Securities and Exchange Commission

Regional Administrators' Conference

Investment Company Act of 1940

Monday, September 16, 1957
2:15 P.M.

Commissioner Patterson Presiding

Commissioner Patterson called the meeting to order, and explained that this session would be concerned with problems arising under the Investment Company Act of 1940. He then turned the meeting over to Mr. Garrett, Director of the Division of Corporate Regulation.

Mr. Garrett stated that the meeting would be devoted to consideration of the following topics:

(1) Inspection program
(2) Insurance Securities Inc. litigation
(3) Variable Annuity Life Insurance Company litigation
(4) Latest revision of the Statement of Policy regarding sales literature employed in the sale of investment company securities.

Mr. Garrett discussed the present directive whereby all interpretive questions of any importance concerning the Investment Company Act of 1940 are referred to the Division for answer. Some discussion ensued of this matter and it appeared to be the consensus of the meeting that the procedure as outlined in the directive represented the most effective method of dealing with inquiries under the specific statutes. However, it was suggested that certain form letters or memoranda might be made available to the Regional Offices for distribution upon receipt of certain routine inquiries. Mr. Pennekamp, of the San Francisco Regional Office, suggested that a form letter or memorandum on how to form an open-end company would be a convenient thing for his office to have on hand. Mr. Green, of the Atlanta Regional Office, made a similar suggestion with regard to the status of investment clubs under the Act. Mr. Garrett acknowledged that both suggestions seemed to have considerable merit and that such memoranda would be prepared by the Division.

Mr. Garrett then introduced Mr. Woodle, the Associate Director of the Division, to the Conference and explained that he would discuss the progress of the inspection program which had been undertaken by the Commission shortly before the Regional Administrators' Conference of last year.

Mr. Woodle then stated that the program as proposed at the last Conference now appears to have been unduly over-ambitious in that it called for a two-year cycle for inspections of each registered active management company. Assuming that each inspection would take about two weeks time per man, so that one man could make 24 inspections per year, on the basis of an assumed 268 such companies, the program would require eleven fulltime personnel. Mr. Woodle stated that a request for additional personnel for this program had been submitted in the budget for fiscal 1958 but had been rejected by Congress. Accordingly, it has been necessary to pursue the program with whatever manpower happens to be not otherwise engaged, and with whatever travel appropriations are also available.

Mr. Woodle pointed out that since the last Conference, at which were given reports of the inspection of two companies, Washington Mutual Fund and Tonopah Mining Company (a closed-end company), seven additional inspections had been completed.

In September 1956 Minnesota Fund, Inc. of Minneapolis, Minnesota, was inspected by a team consisting of Mr. Rodney M. Russell of the Division and Mr. Martin King of the Chicago Regional Office. This Fund has a total net asset value of over $4 million and most of the sales of its shares are made through its own salesmen. The inspection uncovered certain defects in the accounting procedure whereby the entries to reflect payments for purchases of portfolio securities by the custodian were made before actual notice was received that the securities had been delivered and the payments made. Another matter considered by the inspectors was the practice involved in connection with requests for redemption of Fund securities. Since the Fund uses no time stamp to indicate when redemption requests are received, it was impossible to confirm that payments were always made within the 7 day period provided by Section 22(e). It was further indicated that the redemption requests might be held up for a short time if it appeared that such action would result in a better price to the redeeming shareholder. It was suggested to the management that the Fund should use a time stamp on all redemption requests and that the time when the net asset value is calculated for the purpose of determining the price at which redemptions are effected should be specifically stated in the prospectus.

Television-Electronics Fund, Inc. of Chicago, Illinois, was inspected on February 5, 1957, by Mr. Karl C. Smeltzer of the Division and Mr. J. Edwin Corbett of the Chicago Regional Office. The value of this Fund is over $137 million. Among the problems uncovered in this inspection was the practice of handling foreign sales through European banks. The investigation disclosed that quantity discounts are made available to foreign firms which sign a letter of intent or "working arrangement", despite the fact that such firms are buying for resale to European banks rather than for their own investment. One of the Fund officers conceded that such discounts are not extended to dealers in this country unless they are buying for their own investment. It was felt that this matter should be given further consideration and study in the light of the facts disclosed by the inspection of this and others of the larger Funds having foreign distribution.

Another phenomenon revealed by the inspection of this and other companies is the apparently quite commonplace practice of reciprocal trading. Reciprocal trading involves arrangements for benefiting dealers who sell the Fund's shares, and several variations were revealed. The first is the "give-up" by a listed firm of a certain percentage of its commissions on listed transactions to other member firms which the Fund designates. A second is the placement of listed transactions with member firms designated by non-members which the Fund wishes to favor. A third variation is the direction by the Fund to an underwriter that a non-member firm which the Fund wishes to favor be allotted a specific block of shares being offered in an underwriting or secondary offering with the Fund purchasing the shares allotted to that firm. It was felt that the matter of reciprocal arrangements deserved further study in the light of existing or prospective regulations and in connection with the investment company size study.

This investigation also revealed that the president and a director of the Fund had been retained by it as investment advisor on a consulting basis to furnish advice regarding economic factors and trends at an annual compensation of $22,500 per annum, with no disclosure being made in the Fund's prospectus of such employment. It was suggested that the prospectus be amended to include such information.

Dow Theory Investment Fund, Inc. of Hammond, Indiana, was inspected on June 11, 1957, by Julian E. Gillespie of the Division and Frank J. Hoffman and J. E. Corbett of the Chicago Regional Office. Dow Theory is a small ($500,000) open-end investment company selling its securities primarily by mail order. The investigation disclosed minor discrepancies with regard to technical compliance with the Act.

Three companies were inspected in Boston, Income Foundation Fund, Century Shares Trust, and Concord Fund. In connection with the Income Foundation Fund inspection it developed that the investment advisor and principal underwriter had been charging excessive commissions in purchasing portfolio securities. A subsequent broker-dealer investigation of the underwriter revealed that the company was insolvent.

Finally, an inspection of the Investment Company of America in Los Angeles, California, was made by Jack I. Elias of the Division and Mr. Charles R. Burr of the Los Angeles Office. The chief problem appeared to involve the question of the delinquencies in making payments to the custodian of the Fund for purchases of its shares. This, and other inspections, revealed that in some instances a considerable time elapses between the date the order is placed with the dealer by the investor and the date that the proceeds of the sale are credited to the account of the Fund. It was suggested that a uniform procedure should be adopted whereby if the funds are not received by the custodian within a certain period, say 7 days, after the trade date, a letter of inquiry should be sent, followed up by several other letters at succeeding fixed intervals, with the charge against the individual dealer being written off and charged against the principal underwriter at the expiration of the final period. The NASD adopted a procedure, effective November 15, 1957, whereby dealers are required to transmit payment to underwriters within 7 business days following the date of the transaction. Underwriters must pay issuers within 10 business days, but if they fail to receive payment from dealers within the prescribed time, they must redeem the shares, unless an extension of time has been granted by the NASD.

Following this summary of the various inspections completed to date, it was suggested that a pattern may be discernible and that it might be well to develop a list of certain of the more important problems which appear to be of a more general or industry-wide nature. Such a list would include questions such as reciprocal trading, redemption procedure, crediting proceeds of sales of Fund's shares, etc. These and other related problems should be included in a check list to serve as a guide to the persons making the inspections. Furthermore, in accordance with a suggestion of Mr. Moran of the New York Regional Office, it was felt that it might be desirable to make public announcements to the industry regarding any practices which appeared to be widespread and possibly questionable. It was suggested that this information could be disseminated in several ways, including speeches by Commissioners, or through news items distributed to NAIC members.

This matter will be investigated further and discussed with Mr. Vincent Broderick, counsel of the National Association of Investment Companies.

Another question was raised in connection with the inspection program as to the necessity of requiring separate reports of the inspection by both the broker-dealer inspector under the 1934 Act and the analyst/attorney under the 1940 Act. It appeared that certain duplication was involved in requiring separate reports and it was felt that all information could be combined in one comprehensive report. Mr. Woodle agreed to consider the matter further.

Mr. Garrett then turned the meeting over to Jack Elias, a staff member of the Division of Corporate Regulation, for a discussion of the Insurance Securities, Inc. proceeding instituted by the Commission in August 1956. Mr. Elias briefly reviewed the organization and the operations of the Trust Fund sponsored by Insurance Securities, Inc. (ISI) which is also the investment adviser and principal underwriter for the Trust Fund. It was stated that as of January 1956 and for many years prior thereto, four of the individual defendants owned in the aggregate 72.6% of the total outstanding shares of ISI and the remaining outstanding shares, representing 27.4%, were owned by five other individuals. Mr. Elias then proceeded to give a detailed discussion of the background of the transactions which led to the institution of the proceedings by the Commission. In September 1955 counsel for ISI and William Bowen of Texas, now a director of ISI, discussed with the staff of the Division of Corporate Regulation the contemplated sale of ISI stock by two of the defendants who held 26.4% of the ISI stock. This discussion related to the impact of the provisions of Section 36 in the light of the opinion of the Commission's General Counsel ("Lane Opinion") made public on May 11, 1942. Since no definitive plan was then presented, it was suggested that, if a definitive proposal for the distribution of the stock developed, inquiry should be made to the Commission as to whether the proposed program would be considered as contravening the principles set forth in the Lane Opinion. No inquiry was ever made of the Commission, and the stock sales came to the attention of the Commission staff on July 2, 1956 when ISI filed its preliminary proxy solicitation material with the Commission after the sale of all but 16,000 shares had been consummated. A total of 88,000 shares, representing 53% of the total shares outstanding, were sold. The shares were sold in successive stages. The proxy material did not disclose that the shares were sold at $50 per share although the net asset value thereof was only $1.81 per share. The proxy material simply represented that ISI had been advised that the change in majority ownership of ISI stock may be considered an assignment of the advisory and principal underwriting contracts and may have had the technical effect of terminating the contracts. Telephone inquiry was made of the secretary of ISI for additional facts in connection with the sale of ISI stock so that the Commission could be in a position to determine whether the principles of the Lane Opinion had been violated and whether action under Section 36 was warranted. In the discussion the secretary of ISI raised the question of whether the proxy material could be mailed out, to which the staff member replied that this was a management decision which should be considered in the light of Section 36 problem which had been raised and that any decision to mail out the proxy material would be at the risk of an adverse decision by the Commission on this question.

When the information was furnished to the staff (sale at $50 per share with a book value of $1.81 per share) it appeared that there had been an assignment of the contracts for a consideration, the excess of the sale price over the book value of the stock, representing the value of the earning power of such contracts. The Commission then determined to file its complaint under Section 36 of the Act against the four directors of ISI who had sold their stock and ISI. The complaint sought their removal as officers and directors of ISI and the enjoining of ISI from acting as investment adviser and principal underwriter of the Trust Fund. The complaint also sought relief with respect to the use of the proxies at the then forthcoming meeting of the stockholders of the Trust Fund.

The meeting was turned over to Mr. Aaron Levy of the General Counsel's Office for a discussion of the legal aspects of the case and the present posture of the proceedings. Mr. Levy discussed the legislative and historical background of Sections 15 and 36 of the Act and the principles set forth in the Lane Opinion which, among other things, held that the investment adviser occupied a fiduciary relationship with the Trust Fund and could not dispose of such relationship at a profit to himself. He stated that in essence it was the Commission's theory that pursuant to the policy of the Act as contemplated by Congress and the equitable principles incorporated in Section 36, the sale of fiduciary arrangements between ISI and the Trust Fund in the form of a sale of stock control of ISI constituted gross misconduct or gross abuse of trust under Section 36, contrary to the purpose of the Congress to prevent trafficking in investment advisory and principal underwriting contracts. Mr. Levy stated that on November 29, 1956 the District Court issued its opinion granting defendants' motion to dismiss the complaint for failure to allege a cause of action under Section 36 of the Act, and that the Commission had filed a Notice of Appeal with the United States Court of Appeals for the Ninth Circuit and had submitted its brief in the matter at the end of July, 1957.

The meeting was then turned over to Harold C. Lohren, an attorney of the Division of Corporate Regulation, who reported on the variable annuity case. Shortly after the incorporation of The Variable Annuity Life Insurance Company ("Valic") in 1955, the Division of Corporate Regulation looked into the contracts which the company proposed to sell, and after much study came to the conclusion that they were securities rather than insurance contracts as contended by the company, and the company itself was an investment company. As a result of these investigations, and because the company commenced the sale of these contracts, an injunctive action was brought by the Commission in the United States District Court for the District of Columbia in June 1956, to prevent the violation of the 1933 and 1940 Acts. The NASD intervened as a party plaintiff, and another newly formed District of Columbia variable annuity company, The Equity Annuity Life Insurance Company, intervened as a party defendant. This injunctive action culminated in an opinion dated September 3, 1957, and the order pursuant thereto dismissed the Commission's complaint.

For a proper understanding of the litigated issue of insurance v. security, an understanding of an annuity is necessary. A "pure" life annuity is a promise to pay periodically a definite sum throughout the lifetime of the annuitant. For illustration we will assume a monthly payment of $75. It is to be realized initially that if the annuitant dies after receiving but one month's payment his complete interest or claim against the insuring company ceases. This result is a function of the insurance element in the contract since the amount paid to the insurer for the granting of the annuity is determined by application of mortality tables which project the incidence of death, and thus the amounts paid by those of short lives are available for payment to those who are long lived. To illustrate -- if an annuitant must deposit $10,000 with the insurer at age 65 in order to receive $75 a month for life, it is to be realized that the $10,000 is actuarially determined to give effect to the fact that that portion of the $10,000 not liquidated by monthly payments to the short-lived will be available for payment to the long-lived. There is here a spreading of the risk of longevity in the same manner as the conventional life insurance undertaking spreads the risk of premature death. This is the insurance element.

We have been assuming that the $75 monthly benefit is purchased at age 65 by a lump sum payment at the time of the $10,000. Directing our attention to the accumulation of the $10,000 by the annuitant prior to age 65 this can obviously be done by various means, one of which would be by the periodic payments to the insurance company of a fixed amount, which with a guaranteed rate of interest, will amount to $10,000. Of course the prospective annuitant could make periodic purchases of shares of stock in a mutual fund in such amount as he hopes will have a value of $10,000 at the time he attains age 65.

The Valic scheme for an annuity commencing in the future, contemplates periodic payments of a constant amount, to be invested by Valic in a fund of common stocks. The interest of the annuitant therein is evidenced by shares (called "accumulation unit"). If the annuity goal is $75 per month it is hoped that Valic's management of the fund will produce shares having a value of $10,000 at the commencement of the annuity period (i.e., age 65).

If the shares have a greater value at that time the annuity can be greater, and of course the converse is true. The annuitant has a right, as in any mutual fund, to withdraw the value of his shares at net asset value prior to the commencement of the annuity period. Assuming $10,000 is the value of the annuitant's shares upon attainment of age 65, and assuming further that the value of a share is $1, then in essence the contract provides that Valic agrees to pay to the annuitant the value of 75 shares per month (rather than $75) for the life of the annuitant. If the value of the shares was $2, the promise would be for the value of 37½ shares. There is therefore at no time a promise to pay a fixed amount, no guarantee of interest, but merely the agreement that once 75 shares (or 37½ shares) has been determined such number will not be changed if the company encounters adverse mortality.

While the foregoing is obviously an over-simplified statement of the facts, they are essentially the facts on which the court found that the investment elements of the contract gave it its economic character (see the Howey and Joiner cases) rather than the insurance element described above. The court stated that:

> "The logic of the law applied to the established facts seems to bring the variable annuity contract within the purpose and intendment of the Securities Act, and the defendants within the terms and plan of the Investment Company Act. This court would feel constrained to so hold if it were not for the clear and explicit language of the McCarran Act and the fact that the defendants are licensed and regulated by the insurance departments of this District and the States where they operate."

The McCarran Act referred to by the court states in substance that: "no Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance ... unless such Act specifically relates to the business of insurance ... ." The court believed it was precluded by the McCarran Act from "branding" the contract as one of investment and that this was a matter for Congress.

It is my opinion that the court was in error in construing the McCarran Act so as to prevent it from wielding the branding iron. That is to say that the McCarran Act does not affect judicial determination of the fundamental economic character of the instrument in interstate commerce. If the court finds that the economic character of the instrument is insurance, then the McCarran Act would prohibit the construction of a federal statute in any way which would impair state regulation. On the other hand, if the court should find, as it did, that the economic character of the instrument is investment, i.e., a security, then the McCarran Act is inapplicable.

Mr. Garrett turned the meeting over to Mr. Charles J. Sheppe of the Division of Corporation Finance, who gave a brief history of the Commission's Statement of Policy with respect to sales literature used in the sale of investment company shares. Mr. Sheppe stated that some years ago the Commission became concerned with what it considered were misrepresentations in the sales literature being used. The Commission staff, with the assistance of the National Association of Securities Dealers, Inc., made a study of the problem, and this led to the adoption of the original Statement of Policy on August 11, 1950. Subsequently, in January 1955, a revised Statement of Policy was issued. This revision permitted the use of charts showing the results of an assumed investment in an investment company on the assumption that securities profits distributions were reinvested in additional shares. Previously the Statement of Policy had permitted the use of charts only if prepared on the assumption that such distributions were received in cash. The revised Statement of Policy limited the time period which could be covered by such charts or comparable tables to the previous ten years, whereas formerly longer periods had been permitted, and it also limited presentations showing the results of reinvestment of dividends from investment income to a summary table without any annual breakdown.

In adopting this revision, the Commission was under the impression that it represented a compromise of views acceptable both to the industry and the staff. It subsequently developed that there was considerable opposition in the industry to certain provisions of the revised Statement of Policy, particularly the limitations on the time period and the manner of presentation of the results of an investment assuming reinvestment of dividend income. After considering the industry proposals for revision of the Statement of Policy, the Commission on August 9, 1956 published a proposed revision which would have permitted more latitude as to the time period covered by charts and tables, but which would not have permitted any showing of the results of reinvestment of either dividends from investment income or capital gains distributions. In written comments and at a hearing on November 15, 1956 strong opposition was made to the latter proposal. Additional discussions were held with industry representatives, and on May 27, 1957 a revised draft of the Statement of Policy was published for comment. At the same time the Commission published a proposed revision of the form of the ten-year table showing the earnings and asset history of an investment company which is required to be included in the prospectus. After considering the comments received on these proposals, the Commission in August 1957 tentatively decided on certain additional revisions. Mr. Sheppe indicated that it is expected that the revised Statement of Policy shortly will be published in final form.

The meeting was turned over to Mr. Abraham A. Raizen of the Division of Corporate Regulation, who distributed copies of the August 1957 draft of the changes to the Statement of Policy. Mr. Raizen briefly pointed out the major differences between the May 27, 1957 proposed revision and the August draft. Both the May and August versions would permit the use of charts and tables showing the results of reinvestment of dividend income or capital gains distributions. The May proposal would have required that a chart or table prepared on such a basis be accompanied by a per share table showing the record of the fund on a non-reinvested basis in terms of net asset value, dividends from investment income, and distributions from securities profits. This table would also have shown the current rate of return based on the dividends paid from net investment income in the most recent twelve-month period as related to the offering price as of the date of publication of the sales literature. This proposal had been made because it was felt that such a table and Statement of the rate of return might be necessary to give a prospective investor a more complete picture than could be obtained from the chart or table which showed the results of a hypothetical investment in the fund made ten or more years ago with dividends and distributions reinvested. However, in view of the fact that the information which would be presented in such an accompanying table would duplicate information which will be required to be presented in the prospectus which must accompany or precede the use of sales literature, this requirement of the proposed May revision of the Statement of Policy is to be dropped.

Mr. Raizen also pointed out that the model charts and tables proposed in both the May and August drafts of the Statement of Policy would more clearly set forth the inclusion of a sales charge in the cost of investment company shares than the present version of the Statement of Policy. However, instead of requiring, as proposed in the May release, that there be a specific reference on each chart or table to the percentage amount of the sales charge, the August draft would require simply a reference to the fact that the difference between the net asset value and the cost of the investment is the result of the deduction of the sales charge as described in the prospectus. It was also pointed out that other changes were being made in the forms and captions of the model charts and tables in order to emphasize their illustrative nature so that they would not be taken as a representation of the results which may be realized in the future.