Investment Management Division

MEMORANDUM

February 3, 1978

TO: Syd Mendelsohn

FROM: Chairman Williams

RE: Restructuring the Role and Responsibilities of the Division of Investment Management.

I have reviewed your January 27, 1978, Memorandum to me expressing your views on the issues currently facing the Division and its administrators. Having given a good deal of thought over the past several weeks to the Division and its future role within the Commission, and now having had an opportunity to consider your views, I think it would be very helpful if we met once again and discussed in greater depth my concerns and the objectives that I believe we should be seeking to achieve. Before having that discussion, however, I wanted to share with you some of the impressions I have on the direction the Division of Investment Management should be taking over the next two years.

Taking the broadest view, the Division will have to begin the process of readjusting the relationships that have evolved between the Commission and mutual funds, their directors, counsel and professional advisors. When that relationship is in proper balance, we have an opportunity to play an important role in the orderly development of industry practices and remain an active, visible and positive factor in the marketplace. However, through the years it seems that there has developed an increasing dependency on the Commission and its staff to pass upon the legal implications and, more fundamentally, the desirability of general business practices, individual transactions, and available alternatives to respond to real or perceived ethical dilemmas.

When that dependency becomes too great there is a natural tendency for the regulated person to disengage from the responsibility of making difficult decisions and allow the exercise of his judgment to be substituted by that of the regulator. In that environment, I feel the relationships are out of balance and regulation is not playing its proper role. By involving ourselves too directly in the day-to-day business decisions of investment companies, or holding ourselves out as willing to do so, we lose an important perspective and deprive the industry of the rewards that exercises of its own creativity could bring it.

To readjust those relationships we will be required to redefine our role as administrators of the investment management regulation provisions of the federal securities laws. Independent fund directors and their counsel will have to be encouraged, and in many cases required, to make difficult business decisions without detailed comment or liability-shielding "no action" or exemptive relief from the staff. The staff, on the other hand, will have to begin directing its efforts more towards promulgating rules of general application which provide clear guidance

with respect to particular provisions of the '40 Acts and the applicable disclosure provisions of the '33 Act. In addition, they will have to become more actively involved in overseeing the activities of self-regulatory agencies to detect and enforce violations of their, and perhaps, Commission rules and, providing input to the Commission's own enforcement program through regular inspections of regulated persons. As I envision it, the Commission's administration of the Acts would principally be aimed at rulemaking, enforcement and final disclosure policy -- rather than processing applications — where use of its scarce resources would be most effectively maximized. In addition, if we are able to back up the use of clear and precise rules with uniformly applicable private rights of action, much of the cost of enforcement will be shifted to the private sector where individuals can best perform their own risk/reward calculations. As you indicate in your memorandum, we have taken some important first steps in such a reform program but, I believe, our efforts must be more comprehensive in scope and subject to a tight timetable.

A second long term goal that the Division should be working toward is the development of a plan of uniform regulatory coverage for all investment management activities, including investment companies, investment advisers, insurance companies, bank trust departments, and all other forms of institutional investors. The present arrangement, which focuses exclusively on mutual funds and investment advisers, achieves a level of regulation of internal corporate affairs over these smallest of the institutional investors, quite clearly to their economic disadvantage in competing in the marketplace. Thus, a bank or an insurance company product will inevitably be subject to less scrutiny than a mutual fund. We might consider amending aspects of the Investment Advisers Act, or other techniques that you may be able to suggest, to achieve uniform regulatory coverage across the entire panoply of institutional investors.

Finally, I believe we should give serious thought and study over the next 12 to 18 months to the development of an outside self-regulatory agency, such as the NASD, to provide direct ethical and business practice oversight for institutional investors. One obvious advantage of promoting the creation of such an organization would be to unburden the Division's staff from the controversial and time-consuming efforts to provide oversight in problem areas which inevitably follow actual practice perhaps by as much as several years.

Of course, each of these long term program goals will have to be broken down into groups of short run objectives if we are to succeed. For example, a major portion of the Division's work, as I understand it, relates to processing applications for exemption from Section 17 or under Section 6(c) from various sections of the Act. Here we might consider adopting rules under Section 17 which would implement, as Marty Lybecker once suggested in an article on the '40 Act, a "three-tier response" to the need for exemptions.

The first tier would exempt, for all purposes, some minor level of transactions which everyone would agree are so diminimus as to involve no particular conflict of interest. The second tier would exempt transactions which the disinterested directors (or their equivalent) of investment companies deemed in their business judgment to be fair and reasonable to the investment company and in the best interest of their shareholders. The third tier would address all remaining transactions where the disinterested directors were unwilling (or unable) to make such a judgment, and thus effectively defer to the judgment of the Commission. In part, this same analysis would support a change in the Commission's and the Division's approach to Section 6(c), where, I understand, a number of the exemptive orders are repetitive and based on enormous precedent. Permanent rules could be adopted to provide for exemptions that would be self-administering at the institutional investor level.

The directors of the various institutional investors are legally required to process transactions which raise questions of fairness to the investment company in complex business transactions under state law, and, it seems to me, that a good argument can be made that their judgments should be given greater deference under the 1940 Act. However, I agree with your view that if the independent directors fail to fulfill their responsibilities we will have learned something very valuable about the fundamental predicates of the '40 Act. In any event, I believe we can minimize the risks of experimenting with a more self-administered program, particularly under Sections 17 and 6(c), if we implement, as a necessary adjunct, an intensified inspection program of broker-dealers, investment advisers, and investment companies which has within it a substantially upgraded emphasis on surveillance in that area.

I understand that another major source of applications and controversy is Section 22(d). As a resale price maintenance provision, the section obviously mirrors the same practical effect of resale price maintenance practiced within insurance companies and bank trust departments which do not use external sales forces. I suspect that in many ways the issue of whether or not to repeal Section 22(d) is a false one, in that there is in fact competition of an interbrand nature solely over price at some level of mutual fund purchaser. I am told that many people in the industry guess that amount at $50,000, although it is possible that effective competition also occurs as low as $25,000.

Some apparently fear that amending Section 22(d) would strip the mutual fund industry of essential economic protection in competition with other institutional investors. It seems logical, however, to test that hypothesis by repealing Section 22(d) at least as to sales over, say, $50,000 to get some sense of how negotiated commissions would work among those whose economic resources are certainly large enough to suggest that they are able to protect themselves. This relates,

although somewhat obliquely, to the related economic question of use of mutual fund resources to pay underwriting or other sales-related expenses -- another area where I would be inclined to permit experimentation.

Another related problem area is advertising, and while everyone interested in the field is concerned with the nature of advertising, it seems inevitable that investment company advertising should be freed from the restrictive theology of the 1933 Act, and regulated to the extent necessary only under the 1940 Act or the Investment Advisers Act. One cannot watch "piece of the rock" ads and fail to realize that mutual fund tombstones simply cannot compete with such suggestive advertising for the public's savings dollars.

The Advisers Act presents different kinds of problems. Here I see the possible assertion of the regulatory authority presently available over insurance companies as an important issue. Unrelated personnel could be excluded, perhaps in the same way that Congress fashioned the arrangement for regulating the municipal bond departments of banks. Similarly, thought should be given to expanding the Commission's regulatory presence in the Advisers Act using the authority under Section 206 to reach out and address many of the low grade ethical problems, such as churning, suitability, or extensions of the shingle theory, which already exist under the 1934 Act respecting broker-dealers. Again thought could be given to seeking legislation to permit an NASD-type organization, or organizations, to organize to do the direct regulation of the ethical and business problems of investment advisers, perhaps including fees. Finally, if the Investment Advisers Act were amended to exclude the bank exemption, it would then address the major institutional investors all under one act, without displacing the current regulatory authority of the federal bank regulatory agencies to deal with the more exotic trustee beneficiary problems which they are presently equipped, readily able, and organized to regulate during their inspections of the commercial side of banks.

Maintaining the Division's presence in questions involving the Commission's administration of the Exchange Act is also important. It has often seemed to me that the Commission's decisions respecting the structure of the national market system could be enhanced by an empirical data base from which to draw conclusions about how the system that ultimately emerges may effect institutional investors. Implementation of Section 13(f) would serve as such a data base and might provide interesting insights into the actual behavior of institutional investors in an evolving national market. Similarly, the Division should be an invaluable resource to the Commission in establishing an appropriate conceptual framework within which to define the relationships between Sections 13(d), (f) and (g).

Although you have been here much longer than I, and certainly have a much greater feel for the pulse of the Division than I could ever hope to have, I cannot help commenting on how initiating some of these proposals could favorably impact upon the morale of the professionals with whom you work. First, materially shifting the nature of the work now being done within the Division — processing Section 17 or Section 6(c) applications — to drafting rule proposals, or working legislative projects would likely be received as more rewarding professional tasks and have the valuable advantage of appearing at all times to promote the greatest amount of investor protection. As a related matter, you might consider stepping up the rotation of young attorneys and medium range career attorneys within the Division between the disclosure and regulatory branches to vary the legal tasks they perform, to create greater incentives for performance, and to develop more broadly their legal skills under a variety of supervisory techniques. Although I understand that efforts in this area have not worked out in the past, I continue to envision such an atmosphere as promoting morale and as addressing inappropriate feelings of lack of prestige within the Commission. Rather than scrap the idea, I would focus on remedying the problems that arose in earlier attempts to introduce these professional opportunities to the Division.

Finally, I would think the Division could perform an important legal education function and enhance its own self image if it could sponsor both in-house and PLI-type training sessions to broaden exposure of the Commission's staff lawyers and private practitioners to evolving public policy questions under the '40 Acts. As a collateral effect, the external perceptions of the Division would also be substantially enhanced. At the same time I agree with your view that there is a need for the Division's staff to become more familiar with the actual operation of mutual funds and other institutional investors.

I fully understand that it is difficult to react and respond to a nonspecific call for reform in an area as complex and mature as our administration of the '40 Acts. I feel that your memorandum was a good first step in helping me better to understand the issues facing the Division as you perceive them. I hope that this memorandum will similarly serve to sensitize you to some of the issues that I believe deserve priority consideration by the Division over the next two years. I look forward to discussing these matters with you further when I return from California next week.