Address by

RALPH H. DEMMLER

Chairman
Securities and Exchange Commission

before the

FIFTH ANNUAL MUTUAL FUND CONFERENCE

Boston

October 7, 1953

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When I was first asked to address this convention, I was not sure I should accept. My sales experience has been limited - the summer of 1922 as the housewives' friend, the Fuller Brush Man. But I'm not talking to you today as a salesman, but as the representative of the Federal Agency whose job it is to restrain, rather than stimulate your exuberance.

Since the Securities Act, the Securities Exchange Act, the Investment Company Act, and the Securities and Exchange Commission are all part of the climate in which you must do business, it may not be amiss to talk about the why and how of Federal regulation of the investment company business.

The Commission, as you know, first appeared upon the scene in 1934. Then investment companies were treated just like any other issuers of securities. If they wished to sell new securities or if any issue was registered upon a national securities exchange, they were subject, like everyone else, to the Securities Act and the Securities Exchange Act. In 1935, the Congress directed the Commission to make a study of your industry. Fresh in the minds

of the nation was the memory of heavy losses suffered by investors, partly because of general economic depression, partly because of abuses which had permeated the capital markets.

The studies of the investment companies undertaken by the Commission proved to be an example of cooperation between government and the financial community. Ultimately, the recommendations for legislation bargained out by the Commission and the industry were embodied in the Investment Company Act of 1940. This legislation was ultimately endorsed by both the persons for whose regulation it provided and the regulatory agency which was to be charged with its administration. It provided regulation without the death sentence of the Public Utility Holding Company Act. It was passed without a dissenting vote in either House of Congress.

Parenthetically let me suggest that, since the industry succeeded in limiting Federal regulation of its business to an Act with far fewer teeth than the Public Utility Holding Company Act, it is all the more important that investment companies recognize great responsibility in preventing new abuses.

Background of the Act

In the thirteen years since 1935, the Act has not been amended and there have been relatively few changes in its administration. This would, therefore, seem an appropriate

time to review its purposes, its operation, and the progress made toward elimination of the abuses it was designed to correct.

The abuses consisted, in general, of management of corporate affairs so as to benefit insiders and affiliates to the prejudice of the investor. For instance, dealers used controlled investment companies to increase their securities business; insiders acquired securities and sold them to investment companies at a higher price; investors were switched from one company to another to provide extra commissions; camouflaged and grossly excessive selling commissions were charged; many companies maintained inadequate reserves; finally, but by no means least important, control of investment policy was shifted from one person to another or the investment policies were shifted from one direction to another without the consent of public security holders.

In a field so highly technical and complex, I suppose the law had to be technical and complex. At any rate, it is a complicated statute. But in all major areas it seems to have accomplished its purposes. We have had no major investment company bankruptcy since 1940. I am not prepared to present statistics on the performance of investment companies as distinguished from a composite of market performance. Such statistics would not be particularly helpful in any event since the investor does not buy the securities of investment

companies as a whole but the securities of particular investment companies.

Fortunately, the Commission has seldom been compelled to use its disciplinary powers under the Act. This is a tribute to the cooperative attitude of the industry. Regulatory legislation can set guide posts, but it is no substitute for self-control.

It is important that the industry continue to exercise this self-control. Investment companies have recovered the ground they lost in the thirties. In 1929 they were being created at the rate of almost one a day. The public had invested in them almost $7,000,000,000. Then came the crash. Fifty per cent went out of existence by 1940 and investors in bankrupt companies had lost 90 per cent of their investment.

The tide has turned, however. In the last few years there has been an enormous flow of money into these channels. Total assets in the hands of investment companies have increased almost five-fold since 1940. This is due partly, of course, to the fact that aggressive selling is stimulated by sales commissions for investment companies' shares which are relatively higher than brokerage commissions or spreads or concessions on underwritten securities or profits on securities bought or sold by a dealer as principal.

This growth evidences public confidence. But that very confidence imposes a correlative duty and responsibility to sell investment company securities and to manage investment companies with the investors' interest as the paramount consideration. That is good business as well as good salesmanship.

The Investment Company Act of 1940 is designed to protect the public interest and the investors' interest. It provides not only for disclosure but also for the regulation of specific types of transactions, particularly those involving an absence of arms length bargaining. Much of the Act is a chart of permitted and prohibited practices; other parts provide for reports to the Commission; and still other portions confer quasi-legislative and quasi-judicial powers on the Commission. Whatever you may think of it, therefore, your business and the Commission's work are pretty well intertwined.

This, however, is not going to be a section by section description of the Investment Company Act. Suffice it to say that the Act has two basic aims - adequate disclosure and fair dealing.

Since the Act is complex, the Commission and your industry must of necessity do a lot of work together. We are testing cooperative methods in the policing of supplemental sales literature.

In 1950 the Commission issued a Statement of Policy, prepared with the assistance of the National Association of Securities Dealers, which is designed to advise investment companies, underwriters and dealers as to the types of advertising and sales literature which may not meet statutory standards.

The NASD, as a private instrumentality for self-regulation examines all supplemental sales literature, usually before it is distributed. If it does not conform to the policy expressed by the Commission, the NASD committee sees to it that the necessary corrections are made. Thus, the public is better protected, the Commission achieves better enforcement of the law and the industry benefits from reasonable assurance that changes will not have to be made in the literature after the expense of printing a substantial quantity has been incurred.

With a view to providing a better understanding of the Statement of Policy, NASD has prepared a guidebook to the Statement. This, the authors declare, should encourage the sale of investment company shares by objective explanations of their advantages and limitations under a standard of equal treatment to everyone.

The most obvious defect in the Statement of Policy - indeed, in the statute itself - is the lack of a precise definition of what constitutes "sales literature". The Statement of Policy defines

sales literature as including "any communication (whether in writing, by radio or by television) used by an issuer, underwriter or dealer to induce the purchase of shares of an investment company". Almost any article or advertisement can be sales literature, depending on how it is used. Neither the statute nor the Statement of Policy makes an exception of institutional advertising. I humbly and respectfully submit that there are practical limitations to a definition in words of "sales literature". Consequently, I would like to submit for your serious and reflective consideration a different approach to that particular problem than is currently in effect.

Section 24(a) of the Investment Company Act makes it unlawful "to make use of the mails or any means or instrumentalities of interstate commerce to transmit any advertisement, pamphlet, circular, form of letter or other sales literature addressed to or intended for distribution to prospective investors unless three copies of the full text thereof have been filed . . ." within ten days after its use. In other words, the statute is penal. If a citizen violates it, he lays himself open to a penalty. In the case of penal statutes, generally, no interpretative service is provided in advance of the doing of an act which may or may not be construed as a violation. Generally speaking, the Federal Trade Commission does not clear advertising in advance. The citizen (sometimes with his lawyer's advice) makes his own interpretation and the courts punish him if he turns out to have been wrong.

Your industry-established procedure for examination of sales literature is adaptable as a means of reaching some conclusion as to whether particular documents constitute sales literature. What I am suggesting frankly is that the industry and the individual members thereof act at their own peril in deciding what is sales literature. Then the Commission will be free to prosecute on the basis of the particular facts of each case a misuse or non-filing of any material which is in fact used in selling investment company securities. As I pointed out, this is not a revolutionary concept; it is simply laying upon the members of your industry the same obligation that citizens generally have - to read and at their peril interpret the words of a statute which makes a particular act unlawful. The statute has no provision for pre-use determinations of what is or what is not sales literature. Please understand that the foregoing is merely an informal tentative suggestion of one Commissioner for consideration as an approach to the problem.

That is only one of the many problems which the Commission has, all crying for solution. As in the case of our other problems, we shall welcome constructive suggestions from regulated groups.

But, however much self-regulation is effectively imposed by the industry, you and the Commission have a lot of work to do together.

I say that because the Commission in the Acts administered by it is given unusually broad powers to make rules and regulations which have the force of law and naturally in the rule-making process there is great opportunity for cooperation between the regulator and the regulated. This rule-making power is characteristic of administrative agencies, which are executive in their enforcement functions, judicial in their decisional functions and legislative in their rule-making functions. The ingenuity of the American business community constantly creates new problems with which conventional legislation must necessarily deal in general terms, leaving to the administrative agency as a quasi-legislature the job of filling in the details to meet changing conditions and particular types of situation. There are more than 50 instances in which the Commission is expressly granted rule-making power in the Investment Company Act and almost 50 cases in which the Commission may by order relieve against any hardship caused by the Act.

The existence of this rule-making power, however, creates recurring problems which will never be solved to the satisfaction of all:

(a) There is danger of adding new rules to old rules, a revision here and a revision there, until a literal jungle of regulations has grown.

(b) Rule-making power imposes a duty of restraint but it also imposes a duty to use the power to strike down abuses as they develop.

(c) There will always be room for argument on both sides as to whether or not a specific power is being abused.

An alert intelligent community of investment companies and dealers and an alert and intelligent Commission each can make a contribution to the formulation of rules and regulations which are adequate to protect the public interest and the interest of investors but at the same time are practical.

In the last analysis, however, investors are going to get the protection they need from the sound judgment, common honesty, and self-control of the investment companies and the dealers in their securities. The inherent limitations on the ability of government to create either brains or morals makes this a truism.

Now, may I be specific as to a few areas in which the imposition of self-discipline might be considered.

The Commission occasionally receives complaints about the pricing practices of the industry. Quantity discounts, particularly, are the subject of irritation. So long as the sales

load is not "grossly excessive" or so long as there is none of the discrimination prohibited by Section 22, this is a concern of management. If such discounts are granted, however, I commend to you the practice of many companies which question all sales just below the break-point. They make sure that each customer who makes such a purchase understands fully the commission system and knows that for a few more dollars he could receive substantially more stock. In that way, recriminations are avoided.

Those who operate investment companies and make arrangements with the dealers who sell their securities should possess the knowledge to suggest additional techniques to eliminate unfair or unwise pricing practices. The Commission stands ready to lend its aid to that end in its administration under Section 22.

Today, when the competition for the investor's dollar is increasing, it is particularly important that you hold the confidence of investors. This fall will see one of the largest amounts of private financing in our history. Inevitably, that means more selling pressure by brokers and dealers to persuade investors of the merits of particular securities. Only self restraint of the seller can protect the interest of the buyer under those circumstances.

In no area is this more important than in the sale of securities of one investment company after a redemption of the securities of another. Information in the Commission's file indicated that sales of their own securities by open-end investment companies amounted to $167,000,000 in the second quarter of 1953. Repurchases amounted to $69,000,000 in the same period, or 41.2% of sales compared with 33.6% repurchased in the previous quarter. During 1952 repurchases ranged from a high of 28.8% in the second quarter to a low of 21.9% in the fourth quarter. Redemptions may reflect the normal desire of people to shift the character of their investments. Changing markets and interest rates and a change in personal circumstances may each dictate a shift in an investment portfolio. But it must be a cause of concern to any business if there are excessive returns of its merchandise.

Redemptions bear watching. Loss of confidence or even disappointments can do more damage to your business than all the penalties in the Commission's book.

The maintenance of investors' confidence is a fundamental concern of the national economy. Broadly speaking, it is the justification for all the acts administered by the Commission. But the government's part in the creation of that confidence is negative. Basically its job is to prevent and strike down abuses and to punish rascals. The role of private enterprise is positive. It must create soundly and honestly.

Now may I speak briefly - and unfortunately in all too general terms - of our plans for the future.

The Commission has an enormously complicated, never ending task. The statutes which we administer are all complex, and we deal with a pretty delicate mechanism - the process of capital formation. Impulsive action, experimental application of bright ideas can have disastrous consequences. It's easy to agree on catch words like "simplification", "less paper work", "self-regulation", etc., etc. But when we begin to apply these concepts to specific situations, we must move carefully and precisely and with a cautious consideration of consequences.

True, the Commission is an executive agency of an administration dedicated to less government, not more. But in the case of investment companies, I remind you again that it administers an act which the regulated group itself helped to draft - a piece of legislation which was designed to correct admitted abuses. We have no intention of scuttling the ship that we're hired to steer.

From that precautionary observation let me go on to say that we do want to do our job in a workmanlike manner, without any unnecessary red tape, and free of what might be unkindly termed "harassment". We propose to reexamine rules and forms. We are about to adopt a new form of registration statement and prospectus

for investment company securities. We have under active consideration rules for registration of Canadian investment companies. As a long term project we hope to create a greater degree of uniformity in rules and forms under the several acts which we administer.

We present a receptive mind to proposals for improvement, clarification and simplification. We recognize, for example, the problem of repetitive registration of investment company securities. We welcome the help of the industry in solving it - or any other problem. We shall be happy to receive and discuss recommendations for rule or form changes. We hold ourselves in readiness to discuss proposals for legislation. In the legislative sphere, of course, we can do no more than act as a catalyst. We can present our recommendations to the Executive Office of the President for inclusion in the administration's program and we can lend such assistance and counsel as the appropriate committees of the Congress may ask of us.

In view of the comprehensive nature of our statutory responsibilities under the Investment Company Act, we have an obligation to keep advised of the problems which arise in your industry. I'm an inland man myself, but I understand that the Coast Guard has a system of warnings - flag signals for storms, threatened hurricanes and hurricanes. Continuing the figure, the Commission has an obligation to watch the cloud formations and to keep advised

of how the wind is blowing. Changing the figure, it should know what the score is. I don't mean by that that the Commission should be a busybody telling you how to run your business. The Commission can, however, perform a service to the industry and for the public interest if it uses its statutory power wisely to warn of practices which could become abuses.

For example, the Commission is interested in the practice of the giving by investment companies of brokerage business to dealers who have been most effective in the sale of investment company securities. My mention of this subject is not intended as finger-pointing - yet. It is merely illustrative of the Commission's realization that it has a responsibility to know what is going on and to give consideration to the possible consequences of particular practices.

Our job and your job and the job of a lot of other people is to make the American system of free enterprise work. We each have our separate jobs, but neither of us can claim success unless we both act in the public interest and for the protection of investors.

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