SOME THOUGHTS ON THE DUTIES AND RESPONSIBILITIES OF UNAFFILIATED DIRECTORS OF MUTUAL FUNDS *

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Recent discussions of problems in the mutual fund industry—notably in the Securities and Exchange Commission's Report of the *Public Policy Implications of Investment Company Growth* [1] and at a Conference held at the University of Pennsylvania Law School in early February [2]—contain numerous statements of opinion that, in many cases, unaffiliated directors of mutual funds have not performed an effective role in safeguarding the interests of mutual fund shareholders. The Commission report concluded that unaffiliated directors normally lack the power to exercise meaningful restraints on the investment adviser or principal underwriter of the fund with respect to management fees, sales loads or brokerage transactions.[3] In his typically vivid way, a leading critic of the mutual fund industry has argued that since "the men who need to be watched pick the watchdogs," no one can expect the unaffiliated directors to oppose the adviser or the underwriter in areas in which the adviser's or underwriter's economic interests are heavily at stake.[4] These conclusions have not gone unchallenged.[5]

Despite its conclusions about the ultimate effectiveness of unaffiliated directors, the Commission report stated that they "can and should play an active role in representing the interests of shareholders . . . [in] areas where the interests of the professional managers may not coincide with those of the company and its public investors." [6] Indeed, the report made a number of recommendations

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1 H.R. REP. No. 2337, 89th Cong., 2d Sess. (1966) [hereinafter cited as *SEC Mutual Fund Report*].

2 *University of Pennsylvania Law School Conference on Mutual Funds*, 115 U. PA. L. REV. 659 (1967) [hereinafter cited as *Conference*].

3 *SEC Mutual Fund Report* 130-31, 148.

4 *Conference* 739 (comments of Abraham L. Pomerantz). To put it another way, no one will be nominated as an unaffiliated director (nor will anyone accept the position) unless he is satisfied that the existing situation is one which he can support. Men do not normally become unaffiliated directors because they wish to change the existing structure.

5 *Conference* 741, 755 (comments of Joseph E. Welch), 745-46, 759 (comments of Allan F. Conwill).

6 *SEC Mutual Fund Report* 148.

designed to strengthen the position of the unaffiliated directors.[7] Thus, whether or not the Investment Company Act of 1940[8] is eventually amended to reflect some or all of the Commission's recommendations, it appears that the unaffiliated directors will continue to have an important role in representing the interests of mutual fund shareholders.

Whatever the validity of the view that unaffiliated directors realistically do not have the power to provide effective representation for mutual fund shareholders, inadequacies which exist probably are heightened by the frequently vague and incorrect views which unaffiliated directors (and others) have of the scope of their duties and responsibilities. Some writing has explored the duties and responsibilities of mutual fund directors—particularly Alfred Jaretzki, Jr.'s helpful article in the Summer 1964 issue of *Law and Contemporary Problems*.[9] However, there is room for further exploration of this subject and a need for the Securities and Exchange Commission and the mutual fund industry to develop some guidelines for the unaffiliated directors. These comments are designed to further the dialogue which I hope will result in the formulation of such guidelines.

Men who accept positions as unaffiliated directors often picture their role as identical to that which they (or their friends) play as directors of industrial or other corporations. This picture inadequately reflects the special nature of mutual funds, and does not highlight certain distinctions between mutual funds and other corporations which make the role of unaffiliated directors of mutual funds particularly important.

In the usual corporate situation, the interests of management and shareholders are identical on most matters. Management and shareholders alike are interested in having the products or services sold by the corporation produced at the lowest possible cost; they both hope that the price received for these products will, in the long run, be as high as possible, thereby maximizing profits. The shareholders' interest in receiving as high a price as possible for the corporate product runs counter to the interest of the consumers of the product.

A mutual fund primarily sells professional management of a diversified investment portfolio. The consumer of this product is the shareholder. The producer of the investment management is typically an investment adviser, organized as a separate business entity, some

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7 *Id.* 332-34.

8 54 Stat. 789 (1940), as amended, 15 U.S.C. § 80a (1964).

9 Jaretzki, *Duties & Responsibilities of Directors of Mutual Funds*, 29 LAW & CONTEMP. PROB. 777 (1964). Other helpful discussions appear in Eisenberg & Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940*, 20 RUTGERS L. REV. 181 (1966); Conwill, *The Minority Menace to Mutual Fund Selling*, 18 BUS. LAW. 1055, 1060-61 (1963).

of whose chief executives or employees serve on the board of directors or as officers of the mutual fund which is being advised. In addition, the persons who control the investment adviser normally control or have a substantial interest in the principal underwriter of the fund's shares. Although the managers of the mutual fund and its consumer-shareholders have parallel interests (for example, with respect to the quality of investment performance), there are important areas in which their interests may conflict—particularly in the setting of management fees and sales charges, and in certain decisions relating to portfolio transactions. In these areas the consumers' interest in low cost conflicts with management's interest in maximization of its profits. These important conflict of interest areas (which grow out of the special structure of the mutual fund business) define the special problems and responsibilities of the unaffiliated directors.

Conflicts of interest also exist in the usual corporate situation, albeit normally to a much more limited extent. For example, when the compensation of the officers of a corporation is determined, and some of the officers sit on the board of directors, the interests of the officer-directors conflict with the interests of the shareholders of the corporation. But in this situation the compensation paid for the personal services rendered by such officer-directors is relatively easy to identify, since the salaries and other compensation are paid or credited directly to the individual executives. The ease of identifying the amount paid permits both the directors and the shareholders of the corporation to determine the reasonableness of such compensation.[10]

However, in the mutual fund industry, fund directors and officers are often paid no salary or only nominal salaries by the fund itself. The more meaningful compensation of the affiliated officers and directors is derived from the investment adviser, sometimes from an affiliated broker or underwriter serving the fund, and, at times, from a combination of these. The complex corporate relationships which have developed in the mutual fund industry have made it difficult to deal with this aspect of conflict of interest. Form N-1R, the report which each fund must file annually with the SEC, tries to provide a picture of all the compensation received by certain officers and directors from various aspects of the mutual fund's business.[11] Even this picture is not complete. For example, it does not reflect compensation in the form of the increased value of an affiliated director's or officer's shares in the fund's investment adviser, or compensation

[10] In addition, managerial compensation usually constitutes only a relatively small part of the total operating budget of the corporation.

[11] Form N-1R, item 1.12, 17 C.F.R. § 274.101, at 198 (Supp. 1966).

from the fund's investment adviser or broker whose income from non-fund sources exceeds fifty per cent of its gross income.

Further, and again because of the special characteristics of the mutual fund and the complex corporate interrelationships which have developed around it, the unaffiliated directors will find that the full-time directors and officers—those people who know most about the operations of the fund and to whom they would naturally look for information and advice—often have interests in a number of areas which are different from those of the shareholders of the mutual fund. The interest of some of the affiliated persons in management or underwriting fees has already been pointed out. Another area in which the interests of these full-time directors and officers may conflict with the interests of shareholders involves fund portfolio transactions. The brokerage generated by such transactions can buy various services and also can be used to reward the sale of fund shares.[12] The primary beneficiary of these uses of the brokerage may not be the fund itself.[13] Moreover, in some instances directors and officers of the fund may be affiliated with a brokerage firm which does portfolio business for the fund, and thus may share directly in the brokerage profits from the fund's portfolio business. One danger presented by these conflicts is that certain members of the management of the fund may have an incentive to encourage a rate of portfolio turnover greater than that which would be dictated solely by considerations of investment management. Another danger is that efforts by such persons to reward particular brokers can create temptations to execute transactions in markets which may not be the best, or at costs which may not be the lowest, for such transactions.

These examples suggest only some of the major areas of conflict of interest which can exist. The framers of the Investment Company Act of 1940 realized that unless mutual fund managers were to be precluded from serving anyone but the fund, substantial conflicts would exist between the interests of the management group and the interests of the mutual fund shareholders. To insure that these conflicts of interest would be properly resolved, *i.e.*, with sufficient attention to the interests of the fund's shareholders, the Investment Company Act

[12] The kinds of services which may be purchased with brokerage commissions are described in the *SEC Mutual Fund Report* at 162-67. The techniques by which such services are purchased with brokerage commissions are described in the *SEC Mutual Fund Report* at 167-72.

[13] Since management fees are normally calculated as a percentage of net assets managed, growth in the size of the fund will normally increase the amount of the management fee paid to the adviser and also the profit of the adviser. See text accompanying note 19 *infra*. There does not seem to be any clear evidence that growth in the size of a fund confers equally substantial benefits on the fund shareholder. See Wharton School of Finance and Commerce, *A Study of Mutual Funds*, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 31-32 (1962).

of 1940 provided, *inter alia,* that every mutual fund would have one or more unaffiliated directors who would serve as watchdogs over the shareholders' interests.[14] The responsibility of such unaffiliated directors to serve as critical overseers of the activities of the mutual fund is, therefore, both heavy and broad. This responsibility is not made lighter by the fact that the Investment Company Act of 1940 does not prescribe specific solutions for the resolution of each of these conflicts. Their resolution is normally left to the imagination and responsible judgment of the directors, and particularly the unaffiliated directors, in the realization that the varying circumstances under which these conflicts of interest situations arise may call for a variety of solutions.

I now want to turn to the unaffiliated director's responsibility in arranging for the investment advice to be provided to the fund and in arranging for the distribution of the fund's shares.[15] The discussion of these specific problems will not produce formulas which can be mechanically followed. At best it will suggest problems which unaffiliated directors must recognize and questions which they should ask.

Arrangements for Providing Investment Advice

A mutual fund can secure investment advice in a variety of ways, ranging from the generation of advice from within the fund itself by its own employees, to an arrangement with a separate entity (the investment adviser) which agrees to provide such advice. In addition to advisory services, the investment adviser may provide a wide range of managerial services.

Whenever an arrangement is made by which an outside person or separate entity undertakes regularly to serve or act as investment adviser for a mutual fund, the Investment Company Act of 1940 requires that the arrangement be embodied in a written agreement. This agreement must, in the first instance, be approved by the vote of a majority of the outstanding voting securities of the fund. It must contain a provision allowing it to be terminated, without penalty, by the board of directors of the fund, or by a vote of a majority of its outstanding voting securities, on 60 days' written notice to the invest-

[14] Section 10 of the Investment Company Act requires that, except for certain no load funds, at least 40% of the directors of a mutual fund must be persons who are neither officers or employees of the fund nor affiliated with the fund's investment adviser or its affiliates. In addition, section 10 requires that a majority of the directors must be persons who are not investment bankers or principal underwriters or regular brokers of the fund or affiliated persons of such investment banker, underwriter or broker. 54 Stat. 806 (1940), 15 U.S.C. § 80a-10 (1964).

[15] The unaffiliated directors' tasks in these areas—heavy as they are—do not exhaust their responsibilities under the Investment Company Act or under state law. The best discussion of the full range of their duties appears in Jaretzki, *supra* note 9.

ment adviser. The agreement may not continue in effect for a period of more than two years from the date of its original execution, unless such continuance is specifically approved at least annually by the board of directors—including approval by a majority of the directors who are unaffiliated with the investment adviser—or by vote of a majority of the outstanding voting securities of the fund.[16] Whenever the agreement is submitted to the shareholders of the fund, whether for initial or subsequent approval, the directors have a responsibility to evaluate the arrangement and make a recommendation to the shareholders.

The Investment Company Act of 1940, therefore, contemplates that the directors of the fund will play an important role in determining the arrangements which will be made to provide for the investment advice. Further, the act contemplates that a crucial role will be played by those directors who are unaffiliated with the investment adviser. The act does not, however, require that the unaffiliated directors take an active role in managing the investments of the fund. They need not be experts in investments and are not expected to review the advisability of each individual investment decision. Their responsibility on these matters may properly be limited to insuring that investment action furthers the investment policies of and is within the restrictions applicable to the fund.

The unaffiliated directors' major task in this area consists of evaluating the quality of the investment advice received by the fund. This review often seems to be made on the assumption that the existing investment adviser (particularly when the investment adviser is the sponsor of the fund) has a vested right to remain the investment adviser of the fund—that the investment adviser has a property right in having the investment advisory agreement renewed. Such an assumption runs counter to the provisions of the Investment Company Act. On the other hand, as the Commission report points out, it is probably a practical impossibility, in most cases, for a fund to change advisers without the acquiescence of the existing adviser.[17]

A mutual fund is basically a vehicle through which numerous individuals can purchase diversification and investment advice. The investment advice is not custom tailored to all the investment goals and needs of each individual participant, but is intended to serve those investment goals and needs (expressed by the fund's stated investment policy) which are shared by the participating investors. The collective will of these investors is represented by the directors, and particularly

[16] Investment Company Act §§ 15(a), (c), 54 Stat. 812, 813 (1940), 15 U.S.C. §§ 80a-15(a), (c).

[17] *SEC Mutual Fund Report* 131.

by the unaffiliated directors. When the unaffiliated directors consider a specific arrangement with an investment adviser, they should apply standards which are the same as those applied by a prudent individual investor in considering an arrangement for securing advice for his personal fortune.

When the unaffiliated directors consider the arrangements made for providing investment advice, logically, the first question they must ask relates to whether or not the present arrangements should be continued. Although the answer to that question will normally be "yes," the unaffiliated directors should inform themselves about available alternatives. In this connection the unaffiliated directors must determine whether or not the fund can retain, without undue cost or risk, sufficient flexibility to change its arrangements for securing investment advice if for any reason such a change is thought desirable. For example, does the fund have a right (or is it important that it should have a right) to keep copies of the reports and analyses which support the investment decisions made with respect to its portfolio. The size of a fund (or the size of the complex of funds of which it is a part) may dictate different answers to the degree of flexibility which it is possible or desirable to maintain. When a fund or a complex of funds reaches a certain size, the unaffiliated directors may decide that the most satisfactory arrangement involves internalizing the system for providing investment advice. At other stages of a fund's existence, the unaffiliated directors—from the point of view of both increased efficiency and increased flexibility—may feel that it is desirable to have the fund perform certain of the managerial functions for itself (or in cooperation with other funds in the complex).

The unaffiliated directors' attitude toward existing arrangements will depend upon their evaluation of the quality of the services rendered. One aspect of this evaluation involves a study of the performance of the mutual fund in relation to its stated objectives. In looking at performance, the unaffiliated directors should evaluate both the long-term performance record and the short-term performance record: the former to give the adviser a fair chance to prove itself and the latter to spot trends as they occur. Conclusions about performance should also take into account the degree of risk to which the fund was exposed in achieving its performance.[18]

The unaffiliated directors should also inform themselves about the investment adviser—how it operates and how it is staffed. Such

[18] There are problems in devising satisfactory standards for measuring performance. For discussion of a recent effort conducted under the general supervision of Professor James H. Lorie, Director of the Center for Research in Security Prices at the University of Chicago, see Robinson, *Measuring Pension Fund Performance*, 106 TRUSTS & ESTATES 251 (1967).

information is important in evaluating the ability of the investment adviser to perform, on a sustained basis, the kind of work that the fund requires. For example, is the adviser's success based on the ability of one or two key individuals? What happens if the key individual dies or leaves the investment adviser? Other areas of inquiry might include the adviser's willingness to explore the validity of newly developed investment approaches rather than proceeding blindly along traditional routes.

Although the unaffiliated directors should remember that the fund is not frozen into its existing arrangements for securing investment advice, they should also realize that changes in these arrangements can take a variety of forms. The attempt to effect a drastic change, such as the firing of the existing investment adviser and hiring a new one, can be very disruptive and should not be undertaken lightly. Milder measures, such as changes in certain of the investment adviser's personnel, may provide a sufficient remedy for the deficiencies found by the unaffiliated directors.

Although the most important area about which the unaffiliated directors must satisfy themselves is the ability of the investment adviser to perform the services which the fund requires, the amount paid for such services is also an important, if secondary, consideration. The fees paid to investment advisers in the mutual fund industry have generally been based on a percentage of net assets. Typically, these percentages start at one-half of one percent, with some scale-downs in the fee for assets over a certain amount. Studies show that growth in asset size is not accompanied by a proportionate growth in the costs of managing these assets.[19] Indeed, in some situations the costs of management may not grow at all. To the extent that the scale-downs are not meaningfully related to the economies which size achieves in management costs, the present structure permits the compensation of the investment adviser to be based partly on the standard of how successfully shares of the fund have been sold. The Commission's recent report concluded that the primary beneficiary of the present system of compensation has been the investment adviser rather than the fund shareholder.

There have been attempts to justify the present system. One frequently used argument is that each individual investor, with an average shareholding of roughly $6,500[20] pays (even at the rate of one-half of one percent) only $32.50 per year for expert investment advice. The cost of this advice is, so the argument runs, approxi-

[19] Wharton School of Finance and Commerce, *A Study of Mutual Funds*, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 29 (1962).

[20] Investment Company Institute, The Mutual Fund Shareholder 4 (1966).

mately the same as the cost of a subscription to the *Wall Street Journal.*[21] A variation of this argument points out that the individual investor could not buy investment management elsewhere at a cheaper rate.[22] It was pointed out earlier that the investment advice provided is not custom tailored to the individual needs of the shareholders, but is designed to serve certain common needs of the shareholders as a group. It is not unreasonable for these shareholders to expect, among other things, that the bargaining power generated by the aggregation of their investments will be utilized to produce, if possible, a more advantageous fee than would be paid if each individual shareholder had to bargain for himself.

In determining whether the amount of the fee is proper, the unaffiliated directors should have a variety of information. They should be aware of what expenses the fund has to pay in addition to the advisory fee in order to provide necessary services for its shareholders. They must recognize that the investment advisory fee may cover either a narrow or a broad range of services.

The unaffiliated directors should also look at the cost of comparable services. The Commission's report suggested that the fees charged for investment management by investment counsellors, banks and other institutions reflect arms'-length bargaining and provide some basis for comparison. Although there may be adequate grounds to justify differences in the fees charged,[23] it is both proper and desirable that the unaffiliated directors ask the adviser to explain, if it is the case, why the fund should pay more than other clients for investment advisory services. In addition, the unaffiliated directors will also want to satisfy themselves that it is reasonable for the fund to have an expense ratio which is larger than that paid by a fund of comparable size whose investment advisory services are internally generated.

It is also appropriate for the unaffiliated directors to ask how much it costs the investment adviser to provide the fund with the services which it has agreed to furnish. In determining whether or not the fees charged for providing advice are reasonable, it may often be helpful to look at the profit made by the adviser on this aspect of the operation. (A large profit should not necessarily be taken

[21] The cost of a subscription to the *Wall Street Journal* is $26 a year.

[22] This argument is made in a letter from William F. Shelley, Jan. 26, 1967.

[23] A significant difference referred to in the report relates to the entrepreneurial risk which an adviser takes when it organizes a new fund. *SEC Mutual Fund Report* 116. In the early years of the fund many advisers suffered losses or made only very small profits. *Conference* 755 (comments of Joseph E. Welch). The Commission's General Counsel has stated that, within limits, "the contribution made and the losses incurred in getting a fund going should be considered in determining whether or not the fee is reasonable." *Conference* 756 (comments of Philip A. Loomis).

as an indication of unreasonably high profits—otherwise, a premium may be paid for inefficiency.) Looking at the profit of the adviser may be helpful because, as a result of the typically close affiliation in the industry between the mutual fund and its investment adviser, competitive forces probably do not operate effectively to set guidelines for a fair fee. Many unaffiliated directors seem to think that it is unseemly to ask an adviser how much money he is making on the advisory services. Although profits of investment advisers normally are not examined by non-mutual fund clients when the amount of fees to be charged is discussed, bargaining (including a willingness and ability to change investment advisers) by sophisticated investors and by professionals about the amount of the fees to be paid to the adviser is traditional. The competitive forces operating under these circumstances make it unnecessary to seek external standards for determining a fair fee. Further, when fees are paid directly to individuals and one has a fair idea how much time is spent by such individuals in performing the work for which such fees are paid, judgments with respect to the reasonableness of a fee are much easier to make than in the mutual fund situation where the unaffiliated directors may have little idea how much time is spent by various individuals in the investment advisory firm on the fund's business. In this connection, the unaffiliated director should know something about the total business of the investment adviser. For example, he should know if the investment adviser serves a complex of funds or other clients and uses substantially the same persons and data to generate investment advice for some or all of them. This information is useful in light of the previously stated principle that the costs of providing investment advice generally do not increase proportionately with an increase in the size of the assets managed.

As was pointed out previously, almost all fee arrangements in the investment company industry are based on a percentage of net assets. There is no requirement that they be so determined. Directors should give consideration to other arrangements. For example, under certain circumstances, it may make sense to negotiate a flat fee arrangement which will permit the investment adviser to maintain a certain size staff and quality of organization. The negotiation of a flat fee arrangement might be combined with a formula which will give the adviser a bonus if the fund's performance achieves certain objectives (and, possibly, a penalty if it does not). On the other hand, care must be taken so that the formula does not tempt the adviser to subject the fund's assets to unwarranted risk in order to earn the bonus.[24]

[24] See *SEC Mutual Fund Report* 345.

In addition, mutual funds have traditionally conducted negotiations with respect to investment advisory arrangements separately from other funds in the same complex. There are no statutory reasons to do so and in many cases it may make better sense for all the funds in a complex to bargain with the investment adviser on a joint basis.

Discussions of the duties and responsibilities of unaffiliated directors in making arrangements for providing investment management services to the fund—and in other areas too—tend to emphasize the unaffiliated directors' lack of power to implement their ideas. It is argued that fund shareholders bought the fund on the reputation of the adviser—not the reputation of the board of directors. Thus shareholders do not expect that the directors will refuse to renew the investment advisory agreement. Even if the unaffiliated directors wished to do so, in many cases they (or those who object) do not constitute a majority of the board of directors and do not control the proxy machinery. Finally, as suggested previously, severing relations with the existing investment adviser (and as a practical consequence with the principal underwriter who, as pointed out, normally is affiliated with the investment adviser) involves such a major change in the operation of the fund that directors will be reluctant to undertake such action. These circumstances, it is argued, deprive the unaffiliated director of the ultimate economic power needed to win meaningful concessions at the bargaining table.

This conclusion fails to give sufficient weight to at least two important kinds of power which unaffiliated directors do possess. Whatever their legal obligations, businessmen want to do what is "right"—or at least they want to appear to their peers to be doing what is right. Strong and reasoned objections by fellow board members to a particular contract or course of action on the ground of unfairness to fund shareholders will, in many cases, produce modifications of the contract or course of action. In addition to this informal power, unaffiliated directors also have real power insofar as they have a right to have their objections to certain courses of action—including their disapproval of an advisory contract which is submitted to shareholders—set forth in the proxy statement. Threat of a public statements by unaffiliated directors that a particular contract or course of action is unfair to fund shareholders provides an effective bargaining weapon because a fund sponsor will be reluctant to incur the risk of unfavorable publicity which such a public statement would produce.

Arrangements for Distribution of Mutual Fund Shares

The procedures which a mutual fund must follow in arranging for the distribution of its shares are similar to those which a fund must follow in arranging for investment advice.[25] The Investment Company Act contemplates that the directors (and particularly the unaffiliated directors) will play an important role in making these arrangements. Many unaffiliated directors seem to be unaware of their responsibility in overseeing the arrangements made for the distribution of fund shares. Others seem to think that their responsibility is limited to insuring that the arrangements do not violate any provision of law.

This attitude may stem, in part, from a feeling that purchasers of mutual fund shares are strangers to the fund and, therefore, persons to whom the unaffiliated directors owe no duty. However, a substantial portion of fund share sales are made to existing shareholders—both as a result of the reinvestment of dividends[26] and as a result of repeat business. In addition, a major selling point for fund shares is that through this medium, diversification and expert investment advice can be obtained at a relatively low cost. From the purchaser's point of view, the sales charge is an element of the cost of providing investment management and, therefore, the unaffiliated directors of the fund should properly be concerned that the cost remain as low as possible. On the other hand, the fund has a legitimate interest, under most circumstances, in a steady volume of sales.[27] Maintenance of a steady volume of sales seems to require adequate compensation to the sellers of the shares. Thus the unaffiliated directors have the responsibility of balancing the cost to each new shareholder of obtaining sales volume against the benefits which such volume confers upon all the shareholders. In making this determination, the unaffiliated directors should at least know how much is being paid—directly through the sales load and indirectly through brokerage reciprocals—to finance the selling effort.[28]

Unaffiliated directors also must be concerned with the way in which mutual fund shares are sold. As suggested above, directors want to be sure that the distribution system adopted by the fund

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25 See Investment Company Act §§ 15(b)-(c), 54 Stat. 812, 813 (1940), 15 U.S.C. §§ 80a-15(b)-(c). See text accompanying note 16 *supra*.

26 A large proportion of fund shareholders also reinvest capital gain distributions. No sales load is charged on such reinvestment. Practice with respect to the reinvestment of dividends varies within the industry. *SEC Mutual Fund Report* 215.

27 The Commission report raised questions with respect to the desirability of further growth for the largest funds. *SEC Mutual Fund Report* 263. The validity of this conclusion has been vigorously challenged. *Conference* 683-85 (comments of William B. Moses).

28 It should be recognized that downward revisions of the rewards paid to the retailers of fund shares may be much more difficult to achieve than revisions in the management fees. The rewards presently paid the retailers are set by arms-length bargaining and the retailer has, in many respects, the vastly superior bargaining position. On the other hand, directors should not take a "sales at any price" view.

produces sales—that it performs well. On the other hand, these sales should be the result of responsible selling techniques. Poor selling practices can often result in bad publicity for the fund. As a consequence of such publicity, future sales of shares may be hampered and, possibly, wholesale redemption of shares may result. Although it is obviously not possible for the unaffiliated directors to review the sales practices of all the retail distributors of the fund's shares (except where the shares are retailed exclusively by only one or two organizations), they should be knowledgeable about sales practices generally used in the industry, and they should critically review the procedures, if any, that the principal underwriter of the fund's shares has adopted to see that such shares are properly sold. They should receive and study copies of the advertising and sales literature used to sell the fund's shares. They should be particularly sensitive in areas where abuses are likely to appear. For example, the Commission's report pointed out that purchasers of shares through contractual plans frequently paid very high (up to fifty per cent) effective sales loads as a result of high redemption and lapse rates.[29] Such results suggest the presence of poor selling and poor follow-up. Unaffiliated directors of funds whose shares are sold through contractual plans should request information about redemption and lapse rates and satisfy themselves that existing rates are consistent with adequate supervision of sales and follow-up efforts.

Portfolio Transactions

In connection with the creation of arrangements for providing investment advice to the fund and arrangements for the distribution of its shares, the unaffiliated directors should consider the extent to which the brokerage business generated by the fund has been utilized for its benefit. As the Commission's report pointed out, the brokerage which a mutual fund generates is a valuable asset which can be used to purchase various kinds of services. However, as the report also noted, the services which are purchased often seem to be of greater benefit to the investment adviser or the principal underwriter of the fund than to the fund itself.[30]

It is the duty of the directors to see that the fund derives the maximum benefit from its portfolio transactions, both in the form of services and in obtaining the best terms for such transactions. The unaffiliated directors can obtain information concerning the amount of such brokerage business and its use from Form N-1R.[31] They should

29 *SEC Mutual Fund Report* 238.

30 See note 12 *supra*.

31 Form N-1R, items 1.31, 1.32, 2.17, 2.18, 2.19, 2.28, 17 C.F.R. § 274.101 at 204, 214, 216 (Supp. 1966).

require that Form N-1R information be supplemented by periodic reports on the disposition of brokerage business, and they may consider it helpful to review the execution of a random selection of portfolio transactions in order to satisfy themselves that portfolio transactions are being executed in a way which obtains the maximum benefits and best terms available to the fund.[32] In determining what is a proper investment advisory fee, they will want to take into account any services used by the investment adviser in furnishing advice to the fund which, in effect, have been purchased by the fund. In addition, the unaffiliated directors should find out whether services presently paid for in cash by the fund could be purchased with such brokerage business. Further, they should ascertain whether or not the fund can conveniently and properly utilize some of the devices (such as the give-up to non-member firms in transactions executed on certain regional exchanges) which have been developed to permit funds to get what is essentially a rebate on brokerage commissions.[33] If brokerage business has been used to provide additional rewards to those persons who have sold fund shares, the unaffiliated directors may, as suggested previously, want to consider the amount of such brokerage in determining whether the sales charges are reasonable.

Conclusion

Even this brief discussion should make plain that the tasks of the unaffiliated directors are of great importance and require effort, thought and imagination. To do their job properly, the unaffiliated directors must acquire a relatively sophisticated knowledge of the operations of mutual funds and of certain aspects of the securities business.

In performing the specific tasks related to arranging for investment advice and for the distribution of shares, and generally in performing their overseer functions, the unaffiliated directors should not hesitate to consult with and rely upon experts available to the fund. These experts normally include a certified public accountant and legal

32 The Commission has recently instituted administrative proceedings against two funds and their adviser on the ground that the adviser caused the funds to incur unnecessary brokerage costs and charges by interposing a seller of the funds' shares between the fund and other dealers in over-the-counter market transactions. In the Matter of Delaware Fund, Administrative Proceeding, File Nos. 3-1002, 3-1003, 3-1004, March 27, 1967. Shareholder suits are pending against a number of funds and their advisers alleging failure to make adequate use of the Third Market in executing transactions in New York Stock Exchange-listed securities. Transactions in the Third Market are not subject to the New York Stock Exchange minimum commission rate rules, and thus the use of the Third Market by a fund may at times result in cheaper executions. The Third Market is described in DUKE UNIVERSITY SCHOOL OF LAW, CONFERENCE ON SECURITIES REGULATION 171-90 (Mundheim ed. 1965).

33 One use of the regional exchange to provide the fund with a rebate on brokerage commissions is described in *Conference* at 832-33 (comments of Robert M. Loeffler).

counsel. It is not unusual in the fund industry for the accountant and counsel hired by the fund to be the same accountant and counsel used by the fund's investment adviser and principal underwriter or affiliated broker. This arrangement probably keeps accounting and legal fees to a minimum. On the other hand, such an arrangement is not required and, in light of the many areas of conflicting interest between the fund and its adviser and underwriter or affiliated broker, the unaffiliated directors may consider it worthwhile for the fund to hire (either full-time or for special occasions) certified public accountants and counsel who are free at all times to represent only the interests of the fund.[34]

[34] The unaffiliated directors of funds large enough to support independent personnel will also want to consider the desirability of hiring a chief executive who is unaffiliated with the investment adviser or principal underwriter of the fund.