NEWS

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My remarks will be brief today, but not as brief as President Coolidge. When he returned from church one day, his wife asked him what the minister had talked about. "Sin," said the President. "What did he say about it?" she asked. "He was against it."

Today I am going to talk about rationalizing the regulatory process. I'm for it.

The subject of regulatory reform has been pushed hard by the President for 18 months, it has generated substantial Congressional debate, and seems to be a matter of some public interest. It has been a subject of concern to me for the past 14 months: For seven months as counsel to the President helping him deal with the problems caused by such regulation, and the last seven months, according to some, as part of the problem.

The primary focus of regulatory reform, as I see it, should be addressed to this point: we are today, as a nation, less willing to allow free competition to make necessary economic choices and far more willing to resolve those issues in the political arena, a trend accentuated by two other phenomena. First, we generally spend too little time trying to define a problem before we rush in with laws and regulations; second, we continue to share the conceit that we can draft a new law or two that will change the behavioral pattern of our civilization.

It has become increasingly apparent that greater econimic analysis is required in order for the Commission to properly perform its regulatory functions -- both to monitor the effects of existing regulations and to provide an informed basis on which to propose new ones. The Commission is developing that economic capacity and is institutionalizing its use in each of our divisions. Each proposed new regulation should be examined in the light of available economic evidence before being adopted. Monitoring programs should be created to permit us to determine later whether or not the regulations we adopt are producing the results that we expected.

If it cannot be demonstrated affirmatively after a prescribed period of time that the evidence supports the need for the regulation, then the regulation should self-destruct.

We have, for example, recently questioned the relevance today of our short-selling rules --- we will be suspending them for a period and testing the effect.

Study of Investment Management

This same discipline will be used to rethink existing regulations and legislation in the investment company area.

We have asked the Commission's Division of Investment Management to conduct a major study of our regulation of the investment management industry. The '40 Act and all its progeny need to be revisited.

As I envision the study, it will have two main thrusts. One will be a "spring cleaning" of the Investment Company Act, blowing the dust off each provision to see whether each requirement and prohibition provides enough benefit to justify the burden or restraint involved. A modern-day Thomas Jefferson would tell us that 'that regulatory agency is best which regulates least.' That dictum, with appropriate caveats to reflect the complexities of modern American capitalism, would be a good starting point for this aspect of the study. Anne Jones has already taken the first step in this direction by changing her Division's name to the Division of Investment Management, eliminating the word "Regulation".

Of course, nobody should expect that the Investment Company Act will be replaced by an Adam Smith textbook as a guide for the mutual fund industry. Anyone who doubts the need for some regulation in this area need only read the volumes of studies and testimony which persuaded Congress to adopt the Act in 1940.

The second thrust of the study will be to examine whether a statute which relates only to "investment companies", as presently defined, is adequate to protect today's investor. We all know that mutual funds and other regulated investment companies comprise only a part of the modern money management industry. To the extent that real estate investment trusts, oil and gas drilling funds, mini-accounts and bank trust accounts compete with mutual funds for the investor's dollar, mutual funds may be at a disadvantage because of the greater restrictions on their activities.

This does not necessarily mean, however, that those other forms of pooled investment arrangements should be made subject to the Investment Company Act; it means only that we should attempt to equalize the regulatory burden. To me, equal regulation may mean only equal disclosure, for my guiding premise is that disclosure is often a better alternative to regulation.

The staff is going to take a hard look at the '40 Act. The result could be a recommendation to Congress that a new statute -- new not only in its applicability, but in its substantive provisions -- should be enacted to replace the '40 Act.

A Debt-Based Society

I need not emphasize to this group that the investment company industry performs a vital role in facilitating the formation of equity capital in our economy. American corporations recovering from the economic slow-down of the last several years have a tremendous need for equity capital, both for future growth and repayment of debt.

I am encouraged to learn that the rate of net redemptions of mutual fund shares declined in April and am hopeful that this indicates a fundamental shift in the investment attitudes of the small investor.

We must strengthen our equity markets if American business is to meet the challenges of the next decade. Over the past 25 years, the financial structure of American business has been dramatically transformed -- from a structure founded on equity capital to one now overburdened with debt. For example:

-- Since 1951 the ratio of debt to equity for American manufacturing corporations has increased from 18.5 percent to nearly 41 percent.

-- In the early 1960's approximately 15 cents of every dollar of gross earnings of American industrial corporations was used for interest payments: by 1974 this figure was 40 cents.

-- As recently as 1964, total credit market debt exceeded the market value of equity by approximately $300 million; by 1974 the excess was more than $1 trillion.

-- The ratio of corporate earnings to interest charges declined for all industries from 12.8 in 1951 to 1.9 by 1974.

The reasons for this shift from equity to debt are varied. Certainly the tax deductibility of interest payments is a major factor in the decision of many corporations to seek debt in preference to equity. The impact of inflation is another.

I am concerned that this increasing reliance by American business on debt rather than equity is significantly reducing the flexibility of American industry.

The Bank Study

Compounding this trend is the general fear that the capital needs of the next ten years or so cannot be met by traditional methods. A ramification of this fear is that banks will continue to expand their role and displace others in the industry, and that this further concentration of financial power will reduce the healthy diversity of our capital markets. There are obviously some incursions today by the bank industry into the traditional functions of the investment company industry and the securities industry. Which of these should continue and which should be modified or eliminated are matters of legitimate debate.

The Commission currently is actively studying the securities services offered by banks. One of these is the automatic investment service; in particular, I am concerned that the commercial side of banks may be tempted to sell stocks in corporations for which they also provide debt.

The bank study is also examining the brokerage-type services provided by banks. Individuals may be able to effect substantial savings in brokerage commissions merely by placing their orders through a bank's trading desk. This activity could portend significant changes in the way Americans buy and sell securities, and we should know what impact, if any, these changes will have upon the protection of investors and the ability of the securities markets to raise and allocate capital.

Finally, we should know whether these changes constitute a trend leading to more equity and debt financing to be conducted by the same institution for the same issuers, a practice which is now prevelant in many European countries.

NASD Anti-Reciprocal Rule

There are pending matters before the Commission which we should act upon without awaiting the results of either the investment management study or the bank study. One is whether the Commission should change its position regarding reciprocal sales practices. In the past, the Commission concluded that the allocation of brokerage business by a mutual fund to a particular broker-dealer in return for that broker-dealer's sale of fund shares should not be permitted. Therein lies the origin of the NASD's anti-reciprocal rule, which became effective in 1973.

The arguments on both sides of this question are familiar to all of you. Many contend that the rule has done more harm than good. Although the rule was not intended to disqualify a broker-dealer from receiving brokerage business from a fund merely because he happened to also sell shares of the fund, we are told that has been the practical result of the rule. We are also told that the potential for abuse has been alleviated by the advent of negotiated commission rates. On the other hand, proponents of the rule say that reciprocal sales practices led to abuses in the past and that these abuses will return if the rule is repealed.

My own view is that this is a classic case for the application of the principle I ennunciated earlier, namely, that unless economic evidence affirmatively supports the continued need for the rule, the rule should be modified or eliminated. To date, I have not seen convincing evidence to support continuation of the rule in its present form.

No matter what the answer is, I appreciate that having no answer at all is not fair to the industry.

Section 22 (d)

Another subject of current concern to the Commission is whether we should make a recommendation to Congress with respect to Section 22(d) of the '40 Act. Those who support the continuation of a law which requires rigid resale price maintenance in sales to the public must bear a very heavy burden of proof. In 1973, 15 days of hearings were held on this subject at which approximately 70 individuals testified and some 100 written comments were filed.

On the basis of the record, I believe there is a serious question whether Section 22(d) provides sufficient benefit to justify its obvious anti-competitive impact. It may not be practical to abolish suddenly all retail price maintenance in the sale of fund shares after 36 years. But, as the Commission has indicated, the question really is not whether there should be retail price competition in the sale of fund shares; the question is <u>when</u> such competition should come. In my judgment, it should be sooner rather than later.

While I'm speaking of requirements that I'm not sure we need, let me say something about the Commission's rules concerning investment company sales literature. Those rules are a lot less restrictive than they used to be, but Anne Jones is complaining that people in her Division still spend too much time worrying about the type size in a legend, when there are better things they could be doing.

I could be easily persuaded that a perfectly good advertising rule would be one that does no more than prohibit fraud and ensure that all persons receive a prospectus before they invest.

Pending Legislative Matters

There are several pending legislative matters that I should mention.

The Commission is deeply involved with the bill to strengthen the Investment Advisers Act. I'm pretty sure that bill will be passed, and I'm <u>very</u> sure that it <u>should</u> be passed. More than 3,700 investment advisers are registered with the Commission. It has been estimated that, as of 1969, registered and non-registered advisers together had $130 billion of assets under management. Less than half of this represented assets of mutual funds.

An industry of that magnitude cannot continue to be treated like a stepchild in the regulatory process. Investment advisers currently are not subject to any financial responsibility requirements. This particularly troubles me since many advisory accounts give the adviser discretionary control over the money of individuals or personal trusts, where the need for protection is probably the greatest.

On the other hand, we should not impose unnecessary requirements. Therefore, I was pleased when the Senate Banking Committee recently modified the bill to authorize the Commission to exempt advisers and associated persons from financial responsibility requirements, where those persons meet alternative standards.

A second legislative matter relates to the ICI's proposal to amend the tax laws to permit income from tax-free bonds to retain its tax-free status when distributed to fund shareholders. Currently this treatment is only available if the fund is organized as a partnership or the assets are held in a non-managed trust portfolio.

The Commission supports the ICI on this proposal. If it is reasonable as a matter of policy for investors in a fund to receive the tax benefits of municipal bonds when the fund is organized as a partnerhsip, I see no reason why the same result should not apply to a fund organized in corporate form.

Section 28(e)

You probably know that the Commission issued some interpretations concerning Section 28(e) of the 1934 Act a couple of months ago, and that we are now working on disclosure rules with regard to paying up. Until these rules are adopted, there is a danger that some money managers might interpret the new law as relieving them from any obligation to make disclosures with respect to brokerage placement policies. I would advise strongly against such an approach. Although Section 28(e) gives the Commission additional authority to adopt disclosure rules, it does not take away any of the Commission's other powers. And as I'm sure you know, the Commission for a long time has considered certain brokerage placement practices to be material facts which should be disclosed.

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In conclusion, I would like to re-emphasize the critical need for rationalization of the regulatory process. There still is an apparent contradiction between what we are saying and what seems to be happening. Although regulatory reform commands much attention in Washington today, we are at the same time plowing ahead inexorably with new laws, regulations and rulings that materially increase government regulation of the economy.

We must instill in our regulators an appreciation of the therapeutic value of competition and a willingness to temper the lawyers' urge to regulate relentlessly with economic data that tests the need for regulation. Sceptics have warned me that our effort to improve the Commission's capacity for economic analysis rests on a misplaced confidence in the ability of economists. But I am confident that our effort to improve our economic capability will be worth it, if only the influence of the lawyers and the economists cancel each other out.

It is a pleasure for me to be here today to participate in the annual meeting of the Institute. As we proceed in the coming year with our review of the investment management industry, we look forward to your views and active participation.

Thank you.