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THE CHALLENGE OF NEW INVESTMENT SERVICES

An address by

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It is a pleasure for me to be here today. A decade or even five years ago, a conference like this one, concerned with new investment vehicles and increased competition for the nation's savings dollars among traditional financial institutions, could not have been held. Until very recently, investors seeking a greater return than that offered by savings banks, along with professional management, have chosen investment companies, and more particularly equity oriented mutual funds.

On my first tour of duty with the Commission -- for a while as Director of its Division of Corporate Regulation -- we witnessed a period of rapid growth in the investment company industry after 1940 and were starting to face the questions this growth presented. After I left, as an outgrowth of the increased staff and Commission attention to those issues, the Wharton school published its famous study of mutual funds in 1962 and the Commission issued its own report in 1966 on the Public Policy Implications of Investment Company Growth. Many of the recommendations that surfaced at that time ultimately found their way into the Investment Company Act Amendments of 1970.

During this decade of study, the investment company industry did not stand still; rather, it continued its very rapid growth. For a time, it seemed that the pervasive mutual fund, with all its trappings, was an investment vehicle for all seasons. The situation is very different today. Mutual funds have faced an unprecedented period of extended net redemption and, with occasional noteworthy exceptions like the recent Merrill Lynch fund offering, favorable signs on the horizon seem a bit remote.

Where is the public turning? To an increasing extent, the answer, as this conference pointedly demonstrates, is other investment media: the so-called mini-accounts, syndicated offerings of real estate and tax shelter securities, oil and gas drilling funds, bank-sponsored automatic investment plans, and -- just around the corner -- variable life insurance.

These new investment media and their sponsors can provide valuable services to investors and spur our economy. Competition between different financial institutions generally has proven healthy for the economy and for the consumers of their products. Traditionally, a major role for the

Commission has been to see that, when the public invests its savings dollars in securities, it does so on the basis of sales material which fully and completely disclose all relevant facts. The evolving new products we have seen most recently raise unique and different problems.

Reluctantly a number of observers have concluded that many of these products -- such as condominiums and life insurance-sponsored investments -- are securities. The impetus for these conclusions cannot be that Congress found these specific interests to be securities. These interests did not exist in 1933, 1934 or even 1940. But elasticity was built into the federal securities laws so that new offerings, no matter how unique, could be regulated if the public interest required. As new products marketed by new sponsors prove ever more innovative, serious questions of a broad philosophical bent have arisen. Not many people doubt the need for investor protection through disclosure and perhaps substantive regulation. The real questions, which are asked with increasing frequency, are how much regulation is necessary and who should be responsible for

any substantive regulation enacted. For a large number of these services, the federal securities laws offer the only existing hope for federal regulation. The laws we administer have been stretched and twisted a bit to accommodate new investment interests.

What have we been doing to cope with some of these challenges? In the first place, because of the volume and complexity of most of the so-called "tax shelter" offerings, we have established a special branch in our Division of Corporation Finance to deal with these special disclosure problems. The staff in that section has been developing an expertise in this field that is of real benefit to the Commission, to the industry, and to the investing public. Separate disclosure standards tailored to these products have been implemented by our staff. We also have specialists who handle filings for oil and gas drilling funds. Virtually from the inception of our operations, the Commission has recognized that oil and gas offerings are sui generis, presenting unique problems for investor protection; filings for these offerings are reviewed by staff members with geological and engineering expertise. Initially, at least,

variable life insurance registration statements will also be concentrated in a special staff group. In short, the Commission and its staff have developed the necessary expertise to assure investors that the prospectuses they receive do contain, to the best of our ability, full and fair disclosure.

Second, former Chairman Casey appointed advisory committees to study two of these areas and to help us formulate our views. A number of the recommendations that have emerged from these advisory committees have been implemented, either formally or informally at the staff level. Other suggestions are under study right now.

Finally, particularly regarding these complex products, disclosure alone may not prove to be enough. Many of these new financial vehicles, or their sponsors, are subject to substantive regulation by other regulatory structures or other regulatory agencies, either at the state or federal level. As a result, ultimate survival in the marketplace often may not be a function of full disclosure and intelligent investment decisions, but rather a function of advantages accruing to some participants as a result of different

regulatory environments. I believe that we must take a comprehensive view, similar to that taken by the Hunt Commission regarding financial institutions. Although that Commission dealt primarily with the structure and regulation of financial intermediaries with deposit and thrift functions, its philosophy was to develop a framework, which would permit competition between "all financial institutions competing in the same market … on an equal basis." As I have stated in other forums: where investment products are comparable, to the extent feasible, federal regulation for the protection of investors should also be comparable.

At this point you might be saying to yourself, "that's a great philosophy, but what does it mean?" As a first example, let me use the oil and gas drilling funds.

During the 1972 – 1973 fiscal year, we received 106 filings aggregating $940 million. In the case of oil and gas drilling programs, experience shows that sole reliance on a disclosure approach has been inadequate. Investor experience with oil program investments has been marked by many distressing episodes, and sharp and pervasive conflicts of interest between the program managers and the

investors; the intricacies of the limited partnership interests being offered make rational appraisal difficult for the ordinary investor. The Commission long ago concluded that disclosure must be supplemented by substantive regulation. I must also note in this connection that many oil and gas programs offer such features as redemption privileges and installment plan purchases by means of periodic payment plan certificates. These features are designed to appeal to small investors and give them a striking functional similarity to mutual funds.

Accordingly, while we could have deferred to the substantive regulation of the Department of Interior or the Federal Power Commission, the Commission saw a real need for an Oil and Gas Investment Act, comparable to, though by no means identical with, the Investment Company Act. Investor protection is not really a question for those agencies -- that's a job which has been the hallmark of the Commission's proud tradition. We have no interest or expertise in regulating the manner in which oil program exploration is conducted, but we do have expertise in investor protection. With this in mind, the Commission's

staff prepared such a bill, and it has been introduced in Congress. The bill is fairly complex, but in essence covers enough areas, such as management overreaching and sales charges, to insure that investors in the programs get a fair break. We do not maintain that the bill, which was worked out with the assistance of industry organizations, such as the Oil Investment Institute and the Independent Petroleum Association of America, is the last word on the subject or the only feasible solution to the oil program problem.

Real estate and tax shelter securities are also in the picture and are a force to be reckoned with. The importance of these securities is demonstrated by the recent dramatic increase in the amount of investment dollars raised from public offerings filed with the NASD over the last three years: One hundred and forty five tax shelter offerings, aggregating $985 million, were filed with the NASD in 1970; 334 offerings worth $1.57 billion, were filed in 1971; and

539 offerings, worth $3.22 billion, were filed in 1972. Of course, public offerings of real estate and tax shelter securities are much older than the oil and gas programs which I have first discussed.

Real estate syndications have been growing over since the 1950's, in contrast to the mass marketing of oil programs, which is a relatively recent, essentially post-1967, development. Self-dealing, pervasive conflicts of interest, complexity, overpaying for properties, and externalized management (with all of the special problems which that form of organization brings in its wake) are certainly endemic to real estate financing. This has led many to suggest that Investment Company Act type regulation is also needed here.

Ten years ago, the Commission's Special Study of Securities Markets thought the problem was significant enough to address, and concluded that there was a serious question "whether the Commission's power to compel disclosure is adequate to deal with the problems presented by speculative offerings, promoters' benefits, insider transactions and cash flow distributions." Since that time, the NASD has been quite active in the area. Its review of abuses in these

offerings culminated in comprehensive proposals for tax shelter regulation. While there is much we could embrace immediately in the NASD's proposals, some of its proposals at least raise the question whether the NASD's rules would establish a quasi-federal, blue-sky approach to tax shelter securities. Since we are under a statutory obligation to adopt comparable regulations for non-NASD, or SECO, broker-dealers, we though it best to invite the public to file comments on the NASD's proposals directly with us. Although a majority of the commentators suggest that the NASD lacks authority to adopt all of its proposed rules, or should be prevented from doing so, our staff is reviewing the matter and we will soon be grappling with the question.

Salutary attempts at coordination of state regulation of tax shelter securities also have been undertaken -- most notably by the Midwest Securities group -- and, as a result, more than 20 states have subscribed to the Midwest group's general guidelines. While our advisory committee recommended a cooperative, state regulatory approach, there is nevertheless, much to be said for regulatory, legislative solution to the real estate tax shelter problem. Whether or not legislation, perhaps along the lines of 1940 Act legislation

tailored to the special problems of real estate securities, is needed will depend upon the extent and success of the NASD and Midwest Securities group initiatives. It is very clear, in any event, that the present type of disclosure has not been as effective here as we might have hoped. We need a new and different approach.

In the area of variable life insurance, which is the subject for discussion on your program all day today, the Commission also has charted a flexible approach. We have not sought to strait-jacket the variable life product into the Investment Company Act structure and, in fact, in our recent release proposing to condition a 1940 Act exemption for these products on comparable state regulation, we specifically noted that:

> "… The standard will not be whether a model law and regulations are identical to the relevant provisions of the Investment Company Act and the Investment Advisers Act, but whether they provide protections substantially equivalent to those provisions."

The wisdom of our proposal is currently the subject of much debate, and I shall not add further to the din.

There can be little question, however, that the recent increased involvement of commercial banks in the securities markets has raised the most probing questions. As you know, bank trust departments are the largest institutional investors, with more assets under their management than all other institutional investors combined. We are told that most of the "new" money coming into the securities markets emanates from corporate contributions to employee benefit plans. Most of the resulting trust funds are managed by the banks. With the emergence of significant pension reform movements, it is distinctly possible that this particular flow of money will dramatically increase.

At lease some observers have suggested that investment policies followed by bank trust departments have been a principal cause of the so-called two-tier market. I am certain in my own mind only that there is an impressive lack of information on the subject. Those who advocate imposition of substantial restrictions on institutional trading and holdings are bedeviled with the same paucity of hard data to support their position as those who argue that there should be no such impediments in a free marketplace. To solve this informational gap, the

Commission recently submitted institutional disclosure legislation to Congress amending Section 13 of the Securities Exchange Act of 1934. That legislation, which is similar to S.2234, a bill introduced last July by Senator Williams, was introduced in the Senate as S.2683 last Friday.

Our proposed legislation would require specified institutional money managers, including banks, insurance companies and pension funds, managing large portfolios, to report the securities holdings of and the block-sized equity security transactions for, the accounts they manage. We contemplate that the data these proposals would generate should prove to be of value to investors, large and small; the brokerage community; and corporate issuers. The data also should be very helpful in our oversight of the markets and in the conduct of our present regulatory programs. But I am convinced that, regardless of the analyses we may make as a result of this data, a very important benefit will be the added public confidence in the integrity of the securities markets that institutional disclosure will provide.

Substantive regulation of certain bank related securities activities appears to be a topic of great and growing interest. Legislation dealing with the processing of securities and related custodial functions is high on Congress's agenda, although it is not at all clear who will regulate and enforce the provisions of any legislation that may be enacted. Legislation also has been introduced by Senator Williams which would amend the Securities Exchange Act to vest in the Commission regulatory and enforcement jurisdiction over municipal bond underwriting and trading by banks as well as non-bank broker-dealers. The debate here has also focused, thus far, not on whether substantive regulation is necessary, but rather, on who will enforce any legislative standards that may be enacted. We have recommended that the Commission be given complete regulatory authority, but we recognize there are reasonable arguments on the other side of this issue.

The so-called Automatic Investment Service has also captured a great deal of attention recently -- most notably yesterday's action by Senator Brooke, introducing legislation

designed to vest authority in the Commission to regulate these services and, perhaps, other services of a similar nature. Of course, bank-sponsored dividend reinvestment plans and mini-accounts have been raising difficult issues under the federal securities laws for some time. Indeed, Monday's newspaper trumpeted the arrival of a "new" service that has all the earmarks of déjà vu: "minitrusts." We may all be in for another lengthy round of reading up on the Glass-Steagall Act, and Investment Company Institute v. Camp as banks once again attempt to broaden their investment clientele.

As I announced last month at the Bond Club in Chicago, the Commission has determined to notice these particular questions for public comment very shortly. Some administrative approach to these problems may be available to us if we do conclude that the regulatory controls are appropriate here and, consistent with our role of investor protection that they should be administered by the Commission. On the other hand, since it is our view that persons or entities engaged in comparable activities should be subject

to comparable regulation, a legislative approach, whether it be administered by the Commission or bank regulatory agencies, may be warranted. In any event, there is clearly a crying need for greater understanding, consultation, and cooperation between the Commission and the bank regulatory agencies, and the securities and banking industries.

In closing, let me hark back to a theme our staff and other Commissioners have sounded before. There is no reason why the fairness of a transaction should depend upon the presence or absence of pervasive substantive regulation. Those of you who presently engage in counselling [sic] those persons who are structuring, distributing, or managing oil and gas drilling programs, real estate and tax shelter offerings and bank-sponsored investment programs should do what can be done now, voluntarily to fill the substantive regulatory gaps by adherence to high ethical standards.

At least as important is our need for your substantive suggestions concerning appropriate approaches to the troublesome questions I have raised. Your experience in representing clients beset by dual regulation or uncertain as to the

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