

PROJECTIONS, FORWARD PRICING, AND GROUP PURCHASING

Remarks of

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Projections, Forward Pricing, and Group Purchasing*

I greatly appreciate your kind invitation to appear before you who are in the business of selling interests in investment companies. I am always in awe as to your ability to sell your product, and I marvel at the fact that in August of this year you sold some \$531 million of mutual fund shares. It is for this reason that you might perhaps be interested in three recent actions taken, or submitted as possible actions to be taken, by the Commission -- (1) the use of projections in the sale of interests in investment companies, principally variable annuities; (2) the requirement that the price at which open-end fund shares are sold, redeemed or repurchased must be determined on the basis of the net asset value of the shares as next computed; and (3) the recent proposal that a group of individuals be permitted voluntarily to combine their moneys so as to obtain the benefit of quantity discounts.

I

All of you know that the Commission's Statement of Policy Relating to Investment Company Sales Literature provides that it is materially misleading to represent or imply that (1) an investor will receive a stable, continuous, dependable, or liberal return or (2) that his capital will increase. For this reason the Commission has frowned upon the use of assumptions as to what the value of a mutual fund share could be at a future time. Any assumption is purely conjectural and, as we all know, the market value of securities may go down as well as up.

In the early part of this year the staff learned that a number of insurance companies were employing sales literature which showed what the results would be if certain hypothetical investment returns on the portfolio of their separate accounts were "projected" into the future. Thus, the sales literature showed that if a 45 year old man purchased a variable annuity by making an annual payment of \$1,000 for 20 years, and if a "hypothetical" annual net investment rate of 7% were employed, he would, at age 65, have an interest worth \$40,796. And if he then elected to receive variable annuity payments, he would receive \$261 in the first month of his retirement, \$346 for the month which is at the mid-point between the date of his retirement and the end of his life expectancy, and \$459 for the month which is at the end of his life expectancy. Similar calculations were simultaneously presented upon the hypothesis that the annual net investment rate would be 3-1/2% and zero per cent.

*The views expressed herein are solely those of the author and do not necessarily represent those of the Securities and Exchange Commission or any other member of its staff.

The sheet upon which these calculations were set forth did state that the calculations were "hypothetical illustrations using various investment rates" and "bear no necessary relationship to past or prospective investment experience." Nevertheless, the staff objected to the use of this type of "projections" of assumed investment results and so advised all the insurance companies which were selling interests in their variable annuity separate accounts.

The insurance companies appealed to the Commission and set forth a number of arguments. The principal arguments were that (1) the variable annuity was different from a share in a mutual fund, (2) the Statement of Policy did not prohibit the use of "projections" if proper cautionary language was used, and (3) since a purchaser of a variable annuity was interested in what he would receive upon his retirement, it was necessary that the salesman be able to show him what he would receive if he purchased a deferred fixed dollar annuity and contrast it with what he might receive if he desired a variable annuity.

As to the first point, the staff believes that a variable annuity is a security, the Supreme Court having so held in two instances -- that there is no basic difference between it and a share of an investment company. As to the second point, the staff believed that the language I previously quoted from the Statement of Policy expressly prohibited any representation or implication that the investor would receive any return on his investment or that his capital would increase; and this despite the disclaiming language set forth on the sales sheet.

As to the third point, the staff believed that it would be misleading to compare the amount of the monthly payment a person would receive if he purchased a deferred fixed dollar annuity with the payments he might obtain by using assumed rates of return and projecting the results into the future -- perhaps as long as 55 years. In the former situation the insurance company can readily and truly calculate the fixed dollar payments the annuitant will receive each month and which the insurance company "guarantees." In the variable annuity situation the insurance company can make no true calculation as to what the variable annuitant will receive each month upon his retirement, and the insurance company does not "guarantee" any amount he will receive in any month. To compare the two, we felt, would be misleading.

The matter was taken to the Commission which received various memoranda from the insurance industry and orally heard their spokesmen. After careful consideration, the Commission, about a month ago, determined that it would not be appropriate to permit the use of projections in sales presentations -- and this applied to variable annuities and to mutual fund literature, including literature relating to withdrawal or retirement programs.

II

Section 22 of the Investment Company Act provides, in effect, in subsection (a), that the NASD may adopt rules which would prescribe a method for computing the minimum price at which a member may sell, or redeem, a redeemable security in order that the price will bear such relation to the current net asset value of the security, computed as of such time as the rules may prescribe, for the purpose of eliminating or reducing so far as reasonably practicable any dilution of value of other outstanding securities of the company or any other result which is unfair to holders of such other outstanding securities.

Subsection (c) says, in effect, that one year after the effective date of the Act, the Commission may prescribe rules covering the same subject matter as prescribed in subsection (a) and any rules so prescribed will supersede the rules of the NASD.

In 1941, the NASD proposed rules which provided that there be twice-a-day-pricing of shares and that as to sales or repurchases of shares, the price be based upon the net asset calculation as most recently calculated and that it remain in effect until one hour after the next calculation. The rule also permitted the price to be determined upon the basis of the calculation next to be determined.

Under the NASD rules, the prices are calculated twice a day -- at 1:00 p.m. and 3:30 p.m. each day the New York Stock Exchange is open for trading. The 1:00 p.m. calculation is in effect from 2:00 p.m. until 4:30 p.m. of that day and the 3:30 calculation is in effect from 4:30 p.m. of that day until 2:00 p.m. of the next trading day. Thus, a purchaser of shares, or his dealer, may wait until 1:45 p.m. before placing an order to purchase shares and the price will be based upon the calculation made as of 3:30 p.m. the previous day.

The Commission held a conference in 1941 with respect to the proposed rules and concluded it would not, at that time, interpose any objection to the proposed rules but stated that it wished "to make it clear that we are neither approving these [provisions] nor inferring in any way that they are adequate to solve the problems to which they relate." 1/

1/ A proposed amendment to the Rules of Fair Practice of National Association of Securities Dealers, Inc., 9 S.E.C. 38, 43 (1941).

And so for some 17 years these rules have governed the pricing of shares sold or repurchased by members of the NASD; they do not govern those persons who sell or repurchase shares but are not members of the NASD. Many persons, including members of the NASD, price shares for sale at the previously calculated price, i.e., backward pricing, but price shares for repurchases or redemptions at the next calculated price, i.e., forward pricing. There is no conformity.

The staff believed that, because of this pricing mechanism, a number of unfortunate consequences occurred. At least one fund, in its prospectus, stated that its principal underwriter would provide any dealer with the 1:00 p.m. or 3:30 p.m. price after it has been calculated but before it became effective. Thus, some time before 2:00 p.m. the dealer would know the price then in effect, i.e., the price calculated as of 3:30 p.m. the previous day, and he also would know the price that would be in effect at 2:00 p.m. If the previous price was lower than the most recently calculated price, he would place his purchase orders before 2:00 p.m. If the previous price was higher than the most recently calculated price, he would wait until after 2:00 p.m. to place his purchase orders. In fact, in a declining market, and even if the fund's principal underwriter did not give advance information as to what the next price would be, a dealer would watch the various stock market indices to see whether the market was, generally, going up or down. If the 1:00 p.m. market index was higher than the 3:30 p.m. index of the previous day he would place his purchase orders, at say, 1:45 p.m. -- if that market index was lower he would wait for the next "up-tick" and then place his orders. This waiting period, in a steadily declining market, could last for several weeks. As a result, the purchaser would obtain more shares than he would have received if his dealer placed the purchase order at the time the purchaser had definitely determined to acquire the shares. This resulted in a dilution of the value of the outstanding shares.

Sometimes the results were more egregious. You all remember that the President, during the evening of March 31 (a Sunday), announced that the bombardment of North Viet Nam would be curtailed and that he would not accept renomination. During the morning of Monday, April 1, the general market rose sharply -- the highest single day increase in some 4-1/2 years. Some individuals placed large orders for the purchase of fund shares at about 1:30 p.m. and obtained the 3:30 p.m. price of the previous Friday. In fact, in one no-load fund, a million dollar purchase was entered -- and, about 4:00 p.m. those shares were "redeemed" upon the basis of the 3:30 p.m. price -- thereby making a very handsome profit. The purchaser did not even pay any sales load on his purchase since this was a no-load fund -- and, even if he had paid a sales load, presumably only 1% on a million dollar purchase, this was a cheap sales load to pay for an assured quick, handsome profit.

In view of all this, the staff recommended that, pursuant to Section 22(c), the Commission adopt a rule which would require, as countenanced by the NASD rules, twice-a-day forward pricing, i.e., the price would be based upon the net asset value next determined by the company. Thus the price of any order received prior to 1:00 p.m. would be based upon the 1:00 p.m. calculation, and any order received between 1:00 p.m. and 3:30 p.m. would be based upon the 3:30 calculation. As a companion measure, the staff recommended that the appropriate rule under the Securities Exchange Act be amended to require dealers to stamp on the memorandum it supplies its customers the time of receipt of the order.

The Commission noticed the proposal for comment. Some 82 letters of comment were received. The great majority favored the forward pricing requirement. Some of those that opposed argued that forward pricing would be significantly more costly, as well as mechanically more complex, for mutual funds which are distributed through dealers and that the dilution is of negligible proportions. Many, particularly the smaller funds, stated that the twice-a-day requirement would create disproportionately additional expenses and that the 1:00 p.m. computation is not actually calculated but is a mere estimate.

After considering the comments, the Commission very recently announced the adoption of the rule as published for comment except that the twice-a-day pricing was changed to once-a-day, computed as of the close of business of the New York Stock Exchange. The Commission also adopted the companion amendment to the Securities Exchange Act rules requiring the stamping of orders.

Accordingly, after the effective date of the rules, the price at which mutual fund shares are sold, redeemed or repurchased will be based upon the net asset value as next computed after the receipt of the customer's order.

III

Section 22(d) of the Investment Company Act provides, in effect, that no redeemable security may be sold to any person "except at a current public offering price described in the prospectus." The purpose of this provision, as described in the Congressional reports on the Act, is to prohibit the sale of redeemable securities to any person at a price less than that at which it is sold to the public. Although the section makes no reference to quantity discounts, the provision was interpreted, in the very early administration of the Act, as permitting the then prevalent practice of underwriters of open-end companies charging smaller sales loads on larger

purchases if such varying sales loads were clearly set forth in the prospectus and charged to all persons without discrimination. 2/

The question then arose as to who was entitled to the quantity discounts. The "single transaction" doctrine was developed under which a purchase by a group of persons was considered to be a single transaction entitled to the quantity discount based on the amount of the purchase. Thus group purchases by members of the same family and by trustees, fiduciaries, and custodians were permitted by order. 3/ Further, the staff did not object to group purchases by members of a medical or dental society through an agent; the faculty of a university purchasing through a bank as custodian; and members of business, professional, fraternal or labor organizations through a representative. And no objection was made when prospectuses included language which stated that the reduced sales charges would be imposed, based upon the total amount invested, if made under a group investment plan adopted by a duly organized association or other organization.

In early 1958, the NASD expressed its concern that if this practice of grouping purchases, which was becoming more and more widespread, were to continue, the "orderly, effective distribution system would be disrupted." The Commission thereupon, after notice and hearing formal arguments, adopted Rule 22d-1 which, while codifying in most respects prior administrative interpretations and exemptive orders, prohibited for the most part the practice of permitting group purchases. 4/

The situation has since remained unchanged. However, as a result of the Commission's study of the growth of the investment company industry, which culminated in its December 2, 1966 report, 5/ it now appears that no disruption of the orderly, effective distribution system would develop if mutual funds were allowed, on a strictly voluntary basis, to offer quantity discounts to groups of individuals.

Consequently, on October 7, 1968, the Commission published for comment a proposal to amend Rule 22d-1. 6/ Under the amendment, the proviso clause to the last sentence of paragraph (a) of the Rule would be

2/ Investment Company Act Release No. 89 (March 13, 1941).

3/ Investors Diversified Services, Inc., Investment Company Act Release No. 2504 (1950); Axe-Houghton Fund, Inc., Investment Company Act Release No. 1505 (1950).

4/ Investment Company Act Release No. 2798 (December 2, 1958).

5/ Report on the Public Policy Implications of Investment Company Growth, H. Rep. No. 2237, 89th Cong., 2d Sess.

6/ Investment Company Act Release No. 5507.

deleted and it would be made clear that the term "person" as used in the rule would have the same meaning as set forth in the definitive section of the Act. 7/ If adopted, the rule would provide small investors with the opportunity, if agreeable to the mutual fund and its principal underwriter, to join together to purchase mutual fund shares at the lower sales charges at present available only to investors of large sums.

A few words of caution may be in order. The amendment would not relax the obligation under the Securities Act of 1933 of broker-dealers and other distributors of mutual fund shares to provide prospectuses to all persons who are solicited. A prospectus would be required to be furnished to each member of any group being solicited. Similarly, after purchases of mutual fund shares, all proxy soliciting material and reports to shareholders required by the Act and rules thereunder would be required to be provided to each participating group member.

It should also be noted that in order to avoid problems under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940, all group purchases would be required to be handled in a manner substantially similar to ordinary brokerage transactions. 8/ Thus, where limitations are imposed on the rights of an individual participant, or special charges are made, a separate security may be created which would be required to be registered under the Securities Act and the issuer of which may be an investment company required to register under the Investment Company Act. For example, such problems would arise if: (1) sums were accumulated for material periods of time before investment; (2) special fees or charges, such as a front-end load, were imposed; (3) limitations were imposed on the right of participants to withdraw securities held in custody; or (4) limitations were imposed on the rights and privileges of participants as shareholders.

As the release states, all interested persons are invited to submit, on or before November 4, 1968, the views and comments on the proposed amendment.

As I said at the outset, I appreciate this opportunity to discuss with you a few of the present issues as to which we have a mutual interest.

7/ Section 2(a)(27).

8/ See Securities Act of 1933 Release No. 4790, July 13, 1965.