Securities and Exchange Commission Historical Society
Interview with Joel Goldberg
Conducted on April 20, 2016, by William Thomas

WT: This is an interview with Joel Goldberg for the SEC Historical Society's virtual museum and archive of the history of financial regulation. I'm William Thomas. The date is April 20, 2016, and we are in New York City. Thanks very much for agreeing to speak with us today.

JG: My pleasure.

WT: We usually start out with a bit of personal background, so maybe you could tell where you're from, if your family was involved with law, and ultimately what you studied at Brandeis.

JG: Sure. I grew up in Lewiston and Auburn, Maine. Those are two cities across a river from each other. They were, at the time, mill towns. All the mills are now gone. My family really didn't have anything to do with law. My father had a store, and my mother was a housewife.

I went to Brandeis, as you mentioned. I graduated from Brandeis in 1967, and at that time everyone went to graduate school. The money was flowing freely. There were loans, scholarships available. The idea of getting a job didn't occur to anyone. At least it didn't occur to me. Like everyone else, I knew some sort of graduate school was in the offing, and somebody told me that law school offered all kinds of opportunities to do things besides practice law.

WT: What did you study as an undergrad?

JG: I was a political science major, and law school just seemed like it kept more options open. As you can probably tell, I did not have a real plan. I graduated from Columbia Law School in 1970, and the job market wasn't attractive then, especially for me. I basically took the first job offer that came, which was working in the office of General Counsel at the Civil Aeronautics Board. I'm not sure that you even know what the Civil Aeronautics Board was. It was the federal agency that regulated airlines. It was economic regulation, as distinct from what the FAA does, which is safety and that kind of thing. The Civil Aeronautics Board set the fares. An airline couldn't fly a new route without permission from the Civil Aeronautics Board. And this is an example, I think, of how careers can take strange turns. I did not particularly find it interesting working there.

WT: What sort of things did they have you doing?

JG: Well, that's how I got into mutual funds. One thing I did was I wrote a lot of rules. And there are probably fewer and fewer people who can remember this, but the CAB had a lot of rules, very detailed rules, regarding eligibility for charter flights. Because they fixed the airfares at artificially high rates, the airlines weren't allowed to discount the fares except in very narrow circumstances. So they were really higher than the market would have permitted, which meant they had plenty of empty seats, but they were expensive and people developed ways of evading the rules, as you might expect.

One way to evade them was to form a group and have the group charter a flight. If you were a legitimate group, you know, if you were the local chamber of commerce and you wanted to all take a trip somewhere, you could charter a plane. But a lot of tour operators learned that they could put together groups that really didn't have much in common at all, other than they all wanted cheap airfares, and they would charter a plane and then sell the seats on the plane at a discounted price.

And the CAB was always trying to catch up with this. They were always trying to write rules about how long the group had to be in existence, and was it a legitimate group, and it was kind of like the Internal Revenue Code, you know, they would put in a rule to close a loophole and then someone would figure out a way around that and the rules became ever more complex.

I was one of the people who wrote these ever more complex rules. I really knew that was not the place to be. I would probably be giving myself too much credit if I said that I foresaw that they would end the economic regulation of airlines. I didn't really see that coming, but I just decided it was time to make a change. Somebody put me in touch with a person at the SEC in what was then called the Division of Investment Management Regulation. And he was quite pleased to meet me, because the SEC at that time was considering doing rules to change the restrictions of Section 22(d) of the Investment Company Act.

Section 22(d) required fixed sales loads, and you can probably see where this is going. The SEC was thinking of allowing exceptions to that, and one of the exceptions were they were going to allow sales to groups at reduced loads. And they were using the CAB charter rules as a model, but nobody could understand them. And when this person—his name was Lew Mendelson—found that I not only could understand them, but I'd actually written some of them, he gave me a job. So that's how I got to the Division of Investment Management, or at that time Investment Management Regulation.

Somebody had to explain to me what a mutual fund was. And I worked on this proposal for the group sales for sales loads, but by the time it was actually adopted, events had overtaken the SEC's activities in that area. Sales loads were coming down anyway. There was no need for all these very detailed rules about when you can cut the load and everything. People were reducing loads across the board anyway. But I was in the division, I moved on to other things, and that's how I ended up working all those years at the SEC.

WT: That's extraordinary, the parallel between what you were doing at the CAB and at the SEC. It's very interesting.

JG: Yeah. And I think if anyone wants to make an argument for planning out your career, I'm not it.

WT: Was the CAB in Washington?

JG: Yes. Yes.

WT: So the Division of Investment Management had just recently become its own division, is that right?

JG: Well, yes, it is right. That was before I arrived. There had been a Division of Corporate Regulation, which primarily consisted of administrating the '40 Act, as well as the disclosure requirements applicable to investment companies. And it also included the Public Utility Holding Company Act. They reorganized in a way that the Division of Corporate Regulation was left only with the Public Utility Holding Company Act, and all the mutual fund activities were put into the new Division of Investment Management Regulation, but that division had existed as the Division of Corporate Regulation for a long time.

WT: So you arrived in '73.

JG: Yeah.

WT: So what exactly were your responsibilities, then, in the division, besides working on that one project?

JG: Well, for my first year that was my primary responsibility, and it was a huge project. It involved not only the group sales for sales loads, but everything relating to mutual fund distribution, changing the advertising rules, which had been before that very restrictive, allowing other methods to sell mutual funds. That pretty much occupied my first year there.

Then, in 1974, after I had been there for about a year, I was appointed what they called a special counsel that was actually a branch chief type of job. They had three branches that processed exemptive applications and also requests for no-action letters. Before and afterwards, no-action letters were handled in the Chief Counsel's Office, but for a period of time these three branches handled the no-action requests and the exemptive applications, and I was chief of one of the three branches. So that kind of gave me pretty much complete exposure to the Investment Company Act. I moved beyond just working on distribution issues.

WT: The exemptive powers of the Division of Investment Management are, of course, very interesting, and certainly in that period unique. I'm curious about how those powers versus the power to issue no-action letters functioned. Would companies tend to apply for one more than the other, or would there be certain criteria that would govern how they would approach that?

JG: Well, I'll answer that, but then let me come back to the exemptive authority, because I think it is a very fascinating area. Generally speaking, if a company has a choice between getting no-action advice or applying for an exemption, they would probably pick the no-action route because it's easier procedurally. An exemptive application requires publishing a notice of the exemption in the Federal Register. Anyone who wants to object can object. Then they publish a final determination. It's a much more legalistic process, whereas the no-action letter, the staff simply says it's okay.

Now, that said, the staff won't give you a no-action letter if they think something clearly is not permitted by the Investment Company Act. In that case, they'll say that you have to apply for an exemption. So if there's a choice, a company will take the no-action route, but often there isn't a choice.

But the exemptive authority, I think some people don't appreciate how significant it is. It allows the Commission to exempt anyone and anybody or everybody from any section of the Investment Company Act. It's extraordinary. But, the other side of that coin is that the Commission can condition the exemptions in any way it chooses. So the exemptions can be granted either by individual order, or by exemptive rules, but in either case, it allows the Commission to impose requirements that aren't in the Investment Company Act.

Just to take one example that comes to mind, money market funds didn't exist in 1940. They came into existence in the mid-1970s. Without getting too deep into the weeds on this, in order for a fund to be sold at a stable net asset value, a dollar a share, it required an exemption from the SEC, from the Investment Company Act requirements, because the Investment Company Act requires that a mutual fund be priced every day at precisely the net asset value. So that won't always be a dollar, even for a short-term, high-quality fund.

Individual companies applied for exemptive orders to permit them to price their shares at a dollar. It essentially involved amortizing the cost of the investments and then rounding up or down slightly to make it a dollar, and the SEC gave those exemptions. After very protracted hearings, they gave those exemptions, but on conditions relating to the duration of the investments, the quality of the investments, all kinds of other things. So you came up with this whole regulatory scheme for money funds which didn't exist in the Investment Company Act.

The exemptive rule permitted them to price their funds in a way that the Investment Company Act would not permit, but they also imposed all these new requirements, which weren't in the Investment Company Act. And, you know, there are countless examples of that where investment companies now are subject to requirements which you won't find in the Act. I guess a more recent example would be ETFs, exchange-traded funds, another thing that didn't exist in 1940, and they're allowed to trade subject to restrictions which aren't in the Investment Company Act.

So, it's a remarkable provision, and I think it's why the Investment Company Act, even though it's, what now, seventy-five, seventy-six years old, and the framers of the Act wouldn't recognize the industry today, but it still works because of this exemptive authority.

WT: So, of course there are a lot of changes going on in the investment company area in the 1970s. Was that the primary way that the division would react to them? Is it the companies would come to them, funds would come to them with seeking exemptions and that they would then receive them?

JG: It was not the only way. I don't know if I'm anticipating one of your questions, but there were enormous changes in the way mutual funds were distributed, you know, beginning in the early 1970s and then into the '80s. And we've already talked about sales loads, but the biggest change was Rule 12b-1, which allows mutual funds to pay for distribution of their shares, subject to conditions. And there's a lot of mythology about how Rule 12b-1 came about. A lot of people thought at the time, and they still think, that the industry had been in net redemptions in the early 1970s. They came out of it toward the end of the '70s, but it was thought that the industry needed kind of a shot in the arm and the SEC was trying to help them out by allowing them to use some assets to pay for distribution. That's not it at all. That's not how it came about.

The way Rule 12b-1 came about—and as you'll see, it isn't an exemptive rule at all—the way Rule 12b-1 came about was three things happened at about the same time. The SEC historically, until—probably now talking 1976, '77—prior to that the SEC had always taken the position that it was illegal to use fund assets to pay for distribution. They weren't ever quite able to tell you why it was illegal, because it wasn't. There wasn't any section of the '40 Act that said you can't pay for distribution, but the SEC thought it was just a bad thing to do, and they would threaten some sort of vague enforcement action if anyone tried that.

And that sort of kept the lid on the practice until two things happened. One, Vanguard was formed, and they were a no-load fund group, and they were owned by the shareholders of the funds. It's sort of a unique structure in the industry. And they came in with an exemptive application saying, unlike other no-load funds, we haven't got an external investment adviser to pay for the distribution. Other no-load funds would sell through advertising, however, and the expenses were paid by the investment adviser because it was thought that the funds weren't permitted to pay for distribution. But Vanguard said, we haven't got an external investment adviser. Our investment adviser is owned by the funds so there isn't anyone to pay for the distribution, but we have to have distribution.

So they filed an exemptive application, and it wasn't clear what sections they needed an exemption from, but they quite prudently felt they weren't going to do this without some sort of order from the SEC. At the same time, or about the same time, while that exemptive application was being processed—and there were very extensive hearings involving it—the money-fund industry was growing dramatically. Now, you can't sell money funds with a sales load. It just isn't practical, because they're a short-term investment, so the money funds were casting about for ways to incentivize broker dealers to put their customers into the money funds.

And one company came in with a no-action request, and they said, we have an advisory fee of—as I remember, it was fifty points, which at the time was pretty much standard. Now today that would be an extremely high advisory fee for a money fund, but you have to remember in those days the money funds were paying 16 percent. So a fifty-point advisory fee wasn't so bad. And they said, we have about the same fee everyone has, fifty points. But what we want to do is take twenty-five of those fifty points and pay it as a trail commission to the brokers who put their customers in the fund. As long as the customer stays in the fund, we'll give up twenty-five points of our fee to the broker.

That letter came to my branch and I went to the boss, a man named Sydney Mendelsohn, who was the assistant director in charge of our branches at the time. And he was just one of the great men of the SEC. He had spent his entire career there, and he knew everything. And I went to Sydney and I said, you know, I don't see how we can say no to this. It's their money. Their advisory fee seems to be what you'd expect, and if they want to spend twenty-five points on building up their business, it's their money. I don't see anything illegal. And Sydney agreed, so we gave them a no-action letter.

Shortly after that, another company came in and said, we have the same thing. We're a money fund, same thing, fifty-point advisory fee, and we want to pay twenty-five points to the broker. Same as the last one that you gave, but the only difference is, we don't want to play this silly game of claiming our fee is fifty points when it's really only twenty-five. It's a twenty-five-point advisory fee, and we're paying twenty-five points for distribution. Let's just disclose that and not pretend that we're charging fifty points, but then we're giving away twenty-five points.

And at that point, the SEC's position that funds can't pay for distribution was starting to look fragile. And Sydney and I talked about it, said, “Gee, we're kind of in a spot here. Because we've already said it's okay to give up half your advisory fee, and now we'd be saying if you insist on being too honest about it, if you insist on disclosing exactly what the economics of the transaction are, even though it's the same economics, but you're disclosing that the fund is paying twenty-five points for advice and twenty-five points for distribution, we'd be saying that that isn't okay, and how can we say that?” So we said, “Okay, that's okay, too. In fact, that's especially okay.” Well, by now, the industry had gotten wind of the fact that we were planning to allow people to use either part of their advisory fee or part of the fund’s assets to pay for distribution.

Some segments of the industry became very irate about that, because they said—again, take the example of charging fifty points for the investment advice. If that becomes the norm, we're going to have to pay twenty-five points, too. We like it when people aren't allowed to pay anything. So the Commission scheduled hearings. They actually ordered a withdrawal of the no-action letter that permitted the investment adviser to pay half its fee. I think that's the only time the Commission has ever instructed the staff to withdraw a no-action letter. I'm not aware of any other instance. But they instructed us to withdraw that letter, because this was really just a hugely controversial thing. And you had the Vanguard application in, where they were asking for permission to pay for distribution, and large hearings ensued, comments. This went on for a year or two.

WT: About where are we at time-wise now?

JG: Well, we're now probably around 1977. The hearings concluded, and I left. I moved to the Solicitor's Office at the Department of Labor to work with ERISA, which was a relatively recent law. It passed in 1975. But the Commission's consideration of what to do about mutual fund distribution continued after I left, and they ultimately adopted Rule 12b-1, which, as I say, people think that's the rule that permits funds to pay for distribution. What Rule 12b-1 says is you cannot pay for distribution unless you meet the following conditions. And analytically, the SEC had no choice, because yeah, you could have adopted a rule under 12b that said you can't pay for distribution, period, and that would have been the first time there was actually a rule saying you can't pay for distribution.

But had they done that, you would have been right back into the situation that led to this huge proceeding. You'd be saying to Vanguard, you can't have a no-load fund unless you have an external investment adviser. Well, all right, you could give an exemption only to

Vanguard, but then you'd be back to the situation with the money funds. You'd be saying it's okay for the no-load funds, such as a money fund or another no-load fund, to have its investment adviser pay for distribution. But where does the investment adviser get the money? From its advisory fee, which the fund pays.

And the adviser can pay for distribution only if it claims that it's not getting the money from the fund. I mean, it was an untenable position. So the SEC adopted Rule 12b-1, which for the first time regulated the paying of distribution, for distribution from fund assets, but imposed a bunch of requirements. That isn't an exemptive rule, as I say, and I would say that probably that was one of the real important developments of the 1970s, along with the money funds.

WT: I'd like to jump back to 12b-1 some more, but I'd also kind of like to stay in roughly chronological order on things. But before any of that, I guess I have one question. I think I understand that you have funds with sales loads, and then you have no-load funds. What's the structure on a no-load fund as a rule? Do they generally charge fees instead of loads, or, I'm not quite certain about that.

JG: Well, all funds charge advisory fees. What is called a pure no-load fund has no distribution charges at all. The investment adviser pays for the distribution, and that is still permitted, even though 12b-1 exists. A no-load fund can say, we do not have any distribution charges, or, our advisory fee is what it is, and any expenses relating to advertising or other distribution expenses are paid by the investment adviser out of its own resources. That's a pure no-load fund. You also have funds that have sales loads. They're actually becoming increasingly smaller, but it can be a sales load paid at the time of purchase, or—and this is kind of, I think, going out of style—it can be called a contingent deferred sales load, or rear-end load, where a customer buys the fund through a broker.

The broker is paid a commission. But the customer doesn't pay that commission, the distributor pays it, and then the distributor recoups that commission over time through a 12b-1 plan, and if the customer redeems before all of the sales load has been recouped, he then has to pay a rear-end load on the way out. These types of arrangements were very popular for a time. I think they're now going out of style, so probably the two prevalent methods of distribution are just conventional load funds, front-end load, or no-load, either with or without a 12b-1 plan.

WT: So when you arrived, the 1970 amendments to the '40 Act had been in place for a few years, of course. Were there still prevalent discussions or activities relating to those amendments?

JG: Yes. In fact, that's how I got my job.

WT: The sales-load restrictions were part of that.

JG: Yes. The Commission, as you know—I guess the 1970 amendments were preceded by a very large study called *Public Policy Implications of Investment Company Growth*. The acronym was PPI. That was a big study published by the SEC in which they made a number of recommendations for changing the Investment Company Act that led to the 1970 amendments. One of the recommendations was to repeal Section 22(d) requiring fixed sales loads, and the industry opposed that, so Congress sort of compromised by not repealing it but instructing the SEC to do a study of what to do about 22(d), and that's where I came in with my charter rules.

But other things resulted from the 1970 amendments. They greatly restricted the sale of contractual plans, which were heavily front-loaded plans where one would contract to buy mutual funds over a period of years. And they were sold largely to unsophisticated investors. They really weren't a contract. I mean, if you contracted to buy five years worth of mutual funds on an installment plan and you stopped after two years, you wouldn't be sued, but the consequence would be that you had paid almost all the sales loads upfront. So you ended up paying a huge amount of sales load if you did not stick with the plan through its end. They restricted that. They put in provisions that required if a person stops paying into his plan, he has to get some of the sales loads refunded. That pretty much killed contractual plans.

WT: Yeah, you mentioned to me, in an email I think, that that was already pretty much gone by the time you arrived.

JG: By the time I arrived in 1973, there were hardly any more contractual plans. Another very big development was Section 36(b). That's the section that permits either the SEC or a private plaintiff to sue for an excessive advisory fee. And before that, before the 1970 amendments, there was just Section 36 of the Act, which imposed a fiduciary duty on investment advisers involving gross misconduct. The only way to sue for an excessive advisory fee under the pre-1970 standard was to show a breach of fiduciary duty that amounted to gross or wanton misconduct, almost a corporate waste standard. Unless the fee was that much there wasn't any way to sue for it.

The Public Policy Implications discussed various ways of what to do about fees. The thought was that advisory fees were not being held down by competition because people didn't understand them. They didn't know what the fee was. And they weren't being held down by regulation, because the SEC had no authority to regulate what the fee could be. The only check on fees was this very low standard—or high standard, depending on how you look at it—that unless the fee was so excessive as to shock one's conscience, there could be no liability for it. So Congress amended Section 36(b). Well, they amended Section 36, the original 36 is now 36(a), and they put in 36(b) which imposed a fiduciary duty with respect to advisory fees and you don't have to show corporate waste or gross abuse of trust.

That was still a work in progress by the time I got there in 1973. There had been a few lawsuits brought alleging excessive advisory fees and they all had been settled. And typically the way they were settled was the defendants would agree to place breakpoints in the advisory fee that were out of the money. That means if the fund assets were, let's say, $100 million, they would agree as part of the settlement, when the assets reach $200 million we'll reduce our fee to a smaller amount. That didn't cost the defendants anything. The plaintiffs got a victory, which meant a legal fee. And that's really where 36(b) was, until sometime in the mid-1970s Merrill Lynch was sued. They had a gigantic money market fund called Ready Assets Trust, and their advisory fee was not particularly high but that fund was so enormous that, you know, it was a very large fee in terms of the dollars.

And they were sued under 36(b) and they refused to settle. They litigated it. And it went up and down, you know, court of appeals. And that was the *Gartenberg* case, that was *Gartenberg v. Merrill Lynch*, and the courts ultimately held that the fee wasn't excessive under Section 36(b). And the reasons the courts gave for deciding the fee was okay is that they enumerated a bunch of factors: there was a sharing of economies of scale, the directors were fully informed, they had independent counsel, and the court ran through all these factors; the profits weren't excessive.

These are now the factors that are always considered by everybody in connection with advisory fees, and a lot of people think it's in the Investment Company Act. It's not. Those factors were the ones articulated by the court in the *Gartenberg* case. And they've been modified since then, but essentially, that's how people analyze fees now. And 36(b) cases are now active, as you know, but the first few years, nobody knew what to do about 36(b) and there was very little litigation, and what there was, was settled.

WT: So generally, just coming off of that, the SEC has not really had too much oversight over the level of fees. It's mainly been through the litigation process that that pressure has come in?

JG: Yes. Yes. The SEC has the power to sue under 36(b), but they don't. They leave that to private litigation. And very, very rarely do the plaintiffs prevail. Advisory fees have come down of their own accord. I think one of the reasons for that is there's been a lot more attention paid to mutual funds in the popular press and the consumer press. And, you know, when the Commission did their PPI study, *Public Policy Implications*, in 1966, probably most investors weren't even aware they were paying an advisory fee, because it's invisible. You know, you don't actually write a check. It comes out of the fund. Now people understand it, there are all kinds of comparisons available online and in the press, and I think competition is now working to reduce advisory fees and they have tended to get smaller over the years.

WT: Generally, the fees were just taken out of the fund's performance, I guess?

JG: Yeah. Yeah. Yeah. It's an asset-based charge. So, you know, it's a percentage of the fund's assets. It's not really related to performance. The fund could lose money in a given year and still pay the advisory fee. But those fees have become smaller over time.

WT: But it would have, of course, been in the prospectus.

JG: Yeah, if anyone read the prospectus.

WT: Right. Right, that's always the question.

JG: But now the information isn't available only in the prospectus, it's available in all kinds of places. And I think that there's enough attention paid to the fees now that competition is beginning to work.

WT: Concerning the 1970 amendments, the only other section of interest that I had written down to ask about is Section 17(j), concerning the activities relating to fund insiders. Was there a discussion concerning that at the time? I know it became a bigger deal later on.

JG: Yeah, the Commission—17(j) was not self-effecting. That gave the Commission the authority to require codes of ethics, which would relate to insiders or, you know, fund managers taking advantage of their positions. And the Commission ultimately did adopt Rule 17j-1. Again, that was in the 1970s. I've always thought that was really more show than substance. You know, it requires codes of ethics and every fund now has to have a code of ethics. It typically requires that the people working for the fund have to get preclearance for their personal securities transactions, you know, to make sure they're not front-running the fund or trading against the fund. Oftentimes, the code of ethics won't permit personal trading at all.

But I would think that any well-run fund company would have those kinds of procedures in place, whether you had 17j-1 or not. I'm not aware that there was a huge rash of fund insiders doing things that they shouldn't do that they stopped after 17j-1 came in. I think there was an element of show business to that.

WT: I see. Are there any other aspects of the amendments that we should discuss, or should we move on?

JG: I think we can move on.

WT: Well, we've also been discussing some of the changes, the rapid changes that were taking place in the investment company sector. We discussed money market funds, of course. There are also other kinds of non-equity funds that were coming up, bond funds. I think we saw the first municipal bond funds in this time as well. We did a series of interviews concerning municipal securities a couple years ago, so that's an area we're particularly still interested in. And of course, at the time, that was very much a wide open area where there was very little disclosure involved, whereas the funds, I guess they had to report their price on a regular basis.

JG: Yeah, municipal bond funds really were made possible by a change in the Internal Revenue Code around that time in 1975. Before then, if a fund invested in tax-free bonds, then when it paid out its dividends to the shareholders, those were taxable, which defeats the whole purpose of a tax-free fund. The only way to avoid making the tax-free interest taxable when it was paid out as a dividend by the fund was to organize the fund as a limited partnership, and that was a very cumbersome process. That also required exemptive orders, which a few companies received but it was not a very easy way to run a municipal bond fund. But it was the only way until they amended the Internal Revenue Code, or, yeah, I think it was the actual Code that was amended to permit tax-free interest to be passed through as a tax-free dividend to the shareholders. And that led to now you have a lot of municipal bond funds, but they really couldn't exist prior to that amendment to the Code.

WT: Were there any other sorts of actions that needed to be taken concerning other kinds of funds that were cropping up in the mid-to-late-‘70s?

JG: In terms of specific types of funds, yes. The Commission adopted an exemptive rule under 17(f) of the Investment Company Act, which essentially said you had to maintain custody of all the fund's securities in the United States, either in a bank, or in some cases at a broker. But that pretty much made it impossible to have an international fund or a global fund, because this was before the days of electronic entry, when you actually had the security, you know, there were certificates when you bought a security. And if you invested overseas, you had to fly those certificates back to the United States, and then when you sold them, you had to fly them back. It wasn't practical.

So the SEC adopted rules which permitted funds to maintain assets overseas, in either foreign branches of United States banks, or in some cases, actual foreign banks, and that is what permitted the internationalization of the mutual fund industry, and now you have all kinds of international funds, including emerging markets funds. And that would probably be possible anyway now because of changes in industry practices and changes in technology, where you have electronic entries rather than physical certificates. But I think it would still be impossible to have emerging markets funds if the Commission had not relaxed the rules regarding foreign custody.

WT: We talked a little bit about changing distribution models, in particular moving it away from the fund advisers, and in some cases bringing it within the fund itself, through the Vanguard model for example. Of course, they had the investment adviser in house.

But there's also the question of the ad content itself. And I know that you're involved with the dual-form prospectus, but then there are other, more nitty-gritty issues involved with the content as well, which I think would be very interesting.

JG: Yeah, well, there are actually two things. One was the reform of the mutual fund prospectus, and to me what was a lot more significant was greatly expanded advertising being permitted. When I came back to the SEC—I had gone to the Labor Department in 1977, and I came back in 1979 as associate director of the division. And one thing I was responsible for—Syd Mendelsohn had at that point become director of the division, and Syd put me in charge of reforming the rules concerning advertising.

Prior to that, the only advertisements that mutual funds were allowed to do were what are called tombstone advertisements, and essentially they're called tombstone because it just gives the name and the date of the offering, and that's pretty much what a tombstone is, they couldn't really advertise anything. They could give a very brief description of: is it an equity fund or is it a bond fund, but not much else. There was a lot of thought at the Commission by some of the more progressive people, such as Syd, that that was one reason distribution was so expensive. If mutual funds could advertise like other consumer products, that would lower the cost of distribution.

So I worked with another SEC veteran named Stan Judd, who was a career SEC person, very, very smart, and Stan came up with a way of permitting mutual funds to advertise a lot more freely, first in print, and then it was later expanded to TV, and now, of course, it's online. But that was the first time mutual funds could really communicate with the public in any way that would make them want to buy the fund without having a salesman sit down with them and explain it to them. So that was a huge advance in both popularizing funds and reducing the cost of distribution.

Now, the other thing was the reform of the prospectus. And if I sound cynical about mutual fund prospectuses, I suppose that's because I am. I can't imagine that more than 10 percent of investors read it, if that much. You know, the prospectuses are so long and so complicated and so full of legalistic claptrap that nobody would read one who didn't have to. Around the same time we did the advertising rules, we also decided to reform the mutual fund prospectus and we came up with what seemed like a good idea at the time, which was we divided the prospectus into two parts. One part would be what we thought would be maybe eight pages maximum, and it would just tell the essential information about the fund, investment policies, investment objectives, fees, the management, and then all the other stuff would be in a statement of additional information. That would be part two of the prospectus. And that would not routinely be supplied to investors. Anyone who wanted it could call and ask for it, but if you didn't ask for it, all you got was that eight-page informative summary. And we thought that would make the prospectus a readable document, and it did for about a year.

But what inevitably happened was someone would come up with a new investment technique, you know, whatever, derivatives or something. And the staff would be reviewing their prospectus, and they'd say, gee, we're not sure about this. We don't quite understand this. Why don't you add some disclosure to the prospectus explaining it? And, you know, the registrant would say fine. They just wanted their prospectus to go effective. They would put in whatever the staff asked for.

And then the next fund of that type would say, well, we see that this is how that last fund's prospectus got cleared. We'll put in the same thing. So, every time somebody thought of a new thing to add, it became standard. Everyone doing that type of fund in the future would include it, so the prospectus just grew back. Because of the registration process and the way prospectuses are processed, the staff was always thinking of new disclosure to ask for. The registrants were glad to supply it. Every new registrant said, "Gee, I don't know why that's in there, but if that's what works, I'll put it in, too." So the two-part prospectus sort of—it's still a two-part prospectus, but our dreams of an easily understandable, eight-page prospectus are in the distant past. But I think that's why advertising is so important, because that's the only way you can really explain a fund in a way investors can understand.

WT: It's interesting. I mean, you know, I'm thirty-seven years old, and so I've only known the world of advertisements for funds and that sort of thing. It's not intuitive to me, if I were a retail investor at the time, how I would hear about a fund, or if I would just be talking to a stockbroker and they would recommend funds.

JG: It's that. Yes, that's it. Yeah. Yeah. You know, there were no-load funds from the time of the Investment Company Act, but there were very few of them. They were really for sophisticated investors. You know, there would be tombstone ads in the *Wall Street Journal* and would say, you know, T. Rowe Price has a stock fund. And, well, all right. I'll get the prospectus and I'll read it. But as you can imagine, that was only for the cognoscenti. The average person probably didn't know what a mutual fund was. The industry was a fraction of the size then that it is now. And you found out about it, you had a broker, and he would sell it to you.

WT: This kind of leads up to my next question, which is about the increasing prominence of retirement funds in the mutual fund area. Of course, you didn't have 401(k)s yet in the

1970s, but IRAs were becoming more prevalent, I suppose. Was that something that was on the radar at the time?

JG: It got on the radar I would say by the early ‘80s. The industry realized that that was the motherlode. There were huge opportunities there to sell funds, and it probably had to do with economic developments in the economy in the 1970s. Through the 1970s, almost all retirement plans were what were called defined benefit plans. You know, you work for a company and they say, “When you retire, we'll pay you three-quarters of your average-high three years' earnings.”

WT: Pensions mainly.

JG: Yeah. Yeah, yeah, traditional pensions, and then two things happened in the 1970s to all but kill off defined benefit plans. There are still some, but not as many. The two things were huge inflation, and a very bad stock market, what they called stagflation, and that was a poisonous combination for defined benefit plans because the investment portfolio of the pension fund was performing poorly. In the meantime, the pensions that had been promised were growing, because, you know, wages and salaries were growing with inflation. So you had ever-increasing liabilities and ever-shrinking investment portfolios, and it just wasn't a sustainable model. So a lot of companies switched from defined benefit plans to defined contribution plans, which are 401(k)s and IRAs. And the mutual fund industry was really on top of that. They saw a huge opportunity to fund IRAs and 401(k)s, and it really contributed greatly to the growth of the industry.

WT: Well, it seems like a good transition to talk briefly about your time at the Department of Labor. There is the one question I have before that, which is, in discussing the IM Division we mainly talk about the '40 Act and the mutual funds and the like. There's also the Advisers Act. I'm wondering how prominent that end of the regulatory spectrum was in the work.

JG: Not as prominent as it is now. The Investment Advisers Act was almost an afterthought to the Investment Company Act. It was enacted at the same time, in 1940, and it was really almost a census. It was really designed to enable the SEC to find out how many advisers were out there. By requiring registration, they would find out how many advisers were out there and what they were doing. But there was no real substantive regulation beyond the registration requirements.

Again, a lot happened in the 1970s. By the 1970s, the SEC started to become serious about regulating investment advisers, but they weren't quite sure how to go about it. And they said, well, maybe we should have qualifications. You know, you have to have a certain level of education, or you have to know something about investments in order to be an investment adviser, but they weren't ever able to achieve a consensus as to what qualified one to be an investment adviser. Now there's much increased emphasis on the Investment Advisers Act. But really, during my years at the SEC, they were just starting to have an attempt to regulate them, and it never got very far.

WT: Okay. So now in 1977, then, as you mentioned, you go over to the Department of Labor to work on their activities related to ERISA. So how did that come about?

JG: I had a colleague, Burt Leibert, at the SEC, and he had gone over to the Department of Labor from the SEC. And he and I both thought that if you ever wanted to fully understand the investment management industry, you had to understand both ERISA and the Investment Company Act. ERISA, for the first time, was regulating how pension funds could be invested. There had always been tax rules about when someone would vest, and could you discriminate among employees, that kind of thing. But ERISA, for the first time, imposed fiduciary duties on the management of the fund beyond just common law trust law.

Burt went over to the Labor Department first, and then he told me they had an opening for me there, and I went, too. I found it a frustrating experience—and this has since been changed, but at that time ERISA was administered jointly by the Department of Labor and the IRS, and any rules that we did regarding fiduciary responsibility had to be issued jointly by the Labor Department and the IRS, and that was true of exemptive orders, also. And it led to interminable wrangling over words. You know, it's hard enough to get something through one bureaucracy, but when you have to get it through two, it's terribly hard. So when Syd Mendelson offered to bring me back as associate director in 1979, I was only too glad to go back. But my reason for going to the Labor Department to start with was that it seemed that that was such an important segment of the investment management industry that, whether you were in the government or in private practice, you had to understand them both.

WT: Did you have any experiences being in an executive branch department versus in the independent Securities and Exchange Commission that it was really apparent that there was a difference between how the two operated?

JG: Not dramatically. The Labor Department is, of course, much larger than the SEC, but I was part of the solicitor's office that handled ERISA, and that was smaller than the SEC so it's like being at a huge university. You might have 20,000 students, but you don't see all 20,000 students, and it was kind of like that at the Labor Department. I didn't find it oppressive in that sense.

WT: It was interesting, I was talking to Barry Barbash two days ago, and he also went over to the Labor Department for a short period, and I think he had some more difficult experiences a couple years later with some of the start/stop that can happen with funding.

JG: Well, yeah, there was some of that. Actually, he started there. I hired Barry. He worked for me.

WT: He mentioned that, in fact.

JG: Then when I went back to the SEC, I spirited him off to the SEC.

WT: Just on that, of course now one of the big things in the regulatory news is the fiduciary rule. Is that related to the sorts of issues that you were working on during your brief time there?

JG: If I were still there I would have been involved in that, because that's handled by the office I was in. But no, that really has to do with whether—I think that relates more to the broader issue of expanding the Investment Advisers Act. I know this is a Department of Labor rule, but brokers historically have not been required to register as investment advisers, and so they have not been subject to a fiduciary duty to their clients. They have what's called a suitability requirement, but that's a much lower standard. Some brokers have been dually registered as advisers and brokers. They, of course, have a fiduciary responsibility.

But when I was there, there was no thought at the time of requiring brokers to undertake fiduciary responsibilities, unless they were a fiduciary because of their ERISA activities. Even then, if you were a broker, and you had a client who had a business and he said, look, I've got a pension plan here, and I'd like you to run it for me, you would be a fiduciary. But you would not have been a fiduciary if you had a customer who had a 401(k) plan and said to you help me to buy something for my 401(k). You would just be a broker, and now everyone will be a fiduciary.

WT: So then you came back as associate division director. What was within your orbit in that role?

JG: Well, the division was divided in two, really. There were two associate directors, and I was responsible for everything except the Investment Company Act. My half of the division included the disclosure branches, you know, when you filed a registration statement they would process it. They would process proxies, all that kind of thing. The investment advisers, we had an office that was trying to decide what to do about the Investment Advisers Act. That was under my jurisdiction, and that was really my half of the division. It was interesting, because it was the half that I had not previously been involved in. When I had been a branch chief, I had been involved in the Investment Company Act, and now I was involved in the 1933 Act and the Advisers Act.

WT: And then you came up to be division director in 1980, the next year?

JG: Well, yeah. Actually, and I might be remembering this wrong, but with a little bit of license, I believe I actually became director the day before Ronald Reagan was inaugurated, and that was an interesting time. Syd Mendelson had been director, and he had been thinking of retiring the following year, but then he decided to retire at the end of 1980. I'm sorry; I've got the years wrong. I became director in January of '81. I was appointed by Chairman Harold Williams, who had been Carter's SEC chairman.

Of course, Carter had lost the election and Harold Williams was getting ready to leave, because there would be a new administration, and appointing me was one of the last things he did. It was after Carter had already lost the election. Then, when I actually became director, if I'm recalling it correctly, my first day was a Monday. Tuesday, the government was closed for Reagan's inauguration, and I went over there and froze half to death.

WT: Having a new Chairman and new administration, did that change things at all, in terms of what the division was doing and their concerns?

JG: Yes, it had a huge effect. It started under Ford, there had been a trend toward deregulation. There was kind of a consensus in the government that regulation had become too intrusive, not just with the SEC, everywhere. That actually led to the demise of the Civil Aeronautics Board. Someone figured out that having a whole agency whose only responsibility was to keep airline fares high probably was not a good thing.

But there was some tendency toward trying to find ways to ease up regulations, but once Reagan came in that trickle became a flood. The Chairman that President Reagan appointed was John Shad, who was a former vice chairman of E.F. Hutton, very, very smart man, but he had really drunk the Kool-Aid of the Reagan philosophy that we've got to shrink the government, the fewer rules the better. He and I used to arm wrestle a lot. He would often suggest that I come up with some sort of proposal to repeal the

Investment Company Act, and I wasn't about to do that. It's amazing he didn't fire me, because we used to argue all the time. (Laughter)

I sort of believed in deregulation, and I was one of the people who thought we had to end this charade about not permitting funds to pay for distribution. I helped work on the rules to allow advertising. I did believe in deregulation, but this Republican crowd in 1981, they were something, and they really wanted to, if not repeal the Investment Company Act, just greatly reduce its scope.

WT: That's extraordinary. Did they try and work that through Congress at all?

JG: Well, that was one thing that had Chairman Shad so mad at me. He would have liked to have, but any proposal the SEC came up with would have to be drafted by my division. It wasn't happening.

WT: And having been at E.F. Hutton, I had forgotten about his background there, did he have a particular interest, then, in that division in particular?

JG: No, no, and that was the good news and the bad news. He had been a capital markets person, stock underwritings, that kind of thing, and as I say, a very, very smart man, but he never worked very much with mutual funds at all, so he didn't have that much interest in the division. That was the good news. The bad news was that he just said, "I don't know much about this Investment Company Act." I mean, he didn't say this, but "I don't know why we need this big Investment Company Act. Why don't we just have disclosure, like we have for everything else?"

WT: That is remarkable. So meanwhile, of course, Rule 12b-1 has come into effect at this point. That was while you were gone.

JG: No, actually, I think technically, it was pretty much completed while I was gone. I had probably come back as associate director before it was adopted, but I wasn't involved in it. It was on its way to adoption. It was in the other half of the division, the investment company side that I wasn't responsible for.

WT: Of course, it's a very controversial rule, and we got into that a little bit in discussing some of the prehistory of that, but I wonder if we can go into more of the particular points. I guess the principle argument is that people who are already invested in a fund should not be paying for further distribution. Who is making that argument, or at least most strongly?

JG: Well, it was mainly what I'll call—and I don't mean this in a pejorative way—the old guard at the SEC. Most of the veteran SEC people felt that if a fund grows, if it sells shares, that will benefit the investment adviser because it will increase the asset base and the advisory fee is a percentage of the assets, so the more assets, the more the investment adviser makes. But it won't help the shareholders of the fund. As a shareholder, you don't care how big the asset base is. You only care about the investment performance.

And that's true, as far as it goes. But the problem is that, unless a fund sells shares, it won't exist. You have a redeemable security, and you need an ongoing distribution system in order to allow that fund to exist. Otherwise, it will be redeemed out of existence. That, to me, is the real argument for allowing funds to pay for distribution.

During all these debates and hearings leading up to 12b-1, the industry, I think, made the wrong argument. They often argued that sales of shares would help shareholders, because by growing the asset base it will reduce expense ratios. You're spreading the fund's fixed expenses over a larger asset base, so it really does benefit shareholders. That argument was just demonstrably wrong, because any reduction in the expense ratio was dwarfed by the amount of the 12b-1 plan. You never could reduce expenses enough to get back the 12b-1 expense, so the industry really shouldn't have made that argument.

The better argument was if you don't have distribution, you won't have a fund, so the only question is how you pay for it. If you think it's good for all funds to have sales loads, okay, but some people don't want sales loads. Most people don't. You could say, it's up to the adviser to pay for distribution. But then you come back to the conundrum that I was talking about earlier: where does the adviser get the money? The adviser gets the money from the fund, so why pretend that the fund is not paying for it?

The opponents of 12b-1, who as I say, I think were primarily at the SEC, just felt, well, at least if we insist that the adviser has to pay for it, there will be kind of an implicit cap on it. If the advisory fee gets too high, we have 36(b). They can get sued, and it will be less than if they're allowed to tap into the fund directly. That was the argument.

WT: In terms of going away from principle and into practice, was the effect in the industry immediate and noticeable, or did it kind of evolve more slowly than that?

JG: At first there was very little effect at all. I remember I had a friend who came up with a little riff on that. For the first couple years, very few funds had 12b-1 plans, even after it was allowed. And then, a few funds adopted them, and then more and more funds adopted them, and they invented—this was 1982 or '83—they invented contingent deferred sales loads, which depend upon 12b-1 plans. You can't have a contingent deferred sales load without a 12b-1 plan, because the idea is if the investor stays in for a prescribed time, he won't ever have to pay the sales load. But you've already paid out the money to the broker, so you have to get that back somehow.

Once they invented contingent deferred sales loads, which was probably around 1982, then they became very popular and all those funds had 12b-1 plans, and even funds without contingent deferred sales loads adopted 12b-1 plans. But for the first year or so, maybe two years that 12b-1 was in effect, it was almost like a meteor had hit the earth, and everyone was standing around staring at it, saying what is that, and are there any precious minerals in it? They were afraid to touch it. (Laughter)

WT: Reminds me of *2001: A Space Odyssey,* a monolith and all the apes gathered around it (laughter). So the contingent deferred sales load?

JG: Load, or charge.

WT: I was reading the transcript of a roundtable from the museum collection, I guess it was in 2002 or so, and this was viewed, at least by some people, as a kind of unintended negative consequence of the rule. Is that correct?

JG: I will say yes. I will say that those of us who worked on 12b-1 did not foresee that. I don't think anyone foresaw it. When we were thinking about what became Rule 12b-1, we envisioned a pretty small asset-based charge, mainly to pay for advertising, maybe to train salesmen. We had in mind twenty-five points. Once contingent deferred loads came into being, they had 12b-1 plans of eighty points, or even a hundred points, and that was justified by saying, well look, if we didn't have this, we would have a front end load and that would be 8 percent. But yeah, we did not foresee, I didn't foresee, and I don't know anyone who did, that 12b-1 could be used to allow contingent deferred sales loads.

We probably should have foreseen it, because the insurance industry had had that type of arrangement for years, where you buy a variable life insurance policy, the insurance company pays a sizeable commission to the agent, and then the insurance company recoups that over time by having—they don't have 12b-1 charges, they have what's called a mortality and expense charge, but it's a charge against the insurance fund, like a

12b-1 plan. And if you surrender your policy too early, there's a surrender charge. So it's like a contingent deferred sales load. I don't think anyone put that together.

WT: Would you say, based on your experience, that, as much as lifting some of the restrictions on advertising, that that was responsible for an expansion of marketing among mutual funds?

JG: I don't think it was a significant—I know a lot of people won't agree with me on this, but I think what really led to the explosion of the mutual fund industry, I think advertising helped. I think that 401(k) plans and the expanded IRAs helped. And the third thing was money market funds, because when money funds were in their heyday in the 1970s, they were paying double-digit yields, and the banks were still restricted from paying competitive interest rates. They could only pay 5 percent, so people who wouldn't have ever heard of a mutual fund heard about money market funds, possibly through advertising. And there'd be advertisements you'd get 16 percent, and it's almost as safe as a bank. It's not insured, but you know, they were very, very safe investments.

So a lot of people bought money funds, and then once they were introduced to the money funds, then the mutual fund companies would say how about an equity fund. And the stock market started to improve at the end of the 1970s, and the money fund sponsors had the names of the customers and they would sell them other funds. So I think it was those three things, really, that contributed to the explosion, the money funds, the advent of advertising, and the advent of self-directed retirement plans. 12b-1 was a sideshow. There would have been distribution in any case. It's only how you structure it.

WT: You've alluded, I think both in e-mails and in that roundtable I was just talking about, that you have kind of a personal association with 12b-1. I'm just curious what your experience is with that, particularly given the controversies surrounding the rule.

JG: Yeah, well, you know, until I fled to the Labor Department, I was the one who had issued the no-action letters permitting, in a limited way, funds to pay for distribution, which the Commission withdrew. I helped conduct the hearings. And even though I was not there when they actually wrote 12b-1, I guess I'm the one who sort of came up with the idea that here's how we can regulate distribution. Section 12b says that a fund can't act as the underwriter of its own shares in contravention of Commission rules, and I said why don't we define a fund that pays for distribution, let's define that as asking as its own underwriter and then say you can't, and then say but you can if you meet our conditions. So I'm blamed, pretty much, for 12b-1.

A lot of the conditions don't make a lot of sense, but if you look at it in the context of the times, that it was so controversial within the SEC, these conditions were designed to make it possible to get the rule through. Like for example, one of the conditions is the board of the fund has to have the right to terminate the plan at any time. Well, they don't terminate them. That's just silly. If you have a distribution system that turns upon a 12b-1 plan, you're not going to terminate it. The plan has to be renewed each year. We kind of borrowed these conditions from the requirements relating to the advisory contracts, annual approval, terminable any time, but they're really anachronistic.

WT: What were your experiences working with the chairman and other commissioners, just in general, I suppose? Were they supportive of things like 12b-1? Obviously, it got through the Commission.

JG: It was very controversial at the Commission. As I say, I was not there when it was actually adopted. I'm sorry: I was there, but I wasn't involved personally in that final stage. But yeah, there were a couple of commissioners, especially, who really objected to it, just on the grounds that it's not right to charge shareholders to pay to bring more shareholders into the fund, and that's one reason that we had to keep putting in all these conditions.

WT: So from your time as division director, are there any other major policy concerns that we haven't touched on that spring to mind?

JG: No, not during my time as division director. The one thing we did talk about—and it never went anywhere and I still think it would have been a very interesting thing to pursue—there was a proposal at the time. We had put out a concept release asking for comment on a proposal for a unitary investment fund. I believe the author of the proposal was a person named Steve West, who was at that time head of the investment company practice at Sullivan and Cromwell. And his idea, which we actually put out for comment, was that you eliminate 12b-1, advisory fees, forget all of that. You have one fee that covers everything, and you don't have to characterize what it's for. You don't have to debate is this for investment advice, is this for distribution, it's for everything, and that fee would not be subject to challenge under 36(b). It would be whatever it is. It would be disclosed, and people would understand. It's like any other product that you buy. Well, they didn't really have much cable TV then, but when you sign up for your cable they say this is how much it is per month, and you can either pay it or not.

I think that that is still an interesting idea. We put it out for comment. It was roundly criticized. I think there were two criticisms of it, one was fair, the other wasn't fair. The one that was fair was when we put it out for comment we said we would not eliminate 36(b). There could still be suits for an excessive fee, and everyone said, well, thanks a lot, we don't want to get sued. And that was probably fair. We probably should have included repealing 36(b) as part of that proposal. The other criticism, which wasn't on point, was that you can have a single fee now. The prospectus lists all the fees, and all you have to do is add them up, and that tells you what the total charge is. And that's true, but what is problematic about it is that you have to characterize it.

For example, let's say you have a fund that says we have an advisory fee, and we have a shareholders' servicing fee, and we have a transfer agent fee. You can get in trouble if somebody says, you know, that shareholder servicing fee is really not for shareholder servicing. That's really for distribution, and we're going to sue you because you're not complying with 12b-1. You're claiming this is a shareholder servicing fee or a transfer agent fee, and it's really a distribution fee. A lot of energy goes into deciding how to characterize a particular charge, for legal reasons, and just adding them all together won't solve that. The only way to solve it is to say it's irrelevant. It's just one charge, and we don't care what it's for. I still think that would be a very helpful thing to do.

WT: Shifting gears a little bit, in terms of inspection and enforcement, was there much activity back then, in the early 1980s or in the 1970s that you can recall?

JG: Much less than there is now. There would be an enforcement action against a fund once in a blue moon, and it was only for the most egregious types of thing. More minor violations were handled through the inspection process. There was no Office of Compliance and Inspections in those days. The inspections were handled by the Division of Investment Management, which was another thing I was in charge of as associate director. I had forgotten that.

If we went on an inspection and found that something was out of compliance, unless it was really a fraud—and you didn't have many frauds in the mutual fund industry, it's a very clean industry. Usually it was because the Investment Company Act is so technical it's easy to have inadvertent compliance issues. And we would find them, and we would tell the company you've got to fix this and change that, and they would, and there was no need for enforcement.

Now, you see enforcement cases for things that, back in that day, would have been handled informally through the inspection process, and I think there are a few reasons for that. I think now that there's a separate office that handles compliance and inspections, and that office, I think, feels under pressure to make referrals to Enforcement. When the inspections were part of the division, the division wasn't particularly interested in enforcement. But I think having a separate office, to some degree, that's how their effectiveness is measured: how many problems have you found?

Another thing is just a change in sort of the political oversight of the SEC, especially in the wake of the Madoff scandal where the SEC took enormous criticism for not having discovered that. I think that they're now much more prone to bring enforcement cases, and you have an issue of institutional memory. There are probably very few people still at the SEC who know that enforcement cases in the case of mutual funds used to be practically nonexistent. They think that suing mutual funds is part of their job.

WT: As far as resources are concerned, as I mentioned, I was talking to Barry Barbash, and in the 1990s they had issues with the size of the mutual fund industry, but also the sheer number of investment advisers that were out there and their ability to have inspectors inspect all of these entities. Was that an issue for you at the time?

JG: Yes. The inspection cycle, as we called it, was years. I mean, we averaged, I think each adviser or each investment company got inspected maybe once every seven or eight years. I might be off on that, but something like that. Part of it is just the government hasn't ever got enough resources, but another part of it is you really do have to rely upon the industry to police itself. It's like auditing taxes. You can't audit everybody.

WT: There are a couple issues that of course come up much later on in the history, and I'm wondering if there was any sign of them during your time at the SEC, and one is the sheer clout of the mutual fund industry and their proxy activities in the financial world in general. And then the other is the question of the governance of mutual funds, and particularly the proportion of independent directors that were on the board. Was that ever anything that you thought about back in the '70s and '80s?

JG: Yeah, taking the second one first, the Investment Company Act, as you know, requires that only 40 percent of the board has to be independent. But over the years, through this rule making and exemptive process I described, it's essentially that they require now a majority to be independent. That began with Rule 12b-1. One of the conditions of Rule 12b-1 is that the board has to be a majority independent, and now there are a lot of other exemptive rules that require that. So yes, the emphasis on independent directors really began during my time, and preceded my time, when we adopted these deregulatory rules. I mentioned foreign custodianship, and there were many others. And almost routinely, we would put in as a condition of the exemption the independent directors have to approve this, or they have to oversee it. Maybe we went too far. Maybe now, independent directors do more than they're really equipped to do. But yeah, that started with us.

You mentioned clout in proxies. It was at that time, and I think it's still true to a considerable extent, mutual funds did not view themselves as activist investors, they tended to follow the Wall Street rule. If you don't like what the company's doing, you sell the stock. And I think that's still true to a considerable extent. I know every once in a while you read about a mutual fund becoming involved in a proxy fight, but I think it's still pretty rare.

WT: I'd like to ask you about some of the people who you worked with. First of all, before you yourself became division director, I think there were three division directors who you would have worked under, so maybe you could give me some recollections of them, their personal style, personalities, and that sort of thing.

JG: Well, when I first came to the Commission the director was Allan Mostoff, and he was very supportive. I didn't directly report to Allan, but I was working on this big project involving distribution, and especially sales loads, and he gave us an enormous amount of time on that, sometimes more time than I wanted. I remember there was a period of a couple of months, where we were going through repeated drafts of our report, and he had obviously other things to do besides go over my draft, so he scheduled a regular Sunday morning meeting. (Laughter) Every Sunday morning, we'd gather in Allan's office. So he gave us plenty of attention. I could have used a little less attention. (Laughter)

And then after Allan left, Anne Jones became director. My title then was special counsel to the director. I worked directly with Anne. Anne took a lot of the heat that we generated in terms of trying to deregulate, which we really were trying to do. I think some of the younger people at the Commission then, and I was among them, felt that the regulation had become too stultified and we had to ease up on it.

WT: If I can break in there a little bit, of course nowadays we tend to think of questions of are things over regulated, deregulation, and so forth in terms of partisan politics, and that sort of thing. Was that the case so much at the time? You mentioned when Shad came in that he was very ideological about it, but before that, would it have had those resonances?

JG: Even when Shad was there, and even during the Reagan administration, one thing we did not have then, which we do have now, is you actually have Congress telling the SEC do this or don't do that. That really didn't happen with us. We were aware of the political situation in terms of we knew there was a general feeling in the White House and in Congress that too much government regulation was hurting the country and it should be rethought, but we never had anyone tell us you should do this or you shouldn't do that. I was just reading today, I think, in the *Times*, that Senator Schumer has said he won't permit either of the two nominees to the SEC to be confirmed unless the SEC adopts a rule requiring disclosure of campaign contributions by corporations. That kind of thing did not happen in our day.

WT: So I interrupted you. You were talking about Anne Jones taking the heat.

JG: Again, some of the old guard, both among the commissioners and the senior staff, objected to some of the things we were doing, and Anne was very good about don't worry about it, I'll take care of that. Just get it done. And she was very skillful.

And then Syd Mendelson succeeded Anne Jones, and as I say, he was a giant. He knew everything about the Investment Company Act and the industry. There was a little bit of a sort of Nixon-in-China thing with Syd. Syd was a very crusty guy, and I think a lot of people in the industry over the years had wrongly come to think he was anti-industry. He wasn't, but his persona, he was very gruff, and when he put forward a proposal, which, well, 12b-1 being an excellent example, he was director of the division when they adopted Rule 12b-1, how could anyone criticize Syd as being soft on the industry? He had been there for decades, and he was perceived as being really tough on the industry. So if he says we're going to allow funds to pay for distribution, it must be all right. But he was just an enormously effective director. He used to spend a lot of time teaching the young staff. He was very good.

WT: And so, maybe you could talk about some of the division staff, as well, who we might not have mentioned.

JG: Well, I mentioned Stan Judd. He really was the godfather of the advertising rule. He thought it up. There was another person named Tony Vertuno, who was the lawyer for the disclosure branches. He really was very effective in helping to develop the two-part prospectus. And again, both Tony and Stan were career employees, they had been there forever and they knew far more than I knew. The chief counsel of the division at the time I was director was Sid Cimmet. He's now passed on, but he was very effective.

There were two associate directors when I was director. One was Dick Grant. He had my old job overseeing disclosure and inspections and investment advisors, and the other one was Jerry Osheroff, who has also passed on, and he oversaw the investment company regulation side. He had a little of the same element that Syd had. He didn't have the same persona as Syd, but he had been a career staff person, so when he started giving exemptions out he was sort of immune to being criticized for being soft on the industry.

WT: Speaking of the industry, in your own personal interactions with them, if it's possible to speak in generalities, how were relations with the companies and with organizations like ICI?

JG: You mean then, or now?

WT: Oh, then, in your experience.

JG: Actually, very good. You always had to remember the ICI had its own agenda, and that was not necessarily the same as the SEC's agenda. But the ICI really recognized that the credibility of the industry depended upon effective oversight by the SEC. I know when I used to have one of my periodic arguments with Chairman Shad about repealing the Investment Company Act, I used to tell him if you actually send up a proposal like that, the first people lobbying against it would be the ICI, and I believe that was true. They obviously would push the envelope in ways that I didn't necessarily want to accede to, but they were always very responsible. The head of the ICI at the time was a guy named David Silver, and Matt Fink, who became head of the ICI later, was the general counsel, and I always had a sense that a big part of what they did was keep their members in line.

WT: Was there ever any notion that there might be, or should be, an investment company self-regulatory organization?

JG: Oh, yes, there was talk about it. I think a lot of it had to do with—the talk really came after Chairman Shad came in, and he really believed in self-regulation as a substitute for government regulation. We used to put out releases and stuff asking for comment on it, but I think the real problem with it was it's expensive. Why would the industry want to pay for a whole bureaucracy when they can get it free from the government? I think also, it tied into the industry, including the ICI, but pretty much all the major players in the industry really recognize that they gain from strong SEC oversight. So people used to talk about self-regulation, because you don't want to tell the chairman it's a stupid idea, but I don't think anyone took it very seriously.

WT: So then the other question of working relations that I have is with other regulators. I'm thinking in particular of bank regulators. I know by the time you get Gramm-Leach-Bliley in '99, that the divisions, particularly as far as mutual funds were concerned, had pretty much already disappeared, but I know that had begun much before that, so was that something that you were dealing with?

JG: Yes. When the money funds were in their glory days, the bank regulators hated them, because, besides not being under their jurisdiction, it put the banks under tremendous pressure because the banks weren't allowed to pay competitive interest rates, and they were being disintermediated by the money funds. And I used to have conversations with people at the Fed and the Comptroller's office, and I'd say yeah, I see the problem, but is the answer to the problem to kill the money funds, or to get rid of your stupid Regulation Q, it was called, which restricted what the banks could pay. Isn't that the way to eliminate this unfair competition?

We had issues with the states, too. Several states tried to kill the money funds, because the banks, especially in those days, were very powerful in individual states. Now you have nationwide banking, and you have many fewer banks.

WT: Consolidation.

JG: Yeah. But in those days, every state, and oftentimes every county had its own bank, and the local banker was a very prominent citizen and he knew his legislator. There were attempts to essentially legislate the money funds out of existence in a particular state. I remember Utah came closer than anybody. They almost passed something. You might say well, so what, it's just one state, but it's really impossible to sell a mutual fund, especially a money market fund, and say we're not going to make any sales in that state. It's just too hard to keep track of where the investors are, so if you can't sell in every state it's a huge problem. I remember Utah especially, but there were other states that, under pressure from the banks, would try to restrict the money funds. And actually, for a brief period, the Federal Reserve imposed reserve requirements on the money funds. That didn't last long.

WT: No, it's not quite the same instrument as a deposit.

JG: Yeah.

WT: That's about all of the questions I have, I guess, from your time at the SEC. If you want to add anything else, go ahead. Otherwise, we'll just go to your transition to private practice.

JG: Yeah, sure.

WT: Okay, so what brought that about? Why did you decide to leave government service, having spent your career there to that point?

JG: You really can't stay indefinitely in the position of division director. It's not a political appointment in the technical sense, but it is political in every other sense. When I left the SEC, I think I was about thirty-eight, and there wasn't any way I was going to spend another thirty years there. Even if I had wanted to, it wouldn't have been possible. Chairman Shad liked me, despite my obstreperousness, and he would have been happy to have me stay. But eventually, everyone has to go.

I found I was out of ideas. I had these ideas when I started about implementing 12b-1, two-part prospectus, advertising, reforming the inspection program, and a few other things. We got all those done, and I found that I was just sort of driving the bus at that point. I really didn't have a lot of new ideas. I was just trying to make the trains run on time, to mix the metaphors a little, and I figured I needed to go sometime, and this was it.

WT: So what was your experience like, then, in private practice versus in regulation?

JG: I've had people ask me, how did it feel to change sides? After all those years regulating the industry, now you're on the other side, how does that feel? I didn't ever feel I had changed sides. I can understand, let's say, a criminal defense attorney who worked in the District Attorney's office and he was prosecuting people, putting them in prison, and now he's a defense attorney, he tries to keep them out of prison. That's changing sides. But being in private practice, advising mutual fund clients, a large part of the practice consists of helping them comply with the Investment Company Act, making sure they stay out of trouble. This is an industry that does not want trouble. No mutual fund wants to be the subject of an SEC enforcement action. That's why, in those years, there were so few of them. It's a very technical area of law, and a lot of what I did in private practice was to just tell people how to stay out of trouble, which was what I used to do at the SEC.

Now, there was a change of emphasis. A lot of what came up, both at the SEC and in private practice was in a grey area. Maybe when I was at the SEC, I'd be a little quicker not to give them the grey area, or I would be more critical of an argument for an exemption than I was when I was making the argument. But it was really two sides of the same coin. Besides helping people comply with the Act, another thing I think I brought to the table for my clients, if they wanted to do something that, let's say, required an exemption, I would be able to try to understand what will trouble the SEC. What will be their concerns if we ask for this exemption, and how do we address those concerns?

WT: Well, rather than go into all the many changes in both the industry and in its regulation over the past thirty-plus years, I thought I might just ask you for some of your impressions of some of the key things that have impressed themselves upon you. What changes do you think have been the most significant since you've left the SEC?

JG: The changes in how the SEC operates, you mean?

WT: Well, it's an open-ended question. If you want to talk about that, that's all right.

JG: Well, taking the SEC first, a much larger emphasis on enforcement. We talked about that. I think that when Chairman Levitt established the Office of Compliance and Inspections, that was a huge step, and that laid the groundwork for a much greater emphasis on enforcement. And as I say, the Madoff situation increased that, so I think that's one big change.

In terms of the changes in the industry, I think that the growth of international funds, global investing, and that raises all kinds of issues other than custodianship. We dealt with custodianship, but now that you have all this international investing, you have timing issues. The mutual funds price their shares at 4:00 New York time, but the markets they're investing in are still open, and there's all kinds of issues about people being able to trade, knowing what the price of the fund just closed at but the market's open. So I think that internationalization and globalization have been a big change, made possible by foreign custodianship.

The ETFs, I think, are an enormous development in the industry. Some people would tell you they might ultimately supplant conventional mutual funds. I don't know whether that's true, but I think they are certainly taking a very big share of the industry.

WT: I did want to ask specifically about the scandals in the early 2000s and how widespread they seemed to be at the time, and I wanted to ask about your impressions of compliance within the industry and the ability to ensure good practices within it, particularly as it's grown and has become so much more complex.

JG: I was shocked by what they called the market timing or late trading scandals in the early part of the century. When I first heard about it I couldn't believe it, because this had always been such a careful industry, and that was so crude. I think that's another thing, obviously, that preceded Madoff by a number of years, but that's another example where the SEC was kind of asleep at the switch. The scandal was uncovered by Eliot Spitzer, and he made the most of it. The SEC had opportunities to learn about this and they missed it, and I think that's one of the things that has led to the increased emphasis on enforcement. And that embarrassed the SEC greatly, and of course the Madoff thing embarrassed the SEC. Except for the market timing scandal, I'm not sure there have been other big scandals. That's really it.

WT: Finally, I wanted to ask about the increasing importance of hedge funds as something that's like the mutual fund industry, but of course has its own peculiarities with the smaller number of investors within them, and they've not traditionally been regulated in certainly the same way. What are your impressions of that and the growing importance there?

JG: Well, I think that hedge funds, in my time, were sold only to very wealthy investors. They really weren't an issue for the average person. Now they are, people who you wouldn't consider very wealthy can buy hedge funds through fund of funds arrangements and otherwise, and I think they need to be regulated more. I think that the original idea of a hedge fund, the reason they're called hedge funds is they would hedge against losses. They would go long something, but then they'd go short something, to try to minimize the risk. A lot of them I don't think hedge much at all. They're just very aggressive leveraged funds, and they can lose a lot of money, as we've learned recently. I don't have any specific proposals, but I think the SEC is right to look at those.

WT: All right, well, that's pretty much the end of all the things that I wanted to talk about. If there's anything else you'd like to say?

JG: I appreciate this.

WT: Well I very much appreciate your participation. We've gone on for two-and-a-half hours, actually, so that's a tremendous amount of information that you've given us today. Thanks very much.

JG: Thank you.

[End of interview]