Union Calendar No. 1046

89th Congress, 2d Session - - - - - House Report No. 2337

Report of the Securities and Exchange Commission on the PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH

REPORT

OF THE

COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE

Pursuant to Section 136 of the Legislative Reorganization Act of 1946, Public Law 601, 79th Congress, and House Resolution 35, 89th Congress

DECEMBER 2, 1966.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Union Calendar No. 1046

89th Congress, 2d Session - - - - - House Report No. 2337

Report of the Securities and Exchange Commission on the PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH

REPORT

OF THE

COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE

Pursuant to Section 136 of the Legislative Reorganization Act of 1946, Public Law 601, 79th Congress, and House Resdntion 35, 89th Congress

DECEMBER 2, 1966.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

U.S. GOVERNMENT PRINTING OFFICE

71-588 O WASHINGTON : 1966

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price $1.00 (paper cover)

COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE

HARLEY O. STAGGERS, West Virginia, *Chairman*

WALTER ROGERS, Texas
SAMUEL N. FRIEDEL, Maryland
TORBERT H. MACDONALD, Massachusetts
JOHN JARMAN, Oklahoma
JOHN E. MOSS, California
JOHN D. DINGELL, Michigan
PAUL G. ROGERS, Florida
HORACE R. KORNEGAY, North Carolina
LIONEL VAN DEERLIN, California
J. J. PICKLE, Texas
FRED B. ROONEY, Pennsylvanie
JOHN M. MURPHY, New York
DAVID E. SATTERFIELD III, Virginia
DANIEL J. RONAN, Illinois
J. OLIVA HUOT, New Hampshire
JAMES A. MACKAY, Georgia
JOHN J. GILLIGAN, Ohio
JOHN BELL WILLIAMS, Mississippi
BROCK ADAMS, Washington
RICHARD L. OTTINGER, New York [1]
WILLIAM R. ANDERSON, Tennessee [3]

WILLIAM L. SPRINGER, Illinois
J. ARTHUR YOUNGER, California
SAMUEL L. DE-VINE, Ohio
ANCHER NELSEN, Minnesota
HASTINGS KEITH, Massachusetts
GLENN CUNNINGHAM, Nebraska
JAMES T. BROYHILL, North Carolina
JAMES HARVEY, Michigan
ALBERT W. WATSON, South Carolina
TIM LEE CARTER, Kentucky
G. ROBERT WATKINS, Pennsylvania*

W. E. WILLIAMSON, Clerk
KENNETH J. PAINTER, *Assistant Clerk*

Professional staff

ANDREW STEVENSON
KURT BORCHARDT
JAMES M. MENGER, Jr.
WILLIAM J. DIXON

[1] Appointed member of committee Oct. 18,1966, vice Leo W. O'Brien, resigned.
[2] Appointed member of committee Oct. 19,1966, vice Willard S. Curtin, resigned.
[3] Appointed member of committee Oct. 21, 1966, vice Charles P. Farnsley, resigned.

LETTERS OF TRANSMITTAL

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington:D.C., December 2, 1966.

Hoii. RALPH R. ROBERTS,
Clerk, House of Representatives,
The Capitol, Washington, D.C.

DEAR MR. ROBERTS: Pursuant to House Resolution 35, 89th Congress, I submit herewith for the information of the House of Representatives a report of the Committee on Interstate and Foreign Commerce comprisiiig a report of the Securities and Exchange Commission entitled "Public Policy Implications of Investment Company Growth."

Sincerely yours,

HARLEY O. STAGGERS,
Member of Congress, Chairman.

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., December 2, 1966.

Hon. JOHN W. MCCORMACK,
Speaker, House of Representatives.
The Capitol, Washington, D.C.

DEAR MR. SPEAKER: Pursuant to House Resolution 35, 89th Congress, I submit herewith for the information of the House of Representatives a report of the Committee on Interstate and Foreign Commerce comprising a report of the Securities and Exchange Commission entitled "Public Policy Implications of Investment Company Growth."

Sincerely yours,

HARLEY O. STAGGERS,
Member of Congress, Chairman.

Union Calendar No. 1046

89TH CONGRESS } HOUSE OF REPRESENTATIVES { REPORT
2d Session } { No. 2337

REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH

DECEMBER 2, 1966.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. STAGGERS, from the Committee on Interstate and Foreign Commerce, submitted the following

REPORT

[Pursuant to H. Res. 35, 89th Gong.]

The Committee on Interstate and Foreign Commerce submits herewith a report of the Securities and Exchange Commission, entitled "Public Policy Implications of Investment Company Growth."

The committee, by House Resolution 35, acting as a whole or by subcommittee, was authorized to investigate and study the adequacy of the protection to investors afforded by the disclosure and regulatory provisions of the various securities acts. This authorization continues the authorization made to the committee for many years. Accordingly, your committee and its Subcommittee on Commerce and Finance under the chairmanship of Mr. Macdonald have been active in again considering the current operation of the securities laws and the extent to which they afford adequate protection to investors and promote the public interest.

During the 88th Congress, for the reasons set forth in its report (No. 1418, 88th Gong.), the committee approved and the Congress enacted the Securities Acts Amendments of 1964 (Public Law 88467). These amendments extended the disclosure and insider trading provisions of the Exchange Act to several thousand companies with securities traded in the over-the-counter market and strengthened the regulation of broker-dealers in securities and their personnel. This legislation represented the most important advance in Federal securities legislation since the ,enactment of the Investment Company Act and the Investment Advisers Act in 1940.

The 1964 amendments grew out of the comprehensive review of the securities industry, including the functioning of industry self-regulatory organizations, which was conducted by the Securities and Exchange Commission's Special Study of the Securities Markets. The Commission was directed to conduct that study and to report its

results to Congress pursuant to House Resolution 438, which was sponsored by the Subcommittee on Commerce and Finance of your committee. The five-volume Special Study report (H. Doc. 95, 88th Gong.) constituted the most comprehensive review of investor protection under the securities laws since the studies that preceded the enactment of the original securities acts.

The Special Study's 1963 report examined certain aspects of the mutual fund industry, particularly matters relating to the sale of mutual fund shares. In this respect, it supplemented a broad inquiry into the mutual fund industry conducted by the Securities Research Unit of the Wharton School of Finance and Commerce at the request of the Commission and published by this committee in August 1962 (H. Rept. No. 2274). That report described the structure and growth of the mutual fund industry, analyzed the performance and market impact of mutual funds and the relationship between the funds and their investment advisers and principal underwriters.

Neither the Wharton School report nor the Special Study purported to reflect the views or recommendations of the Commission or the committee. When these reports were published, the Commission indicated that it would undertake a thorough evaluation of their findings and recommendations and report its views to the Congress.

This report of the Commission is a result of that undertaking. It discusses various public policy implications stemming from the substantial growth of the investment company industry since 1940 and presents a number of recommendations for changes in the Investment Company Act. Obviously a report of this nature by the agency charged by Congress with responsibility for supervision and regulation of the investment company industry is of the greatest significance to that industry and to the public.

The conclusions and recommendations contained in this report are those of the Securities and Exchange Commission and not of this committee. The Commission has advised this committee that it mill prepare appropriate legislation, based on such conclusions and recommendations, for submission to the 90th Congress early in its 1st session. The Commission has further advised this committee that, in connection with the preparation of this legislation, it invites, and indeed solicits, the views and suggestions of all those affected by, concerned with or interested in such proposed legislation. Committee hearings on any legislation proposed by the Commission will afford a further opportunity for all interested persons to express their views.

In the meantime, in view of the significance of this report of the Commission, it is being submitted herewith as a report for the information of the Members of the House and the general public.

LETTER OF TRANSMITTAL

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., December 2, 1966.

The PRESIDENT OF THE SENATE.
The SPEAKER OF THE HOUSE OF REPRESENTATIVES.

SIRS: I have the honor to transmit a report of the Commission on the Public Policy Implications of Investment Company Growth. The report is submitted pursuant to section 14(b) of the Investment Company Act of 1940, which authorizes the Commission if it believes "that any substantial further increase in the size of investment companies creates any problem involving the protection of investors or the public interest, to make a study and investigation" and to report the results to the Congress.

This report initially describes the dramatic growth of the investment company industry since 1940, with particular emphasis upon mutual funds; i.e., those investment companies which continuously offer new shares to the public and continuously stand ready to redeem their existing shares at net asset value. Between the end of 1940 and June 30, 1966, investment company assets increased from about. $2.1 billion to $46.4 billion. Most of this growth was accounted for by mutual funds, whose net assets increased from $450 million at the end of 1940 to about $38.2 billion at June 30, 1966. The growth of mutual funds has been accompanied by a great increase in the number of mutual fund investors. In 1940 less than 300,000 Americans held mutual fund shares. By the end of 1965 there were more than 3½ million mutual fund investors. This growth and popularity reflects the fact that by offering the American public a medium for professionally managed investment in securities, primarily the stocks of America's leading companies, the investment company industry, and specifically mutual funds, fulfill an important public need. The industry has earned its place as an important component of our Nation's financial community.

The primary function of the report is to examine the present adequacy of the protections afforded by the Investment Company Act of 1940, which has never been significantly amended, to those millions of Americans, many of them of modest means, who have chosen to entrust billions of dollars of their savings to the investment company industry.

The report concludes that the Investment Company Act of 1940 has substantially eliminated the serious abuses at which it was aimed, but that the tremendous growth of the industry and the accompanying changes have created a need for additional protections for mutual fund shareholders in areas which were either unanticipated or of secondary importance in 1940. While the report contains many specific recommendations for legislative improvement, its overall conclusion is that present shortcomings can be rectified and a fuller measure of protection afforded public shareholders without drastic

overhauling of the existing industry structure or regulatory pattern. Consequently, the report should not impair public confidence in any investment company, in the investment company industry, or in the securities markets; rather, public confidence should be strengthened as improved shareholder protections are enacted into law. The stress of the report on regulatory problems and the need for their solution should not obscure the fact that on the whole investment companies have been diligently managed by competent persons and that the general record of the industry is one of which it can be justly proud.

The report, of course, makes no attempt to assess the merits of investment company securities relative to other media of investment. Its concern is with the regulatory and legislative problems which are the responsibility of the Congress and of the Commission.

The structure of the typical mutual fund is rather unique in American business. Although mutual funds are usually organized either as corporations or as business trusts, most of them are primarily managed and operated not by their own officers and employees but by separate entities which provide investment advice and managerial services under contracts with the funds. The Investment Company Act expressly recognizes this structure, and the report does not propose to disturb it even though it has been recognized for many years that this structure involves a conflict of interest between mutual fund managers and shareholders. Since mutual fund managers are usually compensated upon the basis of a percentage of the net assets of the fund, there is a powerful incentive for growth through the sale of new shares.

The report concludes that mutual fund shareholders need protection against incurring excessive costs in the acquisition and management of thew investments and that, given the structure and incentives prevailing in the industry, neither competition nor the few elementary safeguards against conflict of interest deemed sufficient in 1940 and contained in the Investment Company Act presently provide this protection in adequate measure. The aggregate amounts involved are significant by any measure. It is estimated that during 1965 mutual fund shareholders paid an aggregate of $130 million in advisory fees, $260 million in sales loads, and in addition incurred more than $100 million of brokerage commissions on the purchase and sale of securities by their funds.

The report makes two primary legislative recommendations in this area. One relates to costs of management and the second to costs of acquisition. It is recommended that the statute be amended to expressly require that the compensation received by persons affiliated with investment companies, including their management organizations, for services furnished to an investment company be reasonable, and that this standard be enforceable in the courts. It is further recommended that the statute be amended to provide a ceiling on sales charges for mutual fund shares, generally at 5 percent, an amount which is still substantially greater than the sales charges generally prevailing in the securities markets, such as stock exchange commissions and over-the-counter markups for securities comparable in quality to mutual fund shares.

A special problem exists where investors accumulate mutual fund shares pursuant to a plan calling for the payment of relatively small mounts of money at monthly or other periodic intervals over a period

of years. At the end of **1965** there were about **1.3** million of these so-called contractual plans on which about **$3** billion bad been paid. The typical contractual plan investor is a family man of moderate income. Under these plans, **50** percent of the investor's first **12** monthly payments or their equivalent is usually deducted for sales load. The report concludes that investment companies should no longer be permitted to make this type of sales charge, commonly referred to as the "front-end load."

Additional legislative recommendations are made to deal with more specialized problems or to make more effective the administration and enforcement of the existing pattern of regulation. The report also presents proposals for action by the Commission and the stock exchanges leading toward a modification of the stock exchange commission rate structure to provide greater benefits for investment company shareholders as distinct from investment company managements and sales organizations.

This report had its genesis in 1958 when the investment company industry was much smaller than it is today and when its mutual fund sector had slightly over **$13** billion in assets, only a little more than one-third its present size of about $38 billion. In that year the Commission authorized the securities research unit of the Wharton School of Finance & Commerce of the University of Pennsylvania to make a study and *to* submit a report to the Commission. That report, submitted to Congress in August of **1962,** was the most comprehensive analysis of the investment company industry since the studies that preceded the passage of the Investment Company Act. It found that the more important current problems in the mutual fund industry involved the potential conflicts of interest between fund management and shareholders and the impact of fund growth and stock purchases on stock prices.

The Wharton Report was supplemented by the publication in **1962–63** of the report of the staff of the Commission's Special Study of the Securities Markets, which treated aspects of the mutual fund industry outside the scope of the Wharton report. The Special Study focused its attention on sales of mutual fund shares, including selling practices, the special problems raised by the front-end load in the sale of so-called contractual plans and allocations of mutual fund portfolio brokerage.

Neither the Special Study nor the Wharton report was a report by the Commission. When those reports were published, the Commission undertook to evaluate the public policy questions that they raised as part of **a** comprehensive program of study and to report its recommendations to the Congress. This report is a result of that undertaking.

The Commission has directed its staff to draft specific legislative proposals to implement the recommendations contained in the report. It hopes to submit this legislation to Congress early next year. In connection with the drafting of these legislative proposals, the Commission expects to obtain the comments, suggestions, and views of the investment company industry, the securities industry, other segments of the financial community and of the investing public. For this purpose, it welcomes, and indeed solicits, comments from all interested persons.

In concluding, the Commission wishes to express its appreciation to the members **of** the investment company industry, industry organiza-

tions, including the Investment Company Institute, the Association of Closed-End Investment Companies, and the Association of Mutual Fund Plan Sponsors, Inc., and all other members of the financial community who cooperated in the comprehensive examinations of the investment company industry leading to this report. Many persons, companies, and organizations, too numerous to mention individually, gave unstintingly of their time and efforts in assisting the Commission and its staff to gather information and viewpoints.

In the preparation of this report the Commission had the able assistance of many past and present members of its staff. Deserving of special mention are the tireless and devoted efforts of a special task force under the leadership of Philip A. Loomis, Jr., General Counsel, and Richard M. Phillips, Assistant General Counsel, together with Sheldon Rappaport, Lewis J. Mendelson and Bernard Wexler, each of whom is a Special Counsel, Bernard H. Garil, financial economist, and Edward L. Lublin, attorney. Important contributions were made in the Division of Corporate Regulation, by Solomon Freedman, Director, J. Arnold Pines, Associate Director, Harold V. Lese, Associate Director, Allan S. Mostoff, Assistant Director, Francis X. Kelly, Chief Counsel, Alan Rosenblat, Assistant Chief Counsel, Karl C. Smeltzer, Senior Financial Analyst, James L. Akers, and Martin P. Miner, and in the Office of Policy Research by Loughlin F. McHugh, Chief Economist, Roger S. Foster, Special Counsel, and Gene L. Finn, Economist, together with Robert W. Cox of the Commission's Executive Staff, Meyer Eisenberg, Assistant General Counsel, and Morgan Shipman, assistant professor of law at Harvard University and a consultant to the Commission. Since the study and investigation which led up to the report commenced in 1962 many persons not responsible for the final product nevertheless made a substantial contribution to the total undertaking. These include Alan F. Conwill, former Director, Division of Corporate Regulation, Gordon D. Henderson, former Associate Director of that Division, Robert H. Mundheim, professor of law at the University of Pennsylvania, Dennis J. Lehr, Paul J. Mason, and Lawrence W. Newman. We also wish to acknowledge our indebtedness to our colleagues in the initiation and development of this effort, former Chairman William L. Cary and former Commissioners J. Allan Frear, Jr. and Jack M. Whitney II. The responsibility for the findings, conclusions, and recommendations of the report, however, is solely that of the present Commission.

By direction of the Commission.

MANUEL F. COHEN, *Chairman.*