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MUTUAL FUNDS: FIFTY YEARS AND BEYOND

An Address By

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What do you say on the fiftieth birthday of someone who is still pretty big and husky but feeling generally poorly and oppressed on all sides with enemies and tormentors? "Happy Birthday!" may sound a little hollow. I guess it's safe to say that being 50 years old is at least better than the alternative. But is there anything else nice one can say? I think one can observe that the industry has lived through some tough times before and survived, but I would have to admit that it would be hard to find a tougher period since World War II and, as an industry, mutual funds were really not much prior to that time.

Maybe the nicest thing I can say is that I congratulate you on getting this far and, whatever further difficulties lie ahead, age will not hinder your overcoming them. After all, your major competitors are, institutionally, much older.

That's not very cheery, but it is difficult to see any fundamental improvement in the conditions of mutual funds and of those who manage them without substantial improvement in our equity markets, and I am not foolish enough to hazard any public forecasts in that area. It is my own inclination to view the present state of the market as a cyclical thing from which it will, in due course, recover - - perhaps not back to the frenzied days of the late '60's, but to something resembling a more normal condition. If this is correct, we are looking at some fantastic bargains. But also, even if it is correct, there is the big question of when. So I cannot stand here, as Chairman of the SEC, and buoy your spirits by assuring you that everything will be coming up roses by 1975. We can only hope.

What else can we talk about? We could talk about the past and, in the proper spirit of a golden jubilee, remember the good and forget the bad. There has been a lot of good, even in the legal department. It was good that the ’40 Act was adopted when it was. It would have made things easier if it had been written in English but, as we all know, in the end the industry representatives shared at least equal responsibility with those of the government for what we got. If you assume, as I do, that some Federal regulatory apparatus was inevitable for this industry, then it was good for it to be ready and waiting in 1946 when, once again, after many years of abhorrence, individuals in increasing numbers became interested in equity investing.

Whether it was good that I was Director of the then Division of Corporate Regulation for a few years in the mid-‘50’s I leave to future historians, in the unlikely event they ever think about it. I was instrumental in persuading the Commission to bring the first VALIC case, which should please this group as evidence of my wisdom and foresight. I played a similar role in the bringing of the ISI case, which should please you equally as evidence of the lack thereof.

Over the ensuing 20 years, the many estates accumulated for investors and the careers for industry participants were also good, frequently very good. Sometimes it seems to be only incorrigible human nature that, collectively, we could not settle for keeping a pretty good thing going. Someone had to keep trying to make a better thing of it, until it all collapsed. Of course, it isn’t just the mutual fund industry that has suffered from the go-go years and the cult of performance, but it may have suffered especially. It was probably epsecially bad to create unreasonable expectations in mutual fund investors.

But I don’t intend to dwell on our sins of the past. I am sure that we have all sworn off doing it again, while secretly hoping for the day when we will once more be faced with the temptation. What of the future? More particularly, what of the future on the regulatory front, which is our department?

In the broad sense, we have no plans to seek radical changes in the basic regulatory pattern. Even Professor Loss and the Federal Securities Code group propose to preserve this. What we do see before us are two major developments that force us to reexamine certain aspects of our law and regulations. One is the move toward price competition in the securities industry generally, specifically with respect to commission rates. What will this mean for portfolio transactions of funds? Even more, what will this mean for the marketing of fund shares? The other is the advent of new institutional competition for the marketing and management of collective investment vehicles. What should the SEC's attitude be toward apparent regulatory inequalities and toward the efforts of the mutual fund industry to achieve or, as you would argue, preserve, legal protection from competition, with or without equal regulation?

It is tempting to insure your close attention for the next few minutes by letting you savour the expectation that I am going to answer the questions I have thus posed. I wish, that such expectations could be well-founded. In fact, we are still struggling with these matters and will be for some time. The best I can do is to give you some idea of how they look to us and how our thinking is developing.

As to price competition, you are all well aware of the fact that we have finally announced our determination that the securities industry generally shall engage in this form of competition with respect to commission rates beginning May 1, 1975, and that a learning period with respect to smaller orders is now in progress. The question is not resolved with respect to price competition in the distribution of mutual fund shares.

You are aware of the fact that the Antitrust Division of the Department of Justice has challenged the present practice of most funds in this regard on antitrust grounds, and the Solicitor General, it was recently reported, has agreed to prosecute an appeal of an adverse decision of the United States District Court in United States v. NASD.* We did not think the Antitrust Division should have proceeded on this ground under the antitrust laws, because we think the problem should be resolved as a regulatory matter under the Investment Company Act. They have not seen fit to comport with our general views, and we may, in the end, have a definitive court determination that will bind all of us, whatever we might otherwise have done.

In the meantime, our staff is still analyzing the information and arguments provided at the hearings on mutual fund distribution and trying to fashion a proposal. I understand that the staff's proposal is likely to be some middle ground between retention of all of the present practices intact, on the one hand, and the virtual repeal of Section 22(d) on the other. Without expressing any views of my own, I think this is an interesting area to explore and we look forward to receiving the staff's proposals shortly.

As the securities industry generally moves into the era of price competition, we are being asked to reexamine our policy against the using of fund portfolio brokerage business to award sales of fund shares. Serious concern has been expressed over the interpretation of the NASD's anti-reciprocal rule, which requires that brokers seek orders for execution on the basis of the value and quality of their brokerage services and not on the basis of their sales of fund shares. Stated simply, it is urged that fund brokerage should be used to promote fund sales and that so long as the anti-reciprocal rule prohibits

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* [Current] CCH Fed. Sec. L. Rep. ¶94,319 (D.D.C., 1974).

specific agreements and undertakings which encourage churning, the purposes of the rule would be served.

It is true that the Commission's attitudes in this area were developed while brokerage commissions were fixed by the exchanges and many brokers were demonstrating the fact that they were willing to work for much less than the fixed fee. But the Commission's consistently articulated concerns do not seem entirely related to that fact, nor to churning and the need for best execution. The Commission has also been concerned with (1) preventing undue influence on retail sellers of fund shares; (2) limiting anticompetitive impacts on small investment companies and small complexes which cannot allocate as much for sales as larger ones; (3) causing existing shareholders to bear a portion of the cost of selling to new investors; and (4) the difficulty of developing, in a climate of reciprocal relationships, clear disclosure of amounts paid for selling fund shares.

How does the advent of fully unfixed commission rates affect these considerations? If we assume that fund managements will live up to their primary obligation of best execution and no unnecessary transaction costs to the fund, it is obvious that brokerage could be allocated to award sales of fund shares only to dealers who, alone or together with their correspondents, also have a satisfactory brokerage capability. But what will be the role of those firms which presently use a correspondent firm for execution? In an era of unfixed rates, how can they meet their responsibilities if they add an extra amount to the commission the executing broker would have charged had the customer placed his order directly? The brokerage community, you in the mutual fund industry and we at the Commission are going to have to focus very hard on exactly what should be the full scope of satisfactory brokerage capabilities.

We have been faced with this problem in the securities industry generally, in connection with the suggestion, and even proposed legislation, that institutional investors would not be violating their fiduciary obligations by paying something more than minimum commission rates to reward research. One of the difficulties in such proposals, as pointed out by certain members of the industry, is that some of the best research firms do not have adequate ability to execute large and difficult transactions. The same sort of thing is true in the mutual fund area, where dealers who are good at selling fund shares may not be good at executing fund orders. We are reluctant to participate in creating new temptations to seek less than best execution for the sake of rewarding sales, and yet to lift the ban on the rewarding of sales would seem to do this very things. Our staff already has presented us with a comprehensive review of this area. We will be announcing, shortly, the commencement of a public hearing to facilitate our study of these issues.

The question arising from the new forms of competition with mutual funds are even more troublesome. I won’t discuss the matter of variable life contracts, because, as you know, we have just completed extensive hearings on that whole problem, and the matter is still under consideration. But how about other forms of new competition, particularly from banks?

We have naturally thought it inappropriate for us to undertake to instruct federal bank regulatory agencies as to how they should interpret and enforce banking laws. We expect, however, before the year is out, to be asked to express our views before subcommittees of both the House and the Senate on what we think the banking laws should provide relative to banks engaging in aspects of the securities industry. We will, of course, respond as best we can. In the meantime we must work with the law as it is and with such interpretations as bank regulatory authorities render with respect to their own laws.

This mean, in general, that our concern is with the questions of when banks may be issuing securities that require registration under our Acts and when their activities may result in the creation of an investment company as a separate issuer. Insofar as banks may be acting as brokers or dealers or investment advisers, as you know, there is an express exemption for banks, as that term is statutorily defined, from both the Securities and Exchange Act of of 1934 and the Investment Advisers Act of 1940, except for the antifraud provisions. This has led us into consideration of whether the automated investment programs, the dividend reinvestment programs, and the various so-called mini-account programs, should require some sort of registration with us.

As to automated investment plans, if one accepts the Comptroller's decision with respect to the banks' power under the Glass-Steagall Act, to the extent that we are familiar with the present plans, it seems difficult to conclude that either an investment company or a new, nonbank, security is involved. The question is not quite so clear with respect to dividend reinvestment plans where, because of the issuer's involvement along with the trust department of the participating bank, there may be cases where '33 Act registration is appropriate. We have not yet required such registration, except where the program involves the issuance of new shares by the issuer, rather than market purchases by the trust company, but we have announced that we are reconsidering the whole matter.

Various forms of proposed discretionary management services for small investors and the so-called mini-accounts present somewhat more complex problems. Since, as I have stated, banks and trust companies are exempt from the definition of investment adviser, and securities of which the bank itself is the issuer are exempt from registration under the '33 Act, we cannot assert jurisdiction under our laws (except for fraud) unless we find that some entity other than the bank or trust company is created as the issuer of a security, and that this results in securities of the same class being offered publicly.

A little more than a year ago, then Chairman Casey appointed an Advisory Committee on this subject, and it recommended generally that these questions of application of the securities acts be determined according to whether or not the assets of the advisee clients are pooled and whether or not the advisees are given individualized investment advice.

Where the assets are pooled and the advisory clients are not given individual advice, we have no difficulty concluding that an investment fund has been created which is the issuer of a security and which, if offered to persons generally, must be registered under both the '33 and '40 Acts. Our Advisory Committee agreed with this conclusion.

The Division of Investment Management Regulation has been considering this problem with the benefit of the recommendations of the Advisory Committee, and we are developing a series of governing propositions. In the near future, we will announce the direction in which we intend to move, and will solicit comments from the public on certain of our proposed positions.

In summary, these are:

1. Where assets are managed on a discretionary basis, registration would be required under the ’33 and ’40 Acts if clients do not receive individualized treatment, even though the assets are not pooled (that is, investors retain all the incidents of ownership of the underlying securities. Such arrangements would not require registration under either Act if they do in fact afford clients individualized treatment.

Individualization is not an easy concept to pin down when it is transformed into a legal principle with important regulatory consequences. Each of us may have a different idea of what we mean when we talk about individualized treatment, and in practice, mini-account firms vary widely in the degree to which they take into account the client’s particular financial and tax situation when making investment decisions.

It is important that the guidelines we develop for individualization be clear and sufficiently specific so that they can be meaningfully applied. Among the many questions we face are: How frequently should the investment manager contact his clients to update the initial personal data received when the account was opened? How much weight should be given to overlapping advice among clients in determining whether or not a service is individualized? Is it enough to categorize clients by investment objective and make similar investment decisions for all those in the same category, or must the investment manager first review each client’s portfolio and financial and personal data? Should we set up quantitative standards for frequency of review of clients’ accounts or a presumption that a minimum account size is required to make individualized treatment economically feasible?

2. Non-discretionary services should not be treated as offering a security for purposes of either the ’33 or ’40 Acts, if they afford clients a meaningful basis for

making their own investment decisions. Generally, this would mean that clients should receive a statement furnishing them with a reasonable basis for the adviser's recommendation so that they can make an independent judgment as to its merits.

3. Rules and guidelines under the Advisers Act, and possibly the '34 Act, need to be developed to deal with disclosure, conflicts of interest, and other investor protection problems where mini-account arrangements will not be registered under the '33 or '40 Acts. An information statement disclosing the material facts about the advisory service should be required to be transmitted to prospective clients, and other potentially dangerous practices should be prohibited or regulated. For example, the Advisory Committee recommended that advisers should be subject to a prohibition similar to that contained in Section 10(f) of the '40 Act, so that if the adviser is, or is affiliated with, a broker-dealer engaged in an underwriting, the securities being underwritten could not be sold to clients with discretionary accounts during the existence of the underwriting syndicate.

Even before our proposals are finalized, however, a lot can and should be done by some mini-account advisers to upgrade their compliance with the federal securities laws. Some advisers who hold themselves out as providing individualized treatment may not, in fact, do so under any reasonable definition of that term. If not, the antifraud provisions of the statutes we administer would come into play. As we formulate our regulatory posture in this area, we intend also to look very closely from an enforcement standpoint at a number of arrangements now in operation.

Aside from the transcendent importance of the status of our capital markets, the problems of inter-industry competition, of achieving fairness among competition while encouraging healthful and beneficial competition, loom ever larger and more pressing. They are certain to absorb an increasing amount of the attention of ourselves and other agencies of the government.

I realize that in these days of poor performance and, indeed, distress we must seem indecisive or disinterested or both. I realize that you may be impatient with talk about equal regulation when you want legal protection. When things are bad, you don't want justice, you want mercy. But from our point of view, these things are not so easy, given the statutes we are charged with administering and the absence of any mandate to reorder the universe.

Nevertheless, our wheels are turning and not just spinning and we are eager to preserve the viability of investment alternatives. We have recently requested interested persons to submit views and suggestions regarding the application of the federal securities laws to bank activities. We hope that you will respond, individually and through the Institute. We would welcome like submissions - - even though we have not formally requested them - - with respect to other areas in which you think you are at an unfair competitive disadvantage because of legal restrictions or obligations imposed by the federal government. We need and want facts and concrete proposals.

I do not promise instant relief through Commission action. We must take many countervailing considerations into account. But even if your views do no more than help us formulate our views to present to the Congress, they will be most worthwhile.

Meanwhile, we wish you well, now and in the years to come.