basic provisions of the contract, and invites inquiries in regard thereto. The limitations of this clause shall not apply to disclosure made in the course of direct discussion or negotiation of such contract.

"(b) For purposes only of Section 5 of the Act, no 'sale,' 'offer,' 'offer to sell,' or 'offer for sale' shall be deemed to be *involved* so far as an employee is concerned (whether or not there is a public offering to the employer), where allocations of employee contributions are made to a separate account entitled to the exemptions provided by Rule 6e-1 under the Investment Company Act of 1940 pursuant to a contract which meets the conditions and limitations set forth in subparagraph (1) of paragraph (a) of this Rule, provided that:

"(1) The employer does not engage any person for the purpose of inducing employees to participate under such contract or in a plan based on such contract or of inducing any elections on the part of employees under such contract or in such plan; and

(2) Any solicitation of individual employees by or on behalf of the insurance company is limited to discussions with the employer and to furnishing the employer with explanatory documents as required or contemplated by Rule 6e-1 under the Investment Company Act, or giving oral explanations, including answering of questions, at meetings of groups of employees arranged by the employer and no commissions are paid to the persons responsible for drafting the explanatory documents or for inducing any election on the part of the employee; and

"(3) The employer makes a substantial contribution to the overall pension and profit-sharing program of which the contract is a part. An employer's contribution shall be deemed 'substantial,' as used in this Rule, if the overall pension and profit-sharing program applicable to the employees covered by the program can be reasonably expected to provide for a contribution by the employer, over a period for which the program may reasonably be expected to be in operation, which in the aggregate is at least half as much as the contributions made by the employees. The foregoing requirement shall be deemed to have been satisfied if the employer has in the preceding five fiscal years, or since the inception of the program, if less than such five years, contributed in the aggregate at least half as much under such program as have the employees and the basis for determining contributions has not been changed since such past contributions were made to reduce the employer's anticipated contributions. At the inception of a program and at any time thereafter, notwithstanding that the aggregate contributions by the employer during such five year (or shorter) period do not amount to at least half as much under such program as was contributed by the employees, or that the basis for determining contributions has changed, a written certificate by a member of the American Academy of Actuaries, prepared in accordance with generally accepted actuarial standards, stating that the employer's contribution can reasonably be expected to be at least half as much as contributions to be made by the employees over a period for which the plan may reasonably be expected to be in operation and stating the basis thereof, shall be prima facie evidence of satisfaction of the requirement of this subparagraph at that time and for the ensuing year. A copy of each such certificate shall be filed with the Commission as an exhibit to the notification or report next following such certificate, filed pursuant to paragraph (b) of Rule 6e-1 under the Investment Company Act of 1940."

* * * * * * *

All interested persons are invited to submit views and comments on proposed Rule 6e-1 under the Investment Company Act and the proposed amendment to Rule 156 under the Securities Act. Written statements of views and comments in respect of the proposed Rule and the proposed amendment should be submitted to the Securities and Exchange Commission, Washington, D.C. 20549 on or before April 8, 1969. All such communications will be available for public inspection.

By the Commission.

ORVAL L. DUBOIS, *Secretary*

Mr. BUDGE. Overall, it seems to me that the proposals which we advanced at the last session of Congress might more effectively insure fair treatment to investment company shareholders.

On the other hand, enactment of S. 34 would accomplish a great improvement over the present situation and would constitute an important reform. Consequently, if this committee prefers to accept S. 34, I would gladly accept that decision and support that bill.

Senator WILLIAMS. If you can just pause there a moment, let us get the full import of that. [Reading to himself.] Thank you.

Mr. BUDGE. S. 296 differs from S. 34, as I understand it, in only two respects: First, it would substitute the complete repeal of section 22(d), which, in effect, requires resale price maintenance in the sale of mutual fund shares, for the provision I have discussed, granting jurisdiction to the National Association of Securities Dealers, Inc., over such charges, subject to Commission oversight; and, secondly, it would, as the Commission originally proposed, eliminate the so-called front-end load rather than spreading it over a 4-year period.

The Commission has not had an opportunity to arrive at a determination with respect to the comparative merits of these two bills. My own personal view is that I prefer S. 34, since I am unable to foresee completely the consequences which a complete repeal of section 22(d) would have on the distribution and sale of mutual fund shares. I also feel the committee's action to be a fair compromise of the front-end load.

INSIDER TRADING

The matter of so-called insider trading has attracted considerable attention recently, primarily because of the fact that several important cases involving that question have been decided within the last 6 months. Consequently, it seems appropriate to discuss it briefly today.

At the outset, I would like to make it very clear that the principle that corporate insiders who trade on the basis of material information which has not been disclosed, violate section 10(b) of the Securities Act and rule 10b-5 thereunder is not something which the Commission recently invented.

This principle has its roots in the common law and was applied by the Supreme Court of the United States as long ago as 1909. Rule 10b-5 was adopted in 1942. In the Commission's first formal opinion construing this rule, it held that the failure of a corporation to disclose material facts when purchasing its own stock in an organized stock market violated the rule. In 1951, Chief Judge Leahy of the U.S. District Court for the District of Delaware put the matter in the following brief and forceful terms:

> The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers.

While the basic principle is thus clear and well settled, its application in specific cases has continued to present interesting and important questions. These include the question of who is an insider, what information is material, and when is such information deemed to be disclosed so that insiders may trade.

It was clear from the outset that corporate officers, directors, and controlling stockholders, as well as the corporation itself when buying its own stocks, are insiders.

This list, however, is not exclusive. In 1961, the Commission in the *Cady, Roberts* case, held, in effect, that any person who had a relationship with a corporation giving access directly or indirectly to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, could not trade on the basis of such information if it was material, and applied this rule to a brokerage firm which had a representative on the board of directors of a corporation. This formulation was accepted by the Court of Appeals for the Second Circuit in the well known *Texas Gulf Sulphur* case. The same basic principle was applied by the Commission to a prospective underwriter who received material information in that capacity in the *Merrill Lynch* case.

The question of what information is material is somewhat more difficult, since the answer depends to a large degree upon the facts of the particular case. The courts have generally applied two alternative phrasings of the standard of materiality in cases under the rule: First, that the information be of such a nature that it would be important to a reasonable investor, and secondly, that "in reasonable and objective contemplation" it might affect the market price of the stock.

In the cases so far decided, including the recent cases, there has been little question that the information was not only important but rather strikingly so.

The *Cady, Roberts* case involved a cut in the quarterly dividend from 62½ cents to 37½ cents; the *Texas Gulf* case involved an extraordinary mineral discovery; the *Merrill Lynch* case involved a sharp decline in the company's earnings; and the recent *Van Alstyne, Noel* case involved a fivefold increase in the earnings of the company involved.

It probably is not practicable, however, to frame a definitive definition which will make clear in every instance what information is material and what is not. In the context of a particular case, however, it is possible in the exercise of reasonable judgment to make such a determination. In that respect, the concept of material information has been likened to the situation described by Mr. Justice Stewart in one of the obscenity cases in the Supreme Court. He there stated that he was not attempting to define "hard-core pornography" and then continued by saying:

> Perhaps I could never succeed in intelligibly doing so. But I know it when I see it. * * *

The question of when information is "disclosed" for the purpose of the insider-trader decision was considered in the *Texas Gulf Sulphur* case. The court of appeals held that before insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public.

The court said that at a minimum this did not occure until the news could reasonably have been expected to appear over the medium of widest circulation—the Dow Jones broad tape. This particular ruling is the subject of a petition for certiorari now pending in the U.S. Supreme Court.

The *Texas Gulf Sulphur* case also involved the important question of whether or not an insider who himself cannot trade because he has material undisclosed inside information can pass the information on to others in order that they may make use of it.

The court held that the giving of such "tips" was likewise a violation of the act and the rule. The *Merrill Lynch* case presented a similar problem in that certain of the respondents there stipulated to a finding that they had passed on material undisclosed inside information to certain large institutional customers.

The Commission held, in accordance with the decision in the *Texas Gulf* case, that this also was a violation of the rule. The *Merrill Lynch* case also presented the question, which was referred to in the *Texas Gulf Sulphur* case, but not there presented or decided, as to whether a person who receives such a tip violates the rule if he acts on it while the information is still undisclosed. That phase of the *Merrill Lynch* case is now pending before a Commission hearing officer and may be expected, in due course, to come before the Commission, and consequently it would not be approriate for me to discuss it here.

The fact which I earlier referred to, that, largely by coincidence, several important cases involving insider trading have been decided by the courts and the Commission within the last 6 months has given rise to some concern in the financial community that corporate officials can no longer disclose information to interested financial analysts, stockholders, and others unless they make it the subject of a public release, and that a desirable flow of corporate information will thereby be restricted. In my view this concern is unwarranted.

Although it appears that for a while last summer and fall, certain corporate officials and their counsel reacted and, in my view, over-

reacted in this direction, I believe it is now coming to be recognized that the principles announced in the *Texas Gulf Sulphur* and other cases will not unduly restrict the flow of corporate information; on the contrary, they should increase and expedite that flow.

If insiders were in a position to trade upon material undisclosed information, they would have an incentive to delay or manipulate disclosure in order to take advantage of the information. Since, however, recent cases have determined that they are not entitled to trade on this information, they have an incentive to disclose it promptly so that any transaction which they may wish thereafter to have will not raise a question as to a possible violation of rule 10b–5.

Thus, the decisions in the insider-trading area reinforce the policy of the New York Stock Exchange as restated this summer that any corporation whose stock is listed on the exchange is expected to release promptly any information which might reasonably be expected to affect the market for its securities.

Moreover, as various members of the Commission and its staff have made clear in recent public discussions of the question, the principles announced in these cases do not prevent corporations from discussing their affairs with shareholders or security analysts, provided that any material undisclosed information is disseminated publicly to all investors rather than being communicated to a few. In determining what information may be given to persons who inquire, a useful guideline is whether or not the corporation would be willing to disclose this information to any interested person. Information which a corporation has determined to keep secret is more likely to be material inside information.

Thus, I believe that the principle which has been developed by the Commission and the courts over the years with respect to the use and abuse of material inside information will not only improve the quantity and quality of disclosures in our security markets but will also contribute significantly to the maintenance of fair and honest markets and to the presentation of investor confidence in those markets.

After all, if the ordinary investor is to get the impression that insiders and professionals can deal with him on the basis of important information not available to him, he might well conclude that the securities markets were a safe place only for insiders and professionals. Such a conclusion would of course inflict grave harm upon our markets and the economy, and the Commission will continue to do its best to make sure that such conditions do not prevail.

REPORTING FOR CONGLOMERATE COMPANIES

The rapid increase in recent years in the number of companies of the conglomerate type was brought forcibly to public attention by testimony given before the Senate Subcommittee on Antitrust and Monopoly in 1965. In response to an inquiry from the subcommittee, the Commission submitted a memorandum in which its disclosure requirements were explained and some of the accounting problems involved in refining and extending those requirements were discussed.

It was pointed out that the Commission had for many years required companies, whose business consists of the production or distribution of different kinds of products or the rendering of different kinds of services, to include in most registration statements filed under the 1933 and 1934 acts information regarding the relative importance of each product or service or class of similar products or services which contributed 15 percent or more to the gross volume of business.

In May 1966 former Chairman Cohen, in an address before the 19th Annual Conference of the Financial Analysts Federation, discussed the need for more informative financial reporting for the conglomerate company, which he defined as a large corporation engaging in a number of distinct lines of business under the same corporate roof. Following this discussion, Chairman Cohen was invited to testify on this subject before the Antitrust and Monopoly Subcommittee. In his testimony he emphasized that the SEC's interest in the problem was to secure adequate disclosure by companies of this type for the benefit of investors.

During the summer of 1966, at the Chairman's request, the AICPA Committee on Relations with the SEC and Stock Exchanges made a survey of the problem and at the end of September issued its report. At about this time the Financial Executives Institute proposed to the Commission that the institute finance a thorough study of reporing for diversified companies.

This proposal was endorsed by the Commission, and its chief accountant was designated as a member of an advisory committee made up of representatives of organizations concerned with the improvement of corporate reporting.

Dr. Robert K. Mautz, professor of accountancy at the University of Illinois, was engaged to conduct the study. A summary of the work and recommendations was completed in December 1967 and the complete report was published in June 1968 under the title "Financial Reporting by Diversified Companies."

In the meantime others had become interested in the general problem. A subcommittee of the Accounting Principles Board, encouraged by the SEC, released a statement in September 1967 encouraging accountants to support improved disclosure practices. The National Association of Accountants also completed a study on the subject which was published in April 1968 under the title "External Reporting for Segments of a Business."

One other contribution in this area deserves mention here. Professors at the Graduate School of Business Administration of Tulane University organized an excellent 2-day seminar, which was conducted in November 1967 with the participation of many prominent persons, including the chief accountant of the Commission. The papers presented were published in April 1968 under the title "Public Reporting by Conglomerates—The Issues, the Problems, and Some Possible Solutions."

With all of this material available, much of it stimulated by the Commission's interest in the subject, the Commission and its staff undertook to develop amendments of its rules so as to elicit additional information from diversified or conglomerate companies which will be meaningful to investors but not unduly burdensome to the companies.

Proposed revisions of item 9 of form S-1, item 5 of form S-7, and item 3 of form 10 were published for comment in Securities Act Release No. 4922 on September 4, 1968. Over 300 comments were received on the proposals. After consideration of the comments the staff made

certain changes in the proposed revisions. A revised draft was approved by the Commission on February 10 and was republished for comment on February 18, with the period, within which to comment expiring on March 10, 1969.

Senator Williams. Will there be another provision and another opportunity for comment after that one, Mr. Chairman?

Mr. Budge. I would think not, Mr. Chairman.

Senator Williams. This reminds me of the pleadings in the common law before the Queen's Bench and the King's Bench. How many rebuttals were allowed, rebuttal, surrebuttal, the sur-sur—where is the end of the line on this?

Mr. Budge. I think the Commission made it quite plain in the release accompanying this last exposure of the rules that it would not consider further extensions of the time to comment.

Senator Williams. Thank you.

Mr. Budge. In general, the description of business items in these forms as amended would require companies in more than one line of business to disclose separate data on sales and revenues and a defined net income of any such line of business (*a*) which contributed 10 percent or more to total revenues, (*b*) which contributed 10 percent to the total income before income taxes and extraordinary items without deduction of loss lines, and (*c*) which has a loss which equals or exceeds 10 percent of the income as specified in (*b*). Separate reporting for more than 10 lines of business is not required. For companies which are not engaged in more than one line of business separate reporting is required for the amount of sales or revenues for each product or service or class of similar or related products or services which contributed 10 percent or more to the total of sales and revenues. In addition, information is required to be reported regarding (*a*) the importance and the relationship to the registrant of major customers or groups of customers, (*b*) the volume of business and risks attendant upon foreign operations, (*c*) competitive conditions within the industry, and (*d*) any portion of the business subject to renegotiation of profits or termination of contracts or subcontracts at the election of the Government. Comparable proposals to amend disclosure requirements under annual reporting forms have been deferred pending the completion of a disclosure study which is currently in progress under the direction of Commissioner Wheat.

WORKLOAD OF THE DIVISION OF CORPORATE REGULATION

As background to an understanding of the workload of the Division of Corporate Regulation it might be helpful to set forth the area of its responsibilities in assisting the Commission in the administration of the Investment Company Act of 1940. This act provides for the registration and regulation of investment companies and requires them to conduct their affairs in accordance with the standards set forth therein.

Initial registration of an investment company under the Investment Company Act requires the Division to make a careful analysis of the company's financial position, to review its corporate structure and the literature which it intends to use in selling its shares to the public. Once an investment company has started in business, its investments, selling practices, security issuances and transactions with affiliated persons must be closely scrutinized to make certain they comply with the provisions of this intricate statute. Any proposal to deviate from the prohibitions enumerated in the act requires Commission approval as being in the public interest and the interest of investors.

At June 30, 1966, there were 775 registered investment companies. Over the next 2 years the number of registered investment companies increased by 192, jumping to 967 at June 30, 1968. Further, in the 7-month period ended January 31, 1969, an additional 128 companies registered, more than in any full prior fiscal year (except 1968) since the act was passed. By January 31, 1969, the number of registered companies had risen to 1,082, an increase of 307, or 38.6 percent more than the June 30, 1966, figure. During the 7-month period July 1, 1968, to January 31, 1969, the Division processed 580 Securities Act registration statements and posteffective amendments and some 94 applications for exemption from various provisions of the act. It answered 2,837 letters in connection with filings and in reply to congressional and shareholder inquiries relating to investment companies or the administration of the act.

In addition to the increased workload caused by the spectacular increase in the number of registrants, the problem is further aggravated by the decrease of experienced staff personnel to process the continually increasing number of filings. In 1966, when the Division was reorganized as it now operates, it was contemplated that there would be 50 professional employees engaged in the processing of registrations, proxy statements and applications. However, because of budgetary restrictions, only 38 are at the present time engaged in such work. Thus, while the number of investment companies has risen almost 40 percent over the last 2½ years, the number of professional personnel processing those registration statements has decreased by roughly 24 percent over the same period. The loss of experienced personnel through resignations has magnified the problem. Since January 1, 1968, a total of 15 professional employees engaged in this work left the Division. In addition, an Associate Director, an Assistant Director, the Chief Counsel and the Assistant Chief Counsel in the Division have left. Today, only 19 of the Division's personnel engaged in this work have been employed in the Division more than 3 years.

The figures do not tell the entire story. Included in the number of new filings are many which raise novel and complex regulatory as well as disclosure problems. These include the separate accounts of life insurance companies, dual purpose funds, scholarship clubs, companies affiliated with banks, companies designed primarily for institutional investors, companies which will invest solely or predominantly in restricted securities, companies which invest in thinly traded issues, companies which propose unusual performance fees, or companies which seek capital appreciation through short-term trading and the employment of unusual investment techniques such as short sales, leverage, writing and buying and selling options, et cetera.

The greater volume, the increasing number of filings presenting novel and complex problems together with the decrease in personnel, have substantially lengthened the period which now elapses between the filing and the effective date of the Securities Act registration. At present there are some 125 investment company registration statements in the process of review by the staff. It is not uncommon now,

because of the backlog, for a filing to simply stand in line waiting for review for a period of up to 3 months. The Division's branch chiefs estimate that the garden variety filing now requires upward of 4 months before becoming effective. Other filings frequently require longer periods.

In order to attempt to alleviate the situation, we have adopted certain procedures. Among other things, we already have substantially revised the procedures for reviewing and commenting upon registration statements and proxy materials filed pursuant to the requirements of the statutes. We request that all material filed with the staff for review be appropriately marked to show changes from similar material previously reviewed by the staff.

In place of customary letters of comment, the Division now furnishes comments orally in most cases, either in person or by telephone. Where appropriate, it now responds to public inquiries for information by telephone or by a simple handwritten notation on the bottom of the incoming letter. Similarly, most requests for statutory interpretations received by the Chief Counsel's office of the Division are answered by a short typewritten response at the bottom of the incoming letter. Such letters are then photocopied for our files and the originals are returned to the senders. On occasion the Division requests that counsel provide draft notices and orders for its use as a reference and point of initial departure in connection with applications for exemption from provisions of the Investment Company Act.

Each of these steps has proven a significant timesaving device. However, the volume of the Division's work requires that much more be done. For this reason, and also to encourage a general improvement in the quality of investment company filings, the Commission has directed that guidelines for the preparation of the basic Securities Act and Investment Company Act registration statements for open-end and closed-end investment companies be published for comment. The guidelines discuss the problems generally encountered by the staff in reviewing these registration statements and set forth the staff's suggestions as to how these problems should be resolved. We anticipate that the guidelines will be of significant assistance to registrants and their counsel, thereby improving the quality of filings and reducing the time required to be spent by the staff in examination and review.

To deal more directly with delays in processing registration statements, the Division has developed a program for expediting the processing of Securities Act and Investment Company Act regulation statements. Because the Commission, as noted, bears regulatory responsibilities under the Investment Company Act, the procedures currently used by its Division of Corporation Finance for expediting registration statements filed under the Securities Act of 1933 are not wholly appropriate for use by the Division of Corporate Regulation. However, the processing of registration statements filed by investment companies may be expedited through other procedures.

The Division is about to take two major steps in an attempt to reduce the mounting backlog.

First, the Division has designed checklists which are intended to be completed and transmitted, along with appropriate registration statements, on behalf of all investment companies. Since they will provide an opportunity for counsel to consider in advance the questions which the Division routinely raises in its review, the checklists should serve as an aid to counsel in preparing registration statements for investment companies. They should also result in improving the quality of all investment company registration statements.

Second, since the check lists are also designed to assist the staff in ascertaining whether the regulatory provisions of the Investment Company Act and the rules thereunder have been complied with, the Division, relying largely on the representations of counsel contained in the checklists, intends to grant expendited treatment to those registration statements which do not raise novel or complex questions and for which clear disclosure precedents have been established. As the backlog is reduced, this procedure should also permit faster processing of the registration statements of those companies which do not receive expedited treatment. The Commission release which contains copies of the checklists and explains the procedures to be followed by the Division of Corporate Regulation was issued today and I would like to submit a copy for the record.

Senator WILLIAMS. It will be received.

(The following was received for the record:)

Investment Company Act of 1940
Release No. 5632

Securities Act of 1933
Release No. 4955

EXPEDITED PROCESSING OF REGISTRATION STATEMENTS AND OTHER PROCEDURES ADOPTED BY THE DIVISION OF CORPORATE REGULATION

The Securities and Exchange Commission today invited the cooperation of the industry, the bar, underwriters, accountants and other experts in a program which will assist the Commission's staff in its processing of the increased volume of investment company registration statements and applications involving registered investment companies.

As set forth in Securities Act Release No. 4944 (January 15, 1969) the workload of the Commission's Division of Corporate Regulation has greatly increased recently due largely to the substantial increase in the number of companies registered under the Investment Company Act of 1940. The number of registered investment companies increased from 775 at June 30, 1966 to 967 at June 30, 1968. During the fiscal year ended June 30, 1968, a total of 167 companies registered with the Commission under the Investment Company Act, more investment companies than registered in any fiscal year since the Act was passed in 1940. In the seven-month period ended January 31, 1969, additional companies registered, bringing the number of registered companies at that date to 1,082, or an increase of 39.6% over the June 30, 1966 figure. Investment companies file, in addition to registration statements, proxy statements and at least seven periodic reports with the Commission. This enormous increase in the number of investment companies and filings has been accompanied, due to budgetary cuts, by a substantial reduction of personnel in the investment company branches of the Division of Corporate Regulation. As a consequence, there have been lengthy delays in processing all investment company filings.

While proposals for meeting this problem have been under constant study by the Commission and its staff and various steps have already been taken to that end, further measures are necessary to reduce the backlog. Statutory standards, of course, remain unchanged. Because the Commission bears regulatory responsibilities under the Investment Company Act, the procedures currently used by the Division of Corporation Finance (Securities Act Release No. 4934, November 21, 1968) for expediting registration statements filed under the Securities Act of 1933 are not wholly appropriate for use by the Division of Corporate Regulation. However, the processing of registration statements filed by investment companies may be expedited through other procedures. Accordingly, the Division of Corporate Regulation has adopted the following procedures until such time as normal procedures may be resumed.

Mr. BUDGE. While your staff asked me specifically to comment on workload problems of the Division of Corporate Regulation, I should like to point out that our other divisions and offices have similar problems. As a matter of fact, the Commission has some real back office problems, too, as well as those of the industry with which it deals. The Division of Corporation Finance is confronted with a tremendous increase in the number of registration statements for financing other than by investment companies. In fiscal 1967, 1,534 were filed; in fiscal 1968, 2,473 were filed, the highest number in the history of the Commission and a 60-percent increase over 1967. In the 6 months ended June 30, approximately 1,780 were filed. The percentage of these filings representing companies which have never filed before, and many of which are recently organized promotional ventures, has now increased to almost half of the total filings. Owing to the companies' lack of experience with the process and for other reasons, these are considerably harder to handle than those of more experienced companies.

The merger movement and the related takeover efforts have created further problems for the Division, since the prospectuses and proxy statements involved are unusually complex, and where the takeover is resisted, it is a standard tactic to try to get the Division involved on one side or the other.

Similarly, our Division of Trading and Markets and our regional offices have encountered a large increase in workload as a result of the great increase in volume and activity in the securities markets and increased speculative activity which have created a greater number of situations requiring investigation because of suspected fraud or manipulation. Because of improved communications, we have seen an increase in illicit international stock operations which are among the most difficult to detect and deal with. In summary, the situation in the Division of Corporate Regulation is not unique; all of the units of the Commission have seen a great increase in workload with static or declining personnel.

Thank you, Mr. Chairman.

Senator WILLIAMS. Thank you very much, Mr. Chairman, for a very complete summary which has been most responsive to many of the questions which we have discussed informally. You are speaking for yourself, rather than for the Commission this morning, is that correct?

Mr. BUDGE. Yes, sir, except in the areas where a Commission determination has previously been made.

Senator WILLIAMS. I have forgotten exactly how you described your position on mutual fund bill, S. 34. What is your position? Did you state it here?

Mr. BUDGE. Yes, sir; and, of course, it is my understanding that that is what the committee desired, was my personal position, and I think it is appropriate in this instance, particularly because we are now a commission of four members, and we have one of the four members who was not a member of the Commission at the time that our report went up to Congress.

Senator WILLIAMS. We are working under a new rule. Senator Sparkman has ruled that for interrogation of witnesses we are under a 10-minute limitation per member.

I do not believe I will take 10 minutes, but I would like to ask you one or two things, if I may, Mr. Chairman. The New York Stock Exchange, as I understand it, at the urging of the SEC recently adopted a volume discount in commission rates. Former Chairman Cohen recently stated that he would—if he had remained in office—in the near future, impose additional reductions in the minimum commission rate structure. Do you have any personal opinion now as to whether you will follow on with that suggestion?

Mr. BUDGE. I didn't recall that Chairman Cohen had made that statement. I am not familiar with it. As I stated in the material which has been submitted for inclusion in the record, the savings to the public under the interim schedule of commission rates amounts to about $600,000 each trading day. That reduction is now in effect. One of the seven items which are in the order for investigation and hearing which is now underway is the minimum commission rate structure. As I indicated, I would think it would not be proper for me to indicate my conclusions as to any of these seven items until that investigatory hearing has been concluded. I think that was also Chairman Cohen's position.

Senator WILLIAMS. Now, the Department of Justice did file with the Commission a brief that dealt with the commission rate structure through a discussion of the antitrust laws, is that right?

Mr. BUDGE. That is correct, Mr. Chairman.

Senator WILLIAMS. It was their position that over a period of years the system should be changed to a negotiated commission rate system. Is that the position of the Department of Justice?

Mr. BUDGE. That is.

Senator WILLIAMS. And their position also is that the antitrust exemption in this matter of commission rates should not apply. Is that right? Mr. Loomis?

Mr. LOOMIS. I don't believe they have taken the position flatly that the situation violates the antitrust laws. Rather they have said that the Commission should exercise its jurisdiction to bring about this result.

Senator WILLIAMS. Would you say that again?

Mr. LOOMIS. I think they are asking the Commission to bring about this result, rather than claiming that there is a violation of the antitrust laws, in which event they would probably sue. They think the Commission should do it.

Senator WILLIAMS. As I recall it, they were using a pragmatic approach—now I am referring to the Justice Department—the pragmatic approach being the exemption; it would follow if it were necessary for the successful operation of the exchange; if it were not necessary, it would not follow. Is that correct?

Mr. LOOMIS. I think they may feel that way, but their basic view is that negotiated rates are the proper type of rate to have in view of the antitrust policies of the antitrust laws, and consequently, the Commission should so order.

Senator WILLIAMS. I am sure you are not prepared to discuss that this morning, Mr. Chairman?

Mr. BUDGE. I think not.

Senator WILLIAMS. Do you have any personal observation you want to make this morning on the report?

Mr. BUDGE. There, again, Mr. Chairman, since that is one of the areas contained within the investigatory proceeding, I just don't feel it would be proper at this time for me to comment on the proposals made by any people who have testified before the hearing officer.

Senator WILLIAMS. Within the same area generally, but approaching it from another point, the question of membership on the exchange by institutional investors, financial institutions, or their access to the market through the exchange. Do you have any personal observations on that?

Mr. BUDGE. No. There, again, there are two of the seven areas that are included in the order of investigation, and the testimony in those areas, I would expect, Mr. Chairman, would stand over a rather considerable period of time. I don't feel that I would be either qualified, nor that I should, from an ethical standpoint, discuss what impressions I might have until that report comes out.

Senator WILLIAMS. Have you any idea when this report will be ready and when positions will be taken by you and your colleagues on the Commission?

Mr. BUDGE. As I say, I have attempted to determine this morning from our Division of Trading and Markets when the record will be completed, and I am sure if we are talking about all seven of the items, it will be some little time.

I also wish to assure the chairman of the committee that the Commission does not intend waiting till it can deal with all seven items before attempting to deal with them individually.

Senator WILLIAMS. I see. Will that record be made available to this committee?

Mr. BUDGE. Yes.

Senator WILLIAMS. One final question, dealing with the back office problem. I know you have expressed your concern about it. Improvements are being made and are backlogs diminishing, as you suggested in your statement?

Mr. BUDGE. Yes, sir. The figures which I gave are for the last week, and preceding weeks will be furnished for the record.

I think I should say this, Mr. Chairman, that it may very well be the exchanges will have lower backlogs due to changes in volume which have occurred during the last week.

Senator WILLIAMS. Thank you. And just one other observation. Complaints have reached us from small investors who are getting in line with the larger investors and because of the backlogs they are not getting their orders filed. Can there be initiated an equitable system of meeting the small buyer's needs as well as that of the large buyers?

Mr. BUDGE. I think, Mr. Chairman, the Commission has made its feelings in this matter quite apparent, not only to the national stock exchanges, but to the general public, that the commission rate structure has been justified, in part, as enabling member firms to care for the orders of the small investor, and I feel very strongly that the orders of the small investors should be taken care of, and I think I can assure you that the Commission is going to take such steps as are necessary to make improvement in that area.

Senator WILLIAMS. Fine. Senator McIntyre?

Senator MCINTYRE. Yes.

First of all, I want to say, Commissioner Budge, that I have certainly enjoyed the statement you gave us here this morning, and I am pleased, too, that you came here so we could get a good look at you and get acquainted with you.

Mr. BUDGE. Thank you, Senator.

Senator MCINTYRE. I wanted to ask you, last October Candidate Richard Nixon, in a letter to Wall Street, stated as follows:

> The Administration [Johnson Administration] has further sought wide, sweeping new regulatory powers over the mutual funds industry, which powers would be tantamount to rate fixing in a highly competitive industry.

Now, I take it, Mr. Commissioner, in view of your statement here this morning that you do not agree with Candidate Nixon's comments.

Mr. BUDGE. Senator, I would feel that it would be inappropriate for me to comment on a letter attributed to the President.

Senator MCINTYRE. I do not think you really need to comment, because your statement here speaks for itself. First of all, you are part of the Commission that made the recommendations that originally came up here, and I take it overall, as I read your statement—and I intend to pursue that a little bit—that you are trying to be practical on this, saying, "Well, we would like to have this, but if we cannot get it, we will take the compromise worked out on the floor."

Mr. BUDGE. Yes, sir; but I know that ——

Senator MCINTYRE. That is no reason to embarrass you. That is why I termed it "Candidate Richard Nixon," rather than "the President." But I do think that I am heartened by what you have said here this morning.

Now, just for the record, you mention a dramatic growth of the mutual fund industry. Do you know, off the top of your head, what that was in assets in 1940, at the time of the Investment Company Act?

Mr. BUDGE. I would want to check those figures. It is a very small part of what it is now.

Senator MCINTYRE. I will supply them. About $400 million, as I remember it.

Mr. BUDGE. Around $50 billion now.

Senator MCINTYRE. That is what I wanted to say. In 1960 the mutual funds have grown, as you say, dramatically, so that there are $50 billion, in round figures, in the industry.

Now, I wonder if you can help me understand about section 22(d). This, as you know, was the price maintenance provision that was put in the Investment Act. Why was section 22(d) made part of the Investment Company Act of 1940? In your opinion, why was it put in there?

Mr. BUDGE. My understanding, Senator—and certainly, I had nothing to do with the consideration or the action at that time—my understanding may not even be correct, but it was that there had developed a second market and that the second market had undercut the prices that were charged, so that there was a bootlegging operation, so to speak, in the market. That is the only information that I heard since I have been on the Commission. It is one of the major reasons for section 22(d).

Senator MCINTYRE. Well, I believe that I somehow got the impression during our hearings that this 22(d) price maintenance was put into this act because that industry was $400 million, it was relatively a small industry at that time. It was put in there to protect this industry.

And I think you may recall that Congress in 1940 felt strongly that this industry should be watched as it continued to grow, or whatever happened to it. That is why we had the Wharton report at the suggestion of your Commission.

Could you tell me, then, what are some of the adverse effects that could take place in the distribution and sale of mutual fund shares if 22(d) was eliminated?

Mr. BUDGE. Senator, I would say that this is a question which was considered by the Commission over a period of actually many months before the report was submitted to the Congress, and it was also considered by the Commission at the time of the legislation which the Commission proposed was offered to the Congress.

The Commission decided unanimously, I am sure, that it was not prepared to recommend the repeal of section 22(d), because it did not know the consequences. It was represented to the Commission that the consequences of the repeal of 22(d) might be chaotic in the industry, and the Commission had no real way to measure those representations.

There was another element which I recall the Commission considered in its decision against recommending the repeal of section 22(d), and we considered that recommendation for a long time. And that is that a very large segment of the industry has what we referred to as captive sales force. They have their own salesmen, their own sales organization, some of which are really tremendous. They, of course, would not be affected by the repeal of section 22(d), because through their own organization they could set the price at which they planned to sell the shares.

So, actually, the repeal of section 22(d) would affect only the mutual funds who sell through the independent dealers, and we didn't know just what effect that might have. It might conceivably throw all the business one way or the other.

There were other considerations which I would want to review before I expressed them here. But I do wish to assure you that the Commission explored that subject at great length before it made the decision that it was simply not prepared to recommend to the Congress that repealing section 22(d) was good, and it took the alternative course.

Senator MCINTYRE. I appreciate your comments about the distinction between the captive sales force as against the noncaptive. During the hearing we heard a great deal about the claim that if this was put in and instead of the underwriters being about to control the price all the way down the line to the eventual consumer, if I may use those terms, then what would happen is that a great many of what I call the marginal salesmen would drop by the wayside, as their commissions would be reduced by competition. And to me that seemed like a pretty good result, because one of the items that kept bothering me on this story of the mutual funds was that I felt that they had an awful lot of salesmen out there selling after they got

through tending their gasoline station each day, some of them doing estate planning and counseling the widow and telling her what she should buy.

And so I felt bringing free competition into the industry would have a salutory effect on the sales force. The funds make a great deal of the fact that they do train the sales forces and give them some idea of the job they are doing, and I imagine for the majority this is so, but not all of them.

But those are the adverse effects that you can think of now?

Mr. BUDGE. Actually, we had no real way of measuring the entire effect of the repeal of section 22(d), and as the Senator indicates, it is a very unusual type of Federal legislation in that it does fix the price by statute.

Senator MCINTYRE. The record does indicate floor debate about more regulations and everybody admitting that they already had, in the law, protection against price fixing.

Senator WILLIAMS. Following the 10-minute rule----

Senator BENNETT. Are you in the middle of something? Do you have much more? As far as I am concerned, I will be glad to wait, if you are within sight of the end of your questions.

Senator MCINTYRE. I have 4 or 5 more minutes.

Senator BENNETT. I will wait.

Senator MCINTYRE. Thank you.

Here, again, I'd like to make a point. I feel sure you will agree with this. The Commission, as you know, recommended that the front-end load -that this form of selling should be eliminated.

Mr. BUDGE. Yes, sir.

Senator MCINTYRE. And that the result of S. 34, as you know, is a compromise on it, and as you said in your statement, if this is what the Senate or Congress wants, you will go along with it, but it is your personal opinion, Mr. Commissioner, is it not, that these front-end load sales should be eliminated?

Mr. BUDGE. I would say that as the end result, Senator, I think I certainly would favor that. Personally, I would be real happy to accept the improvement which the Senate bill made in this area. The Commission itself has made no evaluation, I think, in that area, but as for myself, I am very happy to accept the in-between position which the Senate took last year.

Senator MCINTYRE. During the hearings, Commissioner Budge, I learned for the first time about what I considered quite a unique setup between the mutual funds and the advisory company. The mutual fund has an advisory manager. And then I found that in 1940 we created what is known as the disinterested director. There was very little said during our hearings that impressed me with the role that the so called disinterested director performs. I would like you to comment on this what is the name---unaffiliated director. Could you comment on the role of the unaffiliated director as you have observed it, or as you have studied it during these past 29 years?

Mr. BUDGE. Senator, my experience in this area has been somewhat limited. It would be by observation only, and I know that it varies, the whole spectrum. Some of the unaffiliated directors, I think, take their work very, very seriously, and I think that the management company furnishes them with very complete information as to the activities of the management company. I am sure that at the other end of the spectrum there are unaffiliated directors who are not furnished very complete information and who perhaps do not play a very effective or active role in the actual management of the affairs of the mutual fund.

I have, myself, some reservations as to the effectiveness of the system, but I have nothing to recommend to you at this time.

Senator McINTYRE. I wonder if it would be possible for you to furnish for the record any changes that have taken place in the last year by mutual fund companies in reducing their overall advisory fees.

Mr. BRUCE. Yes, sir; I would have it.

Senator McINTYRE. I think, for instance, that Investors Diversified even during the hearings or even before the bill was discussed on the floor of the Senate, that they had taken into account the feelings of the committee and had reduced or had scaled down, after a certain amount of assets were involved. I would like to know if there had been any other ripples of moving toward what we would consider much fairer advisory fees.

Mr. BRUCE. Some management companies have reduced their advisory fees by all or part of the amount of fund brokerage commissions they can recapture. I might say that this device in some instances may violate some of the stock exchange rules; we have seen other instances where the advisory fees are substantially greater, based upon performance in exceeding the Dow Jones averages, and so forth.

Senator McINTYRE. I think that was an area that the committee was willing to accept, if some formula could be worked out so the adviser could show that they had actually exceeded and outperformed the standard norm, that they should be compensated over for this.

But I would be happy to know if any of these mutual funds had shown any inclination to reduce their advisory fees that they charge.

Mr. BRUCE. That will be furnished for the record, sir.

(The following tables were received by the committee:)

EXTENSION OF TABLE III-3 (p. 98) OF MUTUAL FUND REPORT[1] TO COMPARE ADVISORY FEE RATES (AS A PERCENTAGE OF AVERAGE NET ASSETS) OF EXTERNALLY MANAGED MUTUAL FUNDS WITH JUNE 30, 1965, NET ASSETS OF $100,000,000 AND OVER FOR THEIR FISCAL YEARS ENDED JULY 1, 1965-JUNE 30, 1966, WITH THE ADVISORY FEE RATES FOR THEIR FISCAL YEARS ENDED JULY 1, 1967-JUNE 30, 1968

Name of fund	Net assets as of June 30, 1965 (millions)	Advisory fee rate (percent)[2] for fiscal year ended July 1, 1965-June 30, 1966	Net assets as of June 30, 1968 (millions)	Advisory fee rate (percent)[2] for fiscal year ended July 1, 1967-June 30, 1968
1. Investors Mutual Inc.	$2,793.0	0.38	$3,017.5	0.30
2. Wellington Fund, Inc.	1,934.5	.26	1,595.8	.25
3. Investors Stock Fund, Inc.	1,546.0	.43	2,214.6	.30
4. Insurance Securities Trust Fund[7]	1,227.1	[3] .47	985.8	[3] .60
5. Affiliated Fund, Inc.	1,134.3	.24	1,615.0	.23
6. United Accumulative Fund	1,040.1	.42	1,399.5	.36
7. Fundamental Investors, Inc.	940.6	.42	1,361.7	.40
8. The Dreyfus Fund, Inc.	937.5	.50	2,463.8	.50
9. United Income Fund	603.5	.42	779.3	.36
10. Fidelity Fund, Inc.	536.4	.40	834.4	.39
11. Hamilton Funds, Inc.	407.1	.50	674.7	.50
12. Investment Co. of America	404.6	.35	918.2	.34
13. Television-Electronics Fund, Inc.[8]	388.7	.44	611.3	.43
14. Investors Variable Payment Fund, Inc.	363.4	.49	1,075.9	.31
15. Boston Fund, Inc.	363.1	.46	307.1	.47
16. Dividend Shares, Inc.	361.9	.28	400.2	.29
17. Chemical Fund, Inc.	360.5	.30	548.1	.29
18. The George Putnam Fund of Boston	350.5	.36	447.9	.35
19. Puritan Fund, Inc.	347.0	.40	726.0	.38
20. Fidelity Trend Fund, Inc.	331.0	.46	1,407.1	.39
21. National Securities Series—Stock Series	294.6	.50	370.6	.50
22. Financial Industrial Fund, Inc.	294.5	.50	381.6	.50
23. American Mutual Fund, Inc.	285.1	.45	403.9	.43
24. The Putnam Growth Fund	284.4	.44	607.7	.42
25. State Street Investment Corp.	270.8	.46	472.1	.43
26. Putnam Investors Fund, Inc.	253.8	.41	307.1	.41
27. Group Securities, Inc.—Common Stock Fund	240.0	.49	340.2	.49
28. United Science Fund	230.4	.44	434.8	.39
29. Axe-Houghton Fund B, Inc.	228.2	[4] .56	327.8	[4] .55
30. Keystone Custodian Fund Inc. Series S-4	226.7	[5] .56	556.5	[5] .54
31. Fidelity Capital Fund, Inc.	225.7	.48	739.6	.44
32. The One William Street Fund, Inc.	225.5	.33	293.9	.32
33. Eaton & Howard Stock Fund	225.1	.50	275.8	.50
34. Eaton & Howard Balanced Fund	224.8	.50	193.1	.50
35. Delaware Fund, Inc.	197.1	.50	451.1	.50
36. Commonwealth Investment Co.	174.9	.48	191.9	.48
37. The Putnam Income Fund	165.8	.27	176.8	.28
38. The Colonial Fund, Inc.	161.0	.49	252.2	.47
39. Selected American Shares, Inc.	148.2	.50	230.7	.50
40. T. Rowe Price Growth Stock Fund, Inc.	146.8	.43	467.6	.40
41. National Securities Series—Growth Stock Series	144.9	.50	271.7	.50
42. Channing Growth Fund, Inc.	143.2	.50	308.9	.50
43. Diversified Investment Fund, Inc.	141.0	.48	175.7	.48
44. Federal Street Fund	134.0	.50	179.9	.50
45. Keystone Custodian Funds, Inc. Series K-2	134.0	[5] .58	510.3	[5] .55
46. Massachusetts Life Fund[9]	130.7	.50	188.4	.50
47. Keystone Custodian Funds, Inc. Series S-2	128.0	[5] .59	347.7	[5] .56
48. Loomis-Sayles Mutual Fund, Inc.	126.5	.48	356.2	.46
49. Washington Mutual Investors Fund, Inc.	123.7	[6] .48	245.7	[6] .48
50. Scudder, Stevens & Clark Balanced Fund, Inc.	118.5	.50	[illegible]	.50
51. Keystone Custodian Funds, Inc. Series K-1	117.7	[5] .57	332.8	[5] .54
52. Capital Shares, Inc.	117.1	.74	78.4	.75
53. Diversified Growth Stock Fund, Inc.	114.8	.49	550.5	.47
54. Keystone Custodian Funds, Inc. Series S-3	109.3	[5] .58	199.2	[5] .56
55. Life Insurance Investors, Inc.	106.6	.30	95.6	.30
56. Bullock Fund, Ltd.	105.3	.23	154.4	.25
57. Stein Roe & Farnham Balanced Fund, Inc.	102.5	.49	161.5	.48
Total	[10] 22,977.6		[10] 34,494.6	
Mean		.45		.44
Median		.48		.47

[1] Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth. Committee on Interstate and Foreign Commerce, H. Rept. No. 2337, 89th Cong., 2d sess. (1966).

[2] [3] [4] [5] [6] Text of these notes is set forth in table III-3, p. 98 of the Mutual Fund Report.

[7] Present name is ISI Trust Fund.

[8] Present name is Technology Fund, Inc.

[9] Present name is Massachusetts Fund.

[10] The total net assets of the mutual funds listed in the table were 70 percent and 64 of the total net assets of all mutual funds registered with the Securities and Exchange Commission at June 30, 1965, and June 30, 1968, respectively.

REDUCTIONS SUBSEQUENT TO THEIR FISCAL YEARS ENDED JULY 1, 1965, TO JUNE 30, 1966, IN ADVISORY FEE CONTRACT RATES OF MUTUAL FUNDS LISTED IN TABLE 41-3 (p. 98) OF MUTUAL FUND REPORT

	Old rate		New rate	
	Fee rate (Percent)	Average net assets (millions)	Fee rate (percent)	Average net assets (millions)
Delaware Fund, Inc.	0.50	All	0.50 on first	$250
			0.475 on next	250
			0.45 on next	250
			0.425 on next	250
			0.40 over	1,000
Diversified Growth Stock Fund, Inc.	0.50 [2]	All	0.50 on first	250
			0.45 on next	250
			0.40 on next	250
			0.35 on next	250
			0.30 on next	250
			0.25 on next	250
			0.20 over	1,500
Fidelity Trend Fund, Inc.	0.50 on first	$200	0.50 on first	200
	0.45 on next	100	0.45 on next	100
	0.40 over	300	0.40 on next	400
			0.35 on next	300
			0.30 over	1,000
Fundamental Investors, Inc.	0.50 on first	500	0.50 on first	250
			0.45 on next	250
	0.40 on next	250	0.40 on next	250
	0.35 on next	250	0.35 on next	250
	0.30 on next	250	0.30 on next	250
	0.25 on next	250	0.25 on next	250
	0.20 over	1,500	0.20 over	1,500
Investors Mutual, Inc., Investors Stock Fund, Inc., and Investors Variable Payment Fund, Inc.	0.50 on first	350	0.50 on first	250
	0.47 on next	300	0.47 on next	250
	0.44 on next	250	0.44 on next	250
	0.41 on next	250	0.41 on next	250
	0.38 on next	250	0.38 on next	250
	0.35 on next	250	0.35 on next	250
	0.32 on next	250	0.32 on next	250
	0.30 over	1,900	0.30 over	1,750
	(Also a flat annual reduction of $170,000, $130,000, and $36,000 for the above funds, respectively, from fees computed in accordance with the above scale.)		(Also, a flat annual reduction of $500,000, $180,000, and $36,000 for the above funds, respectively, from fees computed in accordance with the above scale.)	
National securities series, stock series, and growth stock series.	0.50	All	0.50 on first	410
			0.375 over	410
Scudder, Stevens & Clark Balanced Fund, Inc.; Scudder, Stevens & Clark Common Stock Fund, Inc.	0.50	All	0.50 on first	125
			0.40 over	125
Selected American Shares, Inc.	0.50	All	0.50 on first	250
			0.45 on next	250
			0.40 over	500
State Street Investment Corp.	0.50 up to	200	0.50 on first	200
	0.375 over	200	0.375 on next	100
			0.30 over	300

[1] In addition there is a reduction of up to $165,000 in the advisory fee based on average net assets over $250,000,000. The full reduction is made if average net assets exceed $400,000,000.
[2] Less a deduction of $150 per $1,000,000 of average net assets.
[3] Less a deduction of $250 per $1,000,000 of this portion of average net assets.

Senator McINTYRE. Thank you very much. Thank you, Mr. Chairman.

Senator WILLIAMS. Senator Bennett?

Senator BENNETT. Thank you, Mr. Chairman. I have one or two questions, and Senator Brooke has left me two. He was called away to another hearing.

Reference has been made to the report of the Wharton study. I have the impression that that study recommended against the repeal of 22(d). That is really what I would like to know whether that is true. Could you or your staff provide that information for the record?

Mr. BUDGE. Yes, sir.

(The following was received for the record:)

Senator Bennett has asked whether the Wharton Report recommended the repeal of the resale price maintenance provisions of Section 22(d) of the Investment Company Act.[1] That Report took no position on Section 22(d), as such. However, it did observe:

"Competition among mutual funds has provided investors with a wide range of choice as to fund type, *loading charges*, etc. It has stimulated efforts to achieve outstanding investment performance since fund sales, at least to some extent, have been positively correlated with fund performance. Competition in promoting sales directly as well as indirectly through winning and stimulating dealer sales efforts with respect to particular funds has been an important characteristic of the mutual fund industry. Thus, competition in the mutual fund business has assumed the principal nonprice forms—variety of product, product quality, and sales promotion—but for the most part it has involved price, at the investor level, *only insofar as size of sales charge has become a competitive factor as between the principal funds in the industry and the no-load companies, which will constitute a relatively small fringe of the business.*"[2]

In the Summer of 1967, at the hearings before the Banking and Currency Committee on S. 1659, 90th Congress, first session, two of the four authors of the Wharton Report gave their views as to Section 22(d). Prof. Irwin Friend, the Director of the Wharton School's Securities Research Unit, stated that:

". . . It would be desirable to . . . have the growth of the mutual fund industry involve less selling costs. This requires more effective price competition, which might be achieved by removing the retail price maintenance provisions of Section 22(d) of the Investment Company Act or by providing potential investors with more complete disclosure."[3]

Professor Friend also testified that he "would regard making full disclosure even fuller *and revoking 22(d)* . . . as the most promising steps that could be taken."[4]

Professor Edward S. Herman, a co-author of the Wharton Report, testified that "Most economists would favor abolition of 22(d) and I would also."[5] In his prepared statement Professor Herman observed:

"The case for limiting the size of the charge that can be levied in the sales of mutual fund shares rests on the fact that the market for fund shares is competitive only in a limited and somewhat perverse way. Competition is restricted first, by the Act's section 22(d) provision for resale price maintenance. This is significant restraint on price competition, and one that is desired by the industry. A second limitation on competition stems from the uninformed nature of the small investor market that has been heavily tapped by the fund industry. As noted earlier, this has tended to encourage salesmanship and to reduce further any possible price competition at the retail level. The price competition that remains involves mainly a bidding by issuers of fund shares for dealers to carry and push their wares. Given this direction of competition, market penetration is increased by elevating the sales charge (or the dealer's percentage of the charge) at the expense of the ultimate purchasers of shares. This is perverse price competition."[6]

Senator BENNETT. I am interested in your comment in the discussion here about negotiated rates. Is it your understanding that the Department of Justice is recommending that a man who goes into a brokerage house to buy one share of stock must be required to negotiate the rates on which he will pay the broker for the service?

[1] A Study of Mutual Funds prepared for the Securities and Exchange Commission by the Securities Research Unit of the Wharton School of Finance and Commerce of the University of Pennsylvania (House Report No. 2274, 87th Cong., 2d Sess. (1962)).
[2] At page 35 (emphasis added).
[3] *Hearings before the Committee on Banking and Currency of the United States Senate on S. 1659, 90th Cong., 1st Sess.* (1967) (hereinafter cited as "1967 Senate Hearings"), page 667.
[4] *Id.*, at 670 (emphasis added).
[5] *Id.*, at 729.
[6] *Id.*, at 730.

Mr. BUDGE. I think the recommendation, Senator, is that there perhaps be a minimum commission for smaller transactions and a negotiated rate for larger transactions. Isn't that correct?

Mr. LOOMIS. They said that for small transactions maybe there should be a maximum rate, and they said that the firm should have posted rates so that you did not negotiate in every small transaction.

Senator BENNETT. Did they assume that each firm would have a different maximum rate for small transactions or that this would be set by the Commission?

Mr. LOOMIS. As I understand it, they suggested that the Commission set a maximum rate for smaller transactions, or at least consider doing so.

Senator BENNETT. The Commission would also be required to consider the same where the breaking point was between a small transaction and a transaction to be negotiated.

Mr. BUDGE. I presume so; yes.

Senator BENNETT. Fine. Last year when we were working on this mutual fund bill, representatives of the mutual fund industry and of the Commission were meeting frequently to discuss the problem, and some of us hoped that the final recommended form of the legislation could have been worked out as a result of these discussions. Do you think it is possible that some of the as yet unresolved differences between the committee, the Commission, and the industry can be further resolved by further discussion and negotiation?

Mr. BUDGE. Senator, so far as I am aware, the only really major area where there is a difference between the Commission and the industry is in the determination of the reasonableness of the management fee. The Commission has contended that the management fee should be reasonable. The industry says that it has no desire to charge any fee which is unreasonable. The formulation as to how to pick an umpire to make that determination just hasn't yet come about.

I have indications from the industry that they would very much like to resolve that question, and I am sure the Commission would like to resolve it. I would feel that it is not an insurmountable obstacle, and if that one area could be resolved, I don't know of any real argument between the Commission and the industry——

Senator BENNETT. The Commission has made it clear to the industry that it stands ready to have further discussions of the problem?

Mr. BUDGE. Very definitely. As a matter of fact, it has been discussed within the last week.

Senator BENNETT. These are Senator Brooke's two questions: "What is your opinion of the idea that a ban might be imposed on trading by exchange members for their own accounts until the backlog problem has been brought under control?"

Mr. BUDGE. That proposal has been made to the Commission, Senator. It is not under active consideration right at the moment, because we do feel that this back office problem is improving. I don't recall right now, I would guess that the trading by members for their own account would represent maybe something like, well, 6 or 7 percent of the total volume, say, on the New York Stock Exchange, and how significant that would be in reducing the overall I am not sure. Certainly we cannot ban the trading of the specialists for their accounts, because they are the ones who make the market efficient and not a fluctuating market. But outside of the specialists, I would guess the volume we are talking about would be 6 or 7 percent, and we would certainly want to consider that if the back office problem does not continue to improve.

Senator BENNETT. Thank you. His other question: "What is your opinion regarding the value of the machine-processable stock certificates in facilitating dealing with the flood of paperwork? How many years would it take to implement such a system, assuming that a favorable decision is made regarding its merits?"

Mr. BUDGE. I think as to registered securities, those which are registered on the national stock exchanges that can be brought about within a relatively short period of time, say, oh, even within a period of months. As to the over-the-counter securities, it's a longer range program, and that was one of the major topics for discussion in the meeting which the Commission staff had on Thursday and Friday of last week all day both days with all of the exchanges throughout the country and the NASD. I think that there must be some solution to this matter of having individual certificates to have evidence of ownership of some areas. Perhaps we will have to go to IBM cards or some type of recordkeeping such as the banks use and not so that every transaction involves the manual and physical delivery of the stock certificate. It has to be done; otherwise, with the projections for the increased business on the exchanges and in the open account of the market, they just can't handle the volume, because they have to manually and physically deliver it.

Senator BENNETT. Is it your opinion, then, that we are moving in that direction as rapidly as can be expected under the circumstances?

Mr. BUDGE. I do, Senator.

Senator BENNETT. Thank you. I have no further questions.

Senator WILLIAMS. Senator Cranston?

Senator CRANSTON. I would like to thank you, along with the others, for your appearance here today.

I would like to ask you one question. In your testimony, toward the bottom of page 36, you refer to decisions in the insider-trading area reinforcing the policy of the New York Stock Exchange as restated this summer, that any corporation stock that is listed on the exchange is expected to release promptly any information which might reasonably be expected to affect the market for its securities. Does that refer to both information that would have a favorable and unfavorable effect on securities?

Mr. BUDGE. It does.

Senator CRANSTON. What would be the situation if there is information that would adversely affect the value of securities where there is reasonable hope that steps can be taken to alleviate the situation so that there would not be an adverse effect on these. Would it still be expected that that information would be made public prior to the achievement of the steps to remedy the situation?

Mr. BUDGE. Well, this is a New York Stock Exchange rule and not one of the Commission's. I would feel like the information should be in the public area while the trading is going on, particularly if we are talking about the insiders within the company or the company itself.

Senator CRANSTON. If there is trading of that type going on, I can see how it would be expected. I wonder how we are to be expected to determine whether such information should be made public if steps are being taken to remedy it prior to the fall in the value of the securities.

Mr. BUDGE. It might not be that it need be made public, but it is not, then I would think that the insiders in the company should not be selling shares in the company.

Senator CRANSTON. Yes. In the event they are not making any such sales, would it still be expected that they make public such information? I would like to be realistic.

Mr. BUDGE. I will defer to Mr. Loomis. I would not think so myself.

Mr. LOOMIS. If the information is not really going to have an impact on the market because the situation will be corrected promptly, maybe it isn't the type of information that has to be discussed, because what they are talking about is information that will affect the market. However, if you have a situation where it looks like the company and market is going to go down for a while and come up and then go back, I think those facts should be disclosed.

Senator WILLIAMS. Senator McIntyre.

Senator MCINTYRE. Just one parting thought. Senator Bennett alluded to the fact that perhaps some compromises will still be underway and worked out between the Commission and the industry, and I think your reply was that there was just one point at this time that was really sticking in the craw of the industry. Now, I want to call your attention to page 27 of your statement, and this has to do with the advisory fee. If I remember correctly, the average is one-half of 1 percent, almost, regardless of whether the mutual fund handles $200 milion or $1 billion. I think the average was 0.47 or something like that. And a lot of us for the life of us couldn't understand why as assets went up into such astronomical figures that there could not be some declining rate applied.

So I want to read for the record this particular section on compensation. Some of it was worked out on the floor, and I think it could be improved upon. But here is what the industry is complaining about, as I take it.

No. 1, it says:

> This advisory fee or compensation shall be presumed reasonable if it has been approved or ratified by the affirmative vote of the owners of the majority of the outstanding voting securities—

And you know what a sham that is, and then—

> by the majority of the directors of the investment company who are not interested persons, who are unaffiliated.

That is the first one. We are talking about the test of reasonableness, as some shareholder might try to indicate to a court that it was not reasonable.

The second part says:

> If the court determines that the board of directors of the investment company acted with due care in approving compensation

Acting with due care, not too tough a test—

> then there may be no monetary recovery for any period prior to the institution of the action, or, in the case of an investment advisory contract, prior to the termination date of such contract.

Then third:

> No action may be maintained by a security holder under these provisions unless the Commission refuses or fails to bring such action within 6 months after written request by the security holder.

Now, this is all written in to try to effect a compromise on what seems to most people and seems to me an issue as to why shouldn't the mutual fund industry be subjected to the test of reasonableness in their advisory or management compensation fees. Of course, they should not be harrassed unduly by crackpots, but I don't know any other reason in the world why they shouldn't be subjected to this test. So I will ask you, Mr. Commissioner, in your compromise negotiations, do not retreat.

Mr. BUDGE. Thank you, sir.

Senator BENNETT. Mr. Chairman, may I comment? Senator McIntyre, the first condition is there for the purpose of fixing the burden of proof, that if these steps have been taken, the burden shifts to the attacker to prove the unreasonableness, and this is, I think, the essence and the important factor in this provision.

As I understand it, Mr. Chairman, the Chairman of the Commission has agreed to furnish us with a record of changes in the fees that have occurred over the recent period of time, and I am going to ask him in general, does the trend in fees seem to be toward lower or more "reasonable charges" in the area of large funds?

Mr. BUDGE. My impression is, Senator, that it is being reduced in the areas of the larger purchases. I would like to furnish that material for the record.

Senator BENNETT. Yes, I think it would be important for the committee. I am talking about management fees on the assumption that the larger funds with more money at stake may be reducing the percentage fees they charge. Is that going on in the industry?

Mr. BUDGE. I misunderstood the question the first time. It is my impression that the management fees are being reduced when the funds become larger, but the extent to which they are being reduced I really don't have a firm opinion.

Senator BENNETT. Can you get the information for us that would have some sort of measurement or impression as to the extent and significance of these changes?

Mr. BUDGE. Yes, sir, I shall furnish that for the record.

Senator MCINTYRE. Just one brief comment, Mr. Chairman. I was just wondering, in view of the Senate passage of this bill, in view of the hearings that some of us have heard, we feel we have had an opportunity to assess the situation. I was wondering if the possibility of action by the Congress had caused any of these companies to begin to try to make what I would say are more realistic advisory fee contracts. That is what I was after. But I would like to point out for the record that the important thing here is to understand, as I am sure you know, Mr. Chairman, that today a security holder cannot effectively sue. It seems to me this proposal is nothing for the industry to be squalling about.

Senator BENNETT. I have no further questions.

Senator WILLIAMS. Thank you very much, Mr. Chairman. You have been most helpful.

(Whereupon, at 12:20 p.m., the hearing was closed.)