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# Mutual Fund Industry: A Legal Survey

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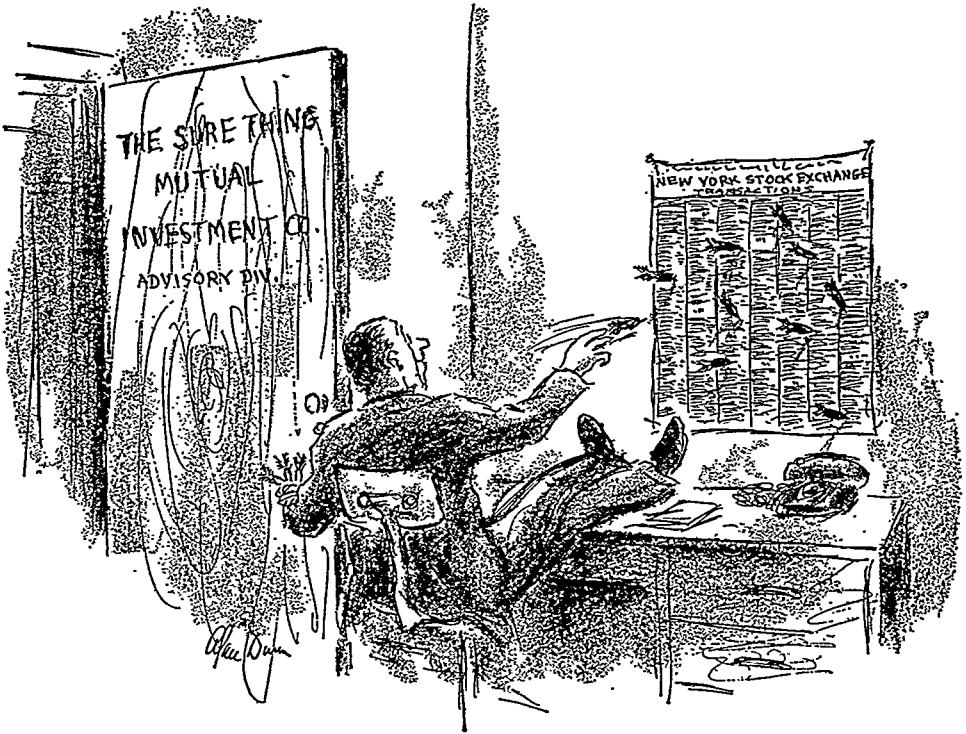
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SURVEY



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THE MUTUAL FUND INDUSTRY: A LEGAL SURVEY

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## THE MUTUAL FUND INDUSTRY: A LEGAL SURVEY

## I. Introduction

The metamorphosis of the American system of property ownership is perhaps the most significant development in the economic growth and structure of the American economy during the twentieth century. The control of productive wealth, long in the hands of the "classic 'owner-entrepreneur' so dear to standard economics"<sup>1</sup> has gravitated toward a new class of owners called "institutional investors."<sup>2</sup> The entrepreneurial society of the past has become the "paraproprietal" society<sup>3</sup> of the present and future.

1 P. HARBRECHT, S.J. & A. BERLE, JR., TOWARD THE PARAPROPRIETAL SOCIETY 3 (1960).

2 Generally classified as institutional investors are investment companies (including mutual funds), banks, pension funds, insurance companies, savings and loan associations, college and university endowment funds, and foundations. D. BAUM & N. STILES, THE SILENT PARTNERS 29 (1965). See also Securities Exchange Act of 1934 § 19(e)(1), 15 U.S.C.A. § 78s(e)(1) (Supp. 1969).

As the table below shows institutional ownership of equity securities is clearly on the upswing:

INSTITUTIONAL OWNERSHIP OF EQUITIES\*  
[Dollar amounts in billions]

	1954	1968	Percent change
Personal trust funds .....	\$37.0	\$87.0	+140
Corporate pension funds .....	3.5	51.3	+1360
Mutual funds .....	5.5	42.8	+680
Charitable trust funds .....	7.0	15.0	+110
Fire and Casualty insurance companies	6.1	13.3	+120
Life insurance companies .....	3.0	10.7	+260
Closed end investment companies .....	3.6	8.2	+130
Banks .....	0.8	1.9	+140
Total, institutional .....	66.5	230.2	+250
All equities .....	268.0	707.6	+160
Institutional share (percent) .....	25	33	.....

\* 115 CONG. REC. E1327 (daily ed. Feb. 24, 1969).

The view has been expressed that the role of institutional investors in the functioning of the securities markets will increase in the coming decades. On October 31, 1968, Mr. John C. Bogle, president of the Wellington Management Company (a mutual fund investment advisory firm), and now president of the Investment Company Institute [ICI], delivered an address before the ICI entitled "The Financial Institution; [A] Vital Force in the Equity Markets." Focusing his attention on the impact that institutional investors will have on the equity markets during the coming decade, he observed that "we must look for continued institutionalization of our equity markets. By the mid-1970's, today's 33% institutional ownership could well be 40%, and today's 50%-plus share of public trading volume could surge toward the 60% level." Address by Mr. John C. Bogle, Investment Company Institute, Oct. 31, 1968, reprinted in 115 CONG. REC. E1324 (daily ed. Feb. 24, 1969).

<sup>3</sup> The phrase "paraproprietal society" was used by Reverend Harbrecht to denote the new system of property ownership now common on the American economic scene whereby a diffusion of corporate income distributed to the American public is achieved by the interpositioning of institutional investors between the corporation and the investing public. Reverend Harbrecht's observation was concurred in by Mr. Adolf A. Berle:

In 1960 the word [profits] suggests a flow of revenue derived from a large group of [corporate] customers generally known as "the public," part of which is destined

That institutionalization of investment has become the earmark of the modern financial scene is nowhere better exemplified than in the phenomenal growth of one member of the family of institutional investors, the mutual fund industry.<sup>4</sup> Between 1940 and 1968 the total assets held by mutual funds increased one hundred times, from \$450 million<sup>5</sup> to \$45 billion,<sup>6</sup> and by the end of 1968, those assets had increased another twenty-two per cent, to \$55 billion.<sup>7</sup> The number of investors owning mutual fund shares increased from 300,000 in 1940,<sup>8</sup> to nearly five million at the close of 1968.<sup>9</sup> In addition, it has been

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for distribution to an even larger group of shareholders, pensioners, insurance policyholders, and others who are even more "the public."

[Corporate] [m]anagements, that is to say, the operators, begin to acquire a singular position quite unknown to nineteenth century [economic] theory. Since they are increasingly immune to change or control by the former ownership group, they are governors rather than agents. The system they operate thus ceases to be a true "property" system and Father Harbrecht is entirely within his academic right in christening it "paraproprietal"—that is, "beyond property." P. HARBRECHT,

S.J. & A. BERLE, JR., *supra* note 1, at 8. For discussions which reveal the rise of the paraproprietal system during the twentieth century see L. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* (1914); J. FLYNN, *INVESTMENT TRUSTS GONE WRONG!* (1931); P. HARBRECHT, S.J. & A. BERLE, JR., *supra* note 1; and D. BAUM & N. STILES, *supra* note 2. Congress has recently expressed concern over the influence which the institutional investors exert on the securities markets. See notes 140-41 *infra* and accompanying text.

4 The designation of mutual funds as "mutual funds" has been generally attributed to the reference to such companies as "Mutual Investment Companies" in the Revenue Act of 1936 § 48, 49 Stat. (Pt. 1) 1669, superseded by Revenue Act of 1942 § 361, 56 Stat. (Pt. 1) 878 (now INT. REV. CODE OF 1954, § 851). See, e.g., H. BULLOCK, *THE STORY OF INVESTMENT COMPANIES* 73 (1959) [hereinafter cited as H. BULLOCK]. Prior to 1936, the funds were commonly known as open-end investment companies, a name presumably derived from the well known "open-end mortgage," or simply as investment trusts. See *Hearings on S. 3580 Before the Senate Comm. on Banking and Currency*, 76th Cong., 3 Sess., pt. 1, at 43 (1940) [hereinafter cited as 1940 Senate Hearings]. The reason why Congress chose the term is unclear, although the record of the Senate hearings on the legislation does contain a statement prepared by two mutual fund industry officials who refer to their respective funds as "mutual investment trusts" which "merely constitute a conduit through which [their shareholders] have made investments in stocks of about 130 different corporations." *Hearings on an Act to Provide Revenue, Equalize Taxation and for Other Purposes, Before the Senate Comm. on Finance*, 81st Cong., 1st Sess., 799-800 (1936), reprinted in part in SEC, *INVESTMENT TRUSTS AND INVESTMENT COMPANIES, PART THREE*, H.R. DOC. NO. 279, 76th Cong., 3d Sess., 802 n.10 (1940) [hereinafter cited as INVESTMENT TRUSTS III]. When one of the fund spokesmen who prepared the statement was questioned regarding the origin of the term, he "intimated that investment companies like [his own] were commonly called 'mutual investment companies,' but he was unable to state the origin of the term." *Id.* In 1940 one fund industry spokesman noted that the Treasury Department "frequently" referred to open-end companies as "mutual funds." 1940 Senate Hearings 452. One possible reason for the use of the term "mutual" to describe such companies was suggested in the testimony of one mutual fund director before an SEC examiner in the 1930's. An SEC official noted that "it may be a very nice word to use in connection with sales . . . it has that conservative ring." The mutual fund spokesman replied, "Yes." INVESTMENT TRUSTS III at 803.

5 *Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess., pt. 1, at 125 (1967) [hereinafter referred to as 1967 Senate Hearings].

6 TIME, Jan. 24, 1969, at 67.

7 *Id.* Another periodical puts the figure at \$54 billion. INV. DEALERS DIGEST, Feb. 10, 1969, at 54.

8 113 CONG. REC. S6107 (daily ed. May 1, 1967).

9 SENATE COMM. ON BANKING AND CURRENCY, 91st CONG., 1ST SESS., ANALYSIS OF S. 34, at v (Comm. Print 1969) [hereinafter cited as ANALYSIS OF S. 34]. *Contra*, 115 CONG. REC. S289 (daily ed. Jan. 15, 1969) (remarks of Senator Sparkman). In the statement made by Senator Sparkman when he introduced S. 34, he set the number of investors holding mutual fund shares at four million. The Committee Print reproduces those remarks verbatim, with one exception—the figure was raised to five million. The change was presumably made in the interest of accuracy.

estimated that by the end of 1969 one-third of all mutual funds will be less than two years old.<sup>10</sup>

Such remarkable growth has not failed to attract widespread attention, much of it fostered by the funds themselves. Teaser ads which earnestly inquire, "What! You still don't own any mutual funds?" are well known to all who read weekly newsmagazines.<sup>11</sup> "Fact Books" distributed by the mutual funds trumpet their "success":

Thirty-five years ago in 1933 . . .

Fundamental Investors began operations with fewer than 100 shareholders, and less than \$100,000 in total net assets.

Today

198,000 shareholders, including

13,765 trustees, guardians, administrators

731 corporations, partnerships, financial institutions

363 churches, ecclesiastical, benevolent associations

471 professional or fraternal groups, pension or employee funds

141 hospitals, libraries or educational institutions

have more than \$1.4 billion invested in its shares. This book tells what has happened in the past to investment programs built on

Fundamental Investors and . . . TIME<sup>12</sup>

The interest generated by the rapid growth of the mutual fund industry has not spent its full force on the American investor. Concern over the public policy implications of mutual fund growth has been registered by both the Securities Exchange Commission [SEC] and the Congress. That concern is centered upon the adequacy of the regulatory framework under which the mutual funds now operate. The Investment Company Act of 1940 [the Act],<sup>13</sup> the Act in question, has not been significantly amended since its enactment and the SEC believes that the tremendous growth of the investment company industry, particularly the mutual funds, has created problems which the Act, in its present form, is incapable of solving. In December, 1966, the findings and recommendations of the SEC were submitted to Congress in a report entitled *Public Policy Implications of Investment Company Growth*<sup>14</sup> [*Public Policy Statement*]. In February, 1967, President Johnson gave the SEC's *Public Policy Statement* his *imprimatur*,<sup>15</sup> and legislation designed to implement the SEC's proposals was introduced before the Ninetieth Congress.<sup>16</sup> Hearings on the proposed amendments were held in both houses; and although a bill embodying the SEC's ideals

10 BROAD STREET INVESTING CORPORATION, 1968 ANNUAL REPORT 7 (page proof ed. 1969).

11 E.g., NEWSWEEK, Nov. 18, 1968, at 115; TIME, Nov. 15, 1968, at 81. The ad was sponsored by the Investment Company Institute, a trade association whose member mutual funds held assets in excess of \$50 billion on Dec. 31, 1968. INV. DEALERS DIGEST, Feb. 10, 1969, at 54. According to the Investment Company Institute, the ads represented a "highly creative approach to the Institute's advertising program." INVESTMENT COMPANY INSTITUTE, 1968 ANNUAL REPORT 17.

12 FUNDAMENTAL INVESTORS, INC., 1968 FACT BOOK.

13 15 U.S.C. §§ 80a-1 to -52 (1964).

14 H.R. REP. NO. 2337, 89th Cong., 2d Sess. (1966) [hereinafter cited as PUBLIC POLICY STATEMENT].

15 See 113 CONG. REC. H1409, S2023 (daily ed. Feb. 16, 1967).

16 S. 1659, 90th Cong., 1st Sess. (1967); H.R. 9510, 90th Cong., 1st Sess. (1967); H.R. 9511, 90th Cong., 1st Sess. (1967).



was passed by the Senate in amended form,<sup>17</sup> it was never reported out of the House Committee on Interstate and Foreign Commerce, and hence was not enacted into law.

Two bills, one identical to the bill that was passed by the Senate last year,<sup>18</sup> and a similar proposal,<sup>19</sup> have been introduced in the current session.† In very general terms, the major aims of those bills are to:

1. Install a court-enforced requirement that the management expenses paid by a mutual fund be reasonable;<sup>20</sup>
2. Permit banks to compete with mutual funds by permitting them to publicly offer shares in "collective trust funds";<sup>21</sup>
3. Reduce the sales charges paid by many investors who acquire mutual fund shares;<sup>22</sup> and
4. Limit the creation and proliferation of the mutual fund holding company or "super fund."<sup>23</sup>

Predictably, such proposals have not been warmly received by the mutual fund industry.<sup>24</sup>

This Survey proposes to analyze the structure and development of the mutual fund industry, and the regulatory systems, both existing and proposed, designed to supervise it. To that end, Parts II and III are crafted to provide a descriptive analysis of the functional characteristics of management investment companies,<sup>25</sup> particularly mutual funds, as well as a perusal of the developmental

17 S. 3724, 90th Cong., 2d Sess. (1968). The bill was passed by the Senate on July 26, 1968. See 114 CONG. REC. S9497 (daily ed. July 26, 1968).

18 S. 34, 91st Cong., 1st Sess. (1969).

19 S. 296, 91st Cong., 1st Sess. (1969).

† A third mutual fund "reform" bill, H.R. 8980, was introduced in the House of Representatives on March 13, 1969. 115 CONG. REC. H1764 (daily ed. March 13, 1969). The bill's provisions differ from its Senate counterparts; and, although its late introduction precludes discussion of it in the body of this Survey, the House proposal is analyzed in Appendix C *infra*.

20 S. 34, 91st Cong., 1st Sess. § 8(d) (1969); S. 296, 91st Cong., 1st Sess. § 8(d) (1969).

21 S. 34, 91st Cong., 1st Sess. § 12(d) (1969); S. 296, 91st Cong., 1st Sess. § 12(b) (1969).

22 S. 34, 91st Cong., 1st Sess. §§ 12(a)-(c), 16(a) (1969); S. 296, 91st Cong., 1st Sess., §§ 12(a), 16(a) (1969).

23 S. 34, 91st Cong., 1st Sess. § 7 (1969); S. 296, 91st Cong., 1st Sess. § 7 (1969).

24 Senator Thomas McIntyre, author of S. 296, noted the unpopularity of his position among mutual fund industry insiders. Writing in November, 1968, he said:

All of the proposals which I intend to make to the Senate Committee on Banking and Currency are designed to help the funds and their shareholders. Regrettably, some persons in the fund industry seem to disagree with my views on the results of my proposed legislation, much as the investment bankers of the 1930's believed that the creation of the SEC would eliminate the stock market and make the grass grow on Wall Street. Letter from Sen. Thomas J. McIntyre to John P. Freeman, Nov. 25, 1968, on file with the *Notre Dame Lawyer*.

The Senator has stated his position more vociferously:

The mutual fund industry, by its extreme defense of its own selfish interests, is raising a cloud of scandal which cannot help casting a dark shadow over the brokers, the Exchange, and the non-fund elements of the financial community. 114 CONG. REC. S11082 (daily ed. Sept. 19, 1968).

25 As defined in section (4)(3) of the Investment Company Act of 1940, 15 U.S.C. § 80a-(4)(3) (1964), a management investment company is any investment company (as defined by section 3 of the Act, 15 U.S.C. § 80a-3 (1964)), except a face-amount certificate company or a unit investment trust. Those types of investment companies are defined in sections 4(1) and (2) respectively. According to those subsections:

"Face-amount certificate company" means an investment company which is engaged . . . in the business of issuing face-amount certificates of the installment

stages of investment company growth—from the embryonic pre-1921 era through the passage of the 1940 Act. Parts IV through VI focus primarily on the sales and management aspects of the mutual fund industry; they are largely devoted to evaluations of the merit of the legislation now pending before Congress, based upon the adequacy of the investor safeguards presently provided by the 1940 Act.<sup>26</sup>

## II. The Nature of Management Investment Companies

### A. Introduction

Because Part III will deal at length with the history of the Act, which is by no means solely a saga of the infancy of the mutual fund industry, a broadly based insight into the operation of the investment company is needed if that discussion is to be meaningful. Accordingly, the initial segment of this Survey is devoted to an analysis of the nature and functional structure of the most prominent class of investment company, the management investment company.

A management investment company is a voluntary organization that issues securities to the public representing a pro rata share in the assets held by the company, which primarily consist of securities issued by corporate enterprises. Management investment companies are usually corporations or trusts,<sup>27</sup> and are

type, or which has been engaged in such business and has any such certificate outstanding.

"Unit investment trust" means an investment company which (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities; but does not include a voting trust.

All other types of investment companies are designated in subsection (3) as management investment companies. It should be noted that certain organizations which issue or propose to issue securities, and which may be engaged primarily in the business of investing, reinvesting, or trading in securities, are not investment companies under the Act. Among the most important exclusions are issuers: (1) whose securities are beneficially owned by fewer than one hundred people and who are not, and do not propose to make a public offering of their securities; (2) who are banks or insurance companies; (3) who are holding companies registered under the Public Utility Holding Company Act of 1935; and (4) who are charitable institutions. Investment Company Act of 1940 § 3(b), (c), 15 U.S.C. § 80a-3(b), (c) (1964).

<sup>26</sup> Before proceeding with these analyses, the authors wish to make a declaration concerning the terminology that will be employed in this exposition. Terms such as "open-end," "closed-end," "front-end load," "no-load," "go-go fund," and the like, will be used repeatedly throughout this Survey. They are examples of the type of jargon common to the investment company industry, and their use may be justified by the same rationale as stated by Professor Leach of Harvard Law School in defending the use of the jargon he employed in his unceasing war versus the Rule against Perpetuities. In Professor Leach's words:

The use of jargon is usually deprecated, but a specialist's jargon can be defended on the ground that it permits shorthand reference to situations or doctrines which, if spelled out at length every time, would bore the reader and spoil the prose. LEACH, *Perpetuities; The Nutshell Revisited*, 78 HARV. L. REV. 973, 991 n.78 (1965).

<sup>27</sup> PUBLIC POLICY STATEMENT 33. The range of organizational forms which an investment company may take is limited only by the exclusion made in sections 3(b) and (c) of the Act, 15 U.S.C. §§ 80a-3(b), (c) (1964). Such breadth is achieved by the Act's definition of an issuer as "every person who issues or proposes to issue any security, or has outstanding any security which it has issued." Investment Company Act of 1940 § 2(21), 15 U.S.C. § 80a-2(21) (1964) (emphasis added). A person is defined in section 2(27), 15 U.S.C. § 80a-2(27) (1964), as "a natural person or a company." (Emphasis added.) For an example of an

designed to provide a service—professional management of the company's "portfolio securities," typically common stocks<sup>28</sup>—in the interest of achieving a yield, including capital appreciation, for their shareholders.<sup>29</sup> Because the assets of the management company are usually held in a varied assortment of securities, an investor who purchases a share in the investment company is commonly able to attain diversification of his investment risk for a much lower cash outlay than would be the case if he attempted to duplicate the company's portfolio by purchasing each of the company's portfolio stocks *seriatim*. It is the "professional management" and "diversification of risk" features which are the distinctive characteristics of the management company.<sup>30</sup>

Through the use of those features, and the implementation of a specific investment policy, the company seeks to achieve an investment goal for its shareholders. The particular objectives sought vary among the different companies. Some seek to invest their funds in securities favored for high yields, while others select their portfolio securities with an eye toward possible capital appreciation; still others follow an eclectic approach, striving to "provide reasonable current income and long-term growth of capital and income."<sup>31</sup>

A variety of policies are used by investment companies in their endeavor to fulfill their objectives. Many companies choose to purchase only common stocks, others hold mainly bonds and preferred stocks, and still others feature "balanced" portfolios. Preference may further be shown for securities issued by companies operating in certain industries, in groups of related industries, or in a particular geographical region.<sup>32</sup> The broad range of objectives sought and

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investment company that was recognized as a "one man show," see notes 201-15 *infra* and accompanying text.

28 INVESTMENT COMPANIES 1968, at 10 (L. Wessmann ed. 1968).

29 This fact seems to distinguish the operational characteristics of investment companies from holding companies who use the medium of investment to control productive wealth. Note, *The Investment Company Act of 1940*, 50 YALE L. J. 440, 440-41 (1941).

30 See, e.g., INVESTMENT COMPANY INSTITUTE, MANAGEMENT INVESTMENT COMPANIES 59, 71 (1962).

31 MASSACHUSETTS INVESTORS TRUST, PROSPECTUS, April 8, 1968, as amended October 9, 1968, at 1.

According to one mutual fund compendium, the income objectives of 222 open-end management companies as of December 31, 1968, were:

Objective	Number of companies	Percent of all companies	Asset size (billions)	Percent of total assets
Income .....	20	9	\$ 2.0	4
Balance .....	25	11	7.7	16
Growth and Current Income, with Relative Stability .....	21	9	4.6	9
Growth and Current Income .....	35	16	13.6	27
Primarily Growth .....	38	17	2.1	4
Growth .....	83	38	21.2	40
Totals .....	222	100	51.2	100

INVESTMENT COMPANIES 1968 (L. Wessmann ed., Supp. Dec. 31, 1968).

32 During fiscal 1968, the SEC registered three investment companies which have particularly unusual investment policies. Two intended to "focus their investments in the securities of unseasoned or newly organized corporations in technological and scientific fields." The third planned to invest between ten and fifteen per cent of its assets in industries that are based in emerging nations and devote their resources to attempting to alleviate the world's "food and population problems." 34 SEC ANN. REP. 129-30 (1968).

investment policies employed by the myriad management investment companies presents the investor with a veritable smorgasbord of investment vehicles. With over 700 companies actively engaged in business it is a formidable array.<sup>33</sup>

Management investment companies are by far the most important of the three types of investment companies. The other two, face-amount certificate companies<sup>34</sup> and unit investment trusts,<sup>35</sup> are dwarfed both in asset size and number of active companies by the management companies. Roughly eighty per cent of all active companies registered with the SEC on June 30, 1968 were management investment companies, and those companies had assets in excess of \$62 billion on that date — nearly ninety per cent of all investment company assets.<sup>36</sup> While the nature and background of the face-amount certificate companies and the unit investment trusts will be discussed only briefly, certain unit investment trusts are important in the distribution process related to the sale of mutual fund shares and will receive a more detailed treatment.<sup>37</sup>

### B. The Two Types of Management Companies

A grasp of the functional characteristics of the companies lumped under the management company heading may be attained by a comparison of the two forms which such companies take, open-end and closed-end investment companies.

#### 1. The Redeemable Security Distinction

The most well-known and the largest form of management company is the "open-end investment company," or, in common parlance, the mutual fund.<sup>38</sup> A mutual fund is a management company that offers for sale, or has outstanding, any *redeemable* security of which it is the issuer.<sup>39</sup> It is the "redeemability" of the security issued by the open-end company that distinguishes it from the other type of management investment company, the imaginatively named closed-end investment company.<sup>40</sup>

By issuing a redeemable security, the open-end company puts itself under a legal obligation to pay its shareholders the approximate proportionate share of its net assets, or the cash equivalent, that the security tendered for redemption represents.<sup>41</sup> The proportionate share of its net assets that the mutual fund

33 *Id.* at 113.

34 *See* note 25 *supra*.

35 *Id.*

36 34 SEC ANN. REP. 113 (1968).

37 *See* text accompanying notes 117-28 *infra*.

38 For a brief discussion of the etymology of the terms "open-end investment company" and "mutual fund," see note 4 *supra*.

39 Investment Company Act of 1940 § 5(a)(1), 15 U.S.C. § 5(a)(1) (1964). See notes 25 & 27 *supra* for a short analysis of the sections of the Act which define investment companies and management investment companies.

40 Closed-end companies are members of a residual class of investment companies. The Act defines a closed-end company as "any management company other than an open-end company." Investment Company Act of 1940 § 5(a)(2), 15 U.S.C. § 80a-5(a)(2) (1964).

41 Section 22(e) of the Act specifically provides that any redeemable security issued by a registered investment company must be redeemed by the company within seven days (exclusive

is obligated to pay is known as the share's *net asset value*. The net asset value of a mutual fund share is determined at least once daily,<sup>42</sup> and is computed by dividing the total net assets of the company (valuing the securities at their market price as of a preselected time), by the total number of mutual fund shares outstanding at that predetermined hour.

The total assets held by the funds active on June 30, 1968 was \$53 billion, comprising eighty-five per cent of all management investment company assets,<sup>43</sup> and representing a huge increase from the 1940 total of \$.5 billion.<sup>44</sup> Although the funds now dominate the management investment company family, their position of ascendancy is a comparatively recent phenomenon — at the time of the 1940 Act's passage, the funds accounted for only forty-four per cent of all management company assets.<sup>45</sup>

As distinguished from an open-end company, the closed-end company undertakes no such redemption obligation; hence capital raised by it through the sale of its shares is viewed as being permanently committed to the enterprise. In this respect the closed-end investment company does not differ greatly from companies that operate in other segments of the economy.

## 2. The Premium-Discount Phenomenon

The obvious effect of the difference between the capital structure of the two types of companies is that, while a mutual fund shareholder may at any time demand that the issuing fund "buy back" his security at its net asset value, subject to the SEC's rarely exercised right to suspend the redemption privilege,<sup>46</sup> the closed-end shareholder must dispose of his security through the market mechanism — either on a stock exchange or by use of the over-the-counter market.<sup>47</sup> Because the closed-end investor is subjected to the vagaries of the marketplace, the price he receives for his share need not, and seldom does, reflect the share's net asset value. Depending on the demand for the share, the sales price may reflect a discount from or premium over the share's actual net asset value.

During the period between 1931 and 1968 the shares issued by the closed-

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of days when the New York Stock Exchange is closed or trading thereon is restricted) after it is tendered by the shareholder unless (1) an emergency exists which makes it "not reasonably practicable" for the company to pay off the shareholder or (2) the SEC permits the company to suspend the shareholder's redeemability privilege. Investment Company Act of 1940 § 22(e), 15 U.S.C. § 80a-22(e) (1964). The Commission recently exercised its prerogative to grant the privilege of redeemability suspension to a fund registered under the Act. *See Mates Investment Co., SEC Investment Co. Act Release No. 5,571 (Dec. 20, 1968)*.

<sup>42</sup> Rule 22c-1, promulgated by the SEC on October 16, 1968, and effective as of January 13, 1969, requires that the computation of the net asset value of mutual fund shares be made "not less frequently than once daily as of the time of the close of trading on [the New York Stock Exchange]." 17 C.F.R. § 270.22c-1 (1969). For the background and purpose of that Rule see notes 398-405 *infra* and accompanying text.

<sup>43</sup> 34 SEC ANN. REP. 113 (1968).

<sup>44</sup> 1967 *Senate Hearings* 125.

<sup>45</sup> 1940 *Senate Hearings* 459-63. Ten years earlier mutual funds accounted for less than six per cent of the assets held by management companies. SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, PART TWO, H.R. DOC. 70, 76th Cong., 3d Sess. 116 (1938) [hereinafter cited as INVESTMENT TRUSTS II].

<sup>46</sup> *See* note 41 *supra*.

<sup>47</sup> The most active market for the stock of closed-end companies is the New York Stock Exchange. *See* INVESTMENT COMPANIES 1968, at 330-33, 370-72 (L. Wessmann ed. 1968).

end companies tended to sell at discounts, prices lower than the net asset value of the shares.<sup>48</sup> That situation was anomalous for two reasons: First, closed-end companies are, like mutual funds, management investment companies, and they provide their investors with the same basic services — professional management and diversification of risk. Indeed, in several cases the closed-ends and mutual funds employ the same management talent.<sup>49</sup> Second, the brokerage fee paid by an investor who purchases the closed-end's security on the market is commonly far lower than the sales charge paid by the mutual fund investor when purchasing the open-end security. The net result is that the closed-end investor normally pays a smaller sales fee and receives a greater interest in the company's assets than the mutual-fund investor who purchases a mutual fund share at its net asset value plus a high sales charge.<sup>50</sup> It is anomalous that the closed-ends' shares sold at discounts for such a long period while investors were flocking to the funds in droves, because the discount represents a lack of demand for the shares, while on paper at least, the closed-ends appear to have been the better bargain.

Probably the most satisfactory explanation for the discount phenomenon is historical. As will be seen, the closed-ends enjoyed their heyday during the early days of the development of management investment companies, especially in the years preceding the depression when they greatly outnumbered the mutual funds in every category: number of companies, total assets, and total shareholders.<sup>51</sup> Without now attempting to discuss the management practices or intricate capital structures then prevalent among the closed-ends,<sup>52</sup> suffice it to say that the image of the closed-ends in the minds of the investing public following the crash and the result of what has been politely termed "maladministration"<sup>53</sup> on the part of the less scrupulous of the closed-end managers, was less than glorious. The effect of the market decline, mismanagement, and the unfavorable tax treatment accorded the closed-ends until 1942<sup>54</sup> led to a slackening in the demand for and a resultant discount on closed-end shares, which had commanded premiums prior to the depression. One SEC official who played a prominent part in the history of the 1940 Act had this to say about the reason closed-ends sold at a discount during the depression:

[T]hese companies which were supposed to be managed by experts sustained bigger losses, or as big losses as anybody else, whereupon the confidence

48 See the graph of sample closed-end companies, *id.* at 21. This phenomenon was reversed for the first time since the 1930's in 1968. On December 31, 1968, the average price paid for the stock of the larger closed-ends reflected a premium. See INVESTMENT COMPANIES 1968 (L. Wessmann ed., Supp. Dec. 31, 1968).

49 *E.g.*, Carriers and General Corporation, a closed-end company, is managed by Calvin Bullock, Ltd., the same advisor hired by five mutual funds: Bullock Fund, Ltd., Canadian Fund, Canadian Investment Fund, Ltd., Dividend Shares, and Nation-Wide Securities. INVESTMENT COMPANIES 1968 (L. Wessmann ed. 1968).

50 See PUBLIC POLICY STATEMENT 210.

51 See, *e.g.*, INVESTMENT TRUSTS II 115-16, 375.

52 See, *e.g.*, text accompanying notes 300-12 *infra*.

53 Senator Robert Wagner, speaking at the 1940 Senate hearings on a regulatory scheme designed to curb managerial malfeasance in the investment company industry, said with reference to one type of malpractice: "Let us say the money was lost through maladministration; perhaps looting is too strong a term in some instances." 1940 Senate Hearings 332.

54 See notes 282-83 *infra* and accompanying text.

. . . in the expertness of the people who were managing these companies faded a little bit. . . .

So there was this reaction about these managements, and an individual who wanted to liquidate his interest in an investment company had to sell his securities at a discount ranging in some instances up to 50 percent.<sup>55</sup>

[The American public was] in effect saying that a dollar in the hands of these expert managers is worth only 50 cents.<sup>56</sup>

By 1940, the price of the average closed-end's shares reflected a discount of roughly thirty-five per cent.<sup>57</sup> The figure tended to decrease over the years, and by the close of 1967 the average discount on closed-end shares was close to five per cent.<sup>58</sup> Finally, during 1968, the average price offered for a share in a closed-end company exceeded the average net asset value of the industry's shares; hence the average price denoted a premium.<sup>59</sup> It would therefore appear that the loss of the public's confidence in the closed-end companies has been the key reason for the discount phenomenon, and that the lost confidence has very gradually been restored.

### 3. Diversification

The two types of management companies, the open-end and closed-end companies, are further divided within their respective categories on the basis of the diversification of the assets which they hold. This refinement produces four mutually exclusive categories:

- (1) Open-end, diversified;
- (2) Open-end, non-diversified;
- (3) Closed-end, diversified; or
- (4) Closed-end, non-diversified.

A management investment company is "diversified" within the meaning of the 1940 Act when, with respect to seventy-five per cent of its total assets, it has not more than five per cent of its total assets invested in the securities of any single company, and does not own more than ten per cent of the voting securities of any one company.<sup>60</sup> An exception is made in the case of a management company that loses its diversified status due to factors other than the original acquisition of a security.<sup>61</sup> Hence, a postacquisition appreciation in the value of the security purchased would have no effect on the investment company's diversified status. All other companies registered under the Act that fail to meet the diversification test are, naturally enough, classified as non-diversified companies.

By virtue of section 13(a)(1)<sup>62</sup> of the Act, an investment company is

55 Testimony of David Schenker, 1940 Senate Hearings 185.

56 *Id.*

57 INVESTMENT COMPANIES 1968, at 21 (L. Wessmann ed. 1968).

58 *Id.*

59 See note 48 *supra*.

60 Investment Company Act of 1940 § 5(b)(1), 15 U.S.C. § 80a-5(b)(1) (1964).

61 *Id.* § 5(c), 15 U.S.C. § 80a-5(c) (1964).

62 *Id.* § 13(a)(1), 15 U.S.C. § 80a-13(a)(1) (1964).

required to receive shareholder approval of a management decision to alter its diversification status; and section 12(c) imposes limitations on the ability of a "registered diversified company to make any commitment as [an] underwriter . . . ."<sup>63</sup> Otherwise, relative diversification makes virtually no difference in the applicability of the Act's provisions to a particular company. The degree of diversification of the management company's assets does have important tax consequences, however.

The Internal Revenue Code allows a "regulated investment company" special tax advantages that enable the investment company to avoid paying a tax on up to one-hundred per cent of its investment income,<sup>64</sup> an obvious advantage to its shareholders. The key Code provisions dealing with the classification of an investment company as "regulated" within the intent of the exemption require the company to meet certain standards of diversification and income distribution.<sup>65</sup> The Code's diversification requirement is similar to that contained in the 1940 Act, the major difference being that the Act permits unlimited concentration of up to twenty-five per cent of a company's assets,<sup>66</sup> while the Code is more liberal, permitting up to fifty per cent of an investment company's assets to be invested in a single company.<sup>67</sup> The other major Code requirement that must be met by an investment company seeking to avail itself of the desirable tax status demands that the investment company pay at least ninety per cent of the dividend and interest income received by it to its shareholders.<sup>68</sup> If the company pays out more than ninety per cent of such income, but less than one-hundred per cent, the difference is taxable to it at whatever the regular rate would be depending on the type of business association the investment company is.

#### 4. The Use of Leverage

Although the Act recognizes only four mutually exclusive categories of management companies, they may be further distinguished by the presence or absence of senior capital in the company's capital structure. The use of senior capital in the form of bonds, debentures, preferred stock, or bank loans enables a management company to create "leverage" which serves to magnify the changes in the net asset value of the company's portfolio securities. During a market upswing this works to the advantage of its shareholders. The effect of leverage on the net asset value of investment company shareholder's security may be seen by the use of a simple illustration:

1. Assume that two investment companies have identical total asset values of \$1,000,000. Assume further that the assets of the leveraged

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63 *Id.* § 12(c), 15 U.S.C. § 80a-12(c) (1964).

64 INT. REV. CODE OF 1954, § 852.

65 *Id.* § 851.

66 The concentration of an investment company's assets in the shares of other investment companies is limited by section 12(d)(1) of the Act, 15 U.S.C. § 80a-12(d)(1) (1964). The effect of that provision is discussed at notes 396-97 and accompanying text *infra*.

67 Compare Investment Company Act of 1940 § 5(b)(1), 15 U.S.C. § 80a-5(b)(1) (1964), with INT. REV. CODE OF 1954, § 851(b)(4).

68 INT. REV. CODE OF 1954 § 852(a)(1).



investment company, Five Talents, Inc.,<sup>69</sup> were supplied by the issuance of \$750,000 in bonds and \$250,000 gained by the sale of 25,000 shares of \$10 par stock; and that the assets of the non-leveraged company, One Talent, Inc.,<sup>70</sup> are attributable solely to the issuance of 100,000 shares of stock which also has a \$10 par value. Immediately after organization the balance sheets of the two companies would appear as follows:

## FIVE TALENTS, INC.

Assets		Capital	
Cash	\$1,000,000	Bonds	\$ 750,000
		Stock (25,000 shares \$10 par)	250,000
Total	<u>\$1,000,000</u>		<u>\$1,000,000</u>

## ONE TALENT, INC.

Assets		Capital	
Cash	\$1,000,000	Stock (100,000 shares \$10 par)	\$1,000,000
Total	<u>\$1,000,000</u>		<u>\$1,000,000</u>

2. Now assume that one year has elapsed since the organization of the companies, that each company invested its cash in equal amounts of identical securities, and that the value of the securities they purchased has quadrupled. Assuming that the portfolio securities of the companies are valued at their market price, and ignoring for the purpose of illustration the interest charged on debt capital, the balance sheets of the companies at year end would look like this:

## FIVE TALENTS, INC.

Assets		Capital	
Securities	\$4,000,000	Bonds	\$ 750,000
		Stock (25,000 shares \$10 par)	250,000
		Unrealized Appreciation	3,000,000
Total	<u>\$4,000,000</u>		<u>\$4,000,000</u>

Net asset value per share of common stock:

Net Assets \$3,250,000 ÷ Number of shares 25,000 = \$130.00

<sup>69</sup> See *Matthew* 25:14-30. "For it is like a man going abroad, who called his servants and handed over his goods to them. And to one he gave five talents . . . and to another one, to each according to his particular ability and then he went on his journey." *Id.* at 14.

It should be noted that the degree of leverage achieved by Five Talents, Inc., would be prohibited by section 18 of the Act, 15 U.S.C. § 80a-18 (1964). That section prohibits the issuance of bonds by a mutual fund, and limits their issuance by closed-ends to instances where the company maintains a 300 per cent asset coverage. The statutory standard was disregarded for illustrative purposes.

<sup>70</sup> *Matthew* 25:14-30.

## ONE TALENT, INC.

Assets	Capital
Securities \$4,000,000	Stock (100,000 shares \$10 par) \$1,000,000
	Unrealized Appreciation 3,000,000
Total <u>\$4,000,000</u>	<u>\$4,000,000</u>

Net asset value per share of common stock:

Net Assets \$4,000,000 ÷ Number of shares 100,000 = \$40.00

As is apparent, the net asset value of the shares of the leveraged company, Five Talents, Inc., increased appreciably more than that of the non-leveraged company's shares. In essence, Five Talents, Inc.'s stockholders had "more assets working for them," and benefited handsomely.

Leverage has been most commonly employed by the closed-end variety of the management investment company family. In 1929, the leveraged closed-ends dominated the investment company industry, outnumbering the mutual funds by more than six to one.<sup>71</sup> However, as was discovered by those investors who held shares in the leveraged companies during the depression, the leverage mechanism works equally well in reverse, and a falling market will naturally magnify the decline in a share's net asset value. For instance, it would have taken only a twenty-five per cent decline in the market value of Five Talents, Inc.'s original investment to eliminate the equity value of its shareholders. Negative net asset values were not at all uncommon during the depression; in fact, by the end of 1932, the shares of two-thirds of all leveraged closed-end companies were "under water."<sup>72</sup> As might well be expected, the proven efficiency of the leverage mechanism when working in reverse cooled investor ardor for the leveraged closed-ends, and the number of companies using leverage decreased until, by the end of 1966, only a handful of companies continued the practice.<sup>73</sup>

Leverage has since made a comeback. Early in 1967, a new form of investment package was made available to the American investor. A British innovation variously called the "dual fund" or "split-purpose" fund, this new investment strategy has been incorporated by eight closed-end companies and one mutual fund to date. The dual funds possess a unique capital structure which enables them to double up the principle of leverage, to the advantage of their two classes of stockholders: those holding "income" shares and those holding "capital" shares. The dual fund achieves double-barreled leverage by requiring each class of security holder to make equal capital contributions and permitting the income shareholders to receive all of the income derived from the investment of the pooled funds, with all of the capital gains earned by the funds going to the fund's capital shareholders. The fund's operating expenses are paid from its investment income, and hence are paid by the income shareholders, while all capital losses incurred by the fund are borne by the capital shareholders up

<sup>71</sup> INVESTMENT TRUSTS II 115.

<sup>72</sup> *Id.* at 816-17.

<sup>73</sup> INVESTMENT COMPANIES 1968 22 (L. Wessmann ed. 1968).

to the point where the equity investment of the capital shareholder vanishes, at which point the income shareholder begins bearing the losses. In essence, the income and capital shareholders are "using each other's money" in their quest to reach their respective investment objectives.

This unique investment technique has not proven extremely popular with the investing public,<sup>74</sup> and the companies offering dual funds account for less than one per cent of the total assets held by management companies.<sup>75</sup> Their significance for the purpose of this discussion lies solely in the fact that they represent the resurrection of the principle of leverage, and, as will be seen, that feature was important in the shaping of the modern investment company industry.<sup>76</sup>

### *C. The Operational Characteristics of Mutual Funds and Closed-end Companies*

This discussion has heretofore centered on the differences between the open-end and closed-end investment companies relating to the redeemable security distinction, the closed-end's premium discount phenomenon, diversification, and the feature most commonly used by the closed-end companies, leverage. The next area to be considered deals with the manner in which the assets of the mutual funds and closed-end companies are managed, and the way they distribute their shares to the public.

#### 1. Management

The closed-end companies tend to operate in much the same manner as companies doing business in other sectors of the economy. They are generally managed by their officers and a board of directors,<sup>77</sup> and use the standard underwriter-broker relationship when they seek to issue their securities, which in many cases are traded on the New York Stock Exchange [NYSE].<sup>78</sup> In these respects, the practices of the mutual fund industry vary significantly from those utilized by its closed-end cousin.

Unlike most other types of companies, which derive their managerial expertise from internal sources—the company's officers and board of directors—the overwhelming majority of the mutual funds choose to hire their manage-

74 The capital shares issued by eight of the nine dual funds were selling at discounts on December 31, 1968, at a time when most closed-end shares commanded premiums. INVESTMENT COMPANIES 1968 (L. Wessmann ed., Supp. Dec. 31, 1968). Since the shares are exchanged at an auction market, the discount is attributable to a lack of investor demand for the shares.

75 The total "investment assets" of the nine dual funds was \$469.1 million on December 31, 1968, compared with assets of \$55 billion on the same date for mutual funds. Compare *id.* with TIME, Jan. 24, 1969, at 67.

76 For a more detailed discussion of the functional characteristics of the dual funds, see FORTUNE, Feb. 1967, at 201. See also a sequel to that discussion which presents an analysis of the reception given the dual funds by the investing public, FORTUNE, Aug. 1967, at 175.

The dual funds have also provoked some comment concerning the adequacy of the existing federal securities regulation to cope with various problems raised by their unique capital structure. See Note, *The Regulation of the Dual Funds*, 54 VA. L. REV. 1396 (1968).

77 PUBLIC POLICY STATEMENT 87.

78 As noted, the shares of the majority of closed-end companies are listed on the New York Stock Exchange. See note 47 *supra*.

ment talent by contracting for the services of an "investment advisor." Usually a corporation or partnership, the investment advisor renders many services to the fund in addition to supplying the financial acumen required to manage the mutual fund's portfolio securities. Among the extra-advisory services commonly rendered by a fund's investment advisor are: paying the salaries of the fund's officers, keeping the mutual fund's books of account, and paying the rental fees for the mutual fund's offices.<sup>79</sup> As is apparent, the advisor is intimately related with the operation of the fund; he is, in most cases, the ringmaster and the mutual fund is the trained seal. Former SEC Commissioner Manuel Cohen pointed this out in 1967 when testifying before the House subcommittee that was considering a bill embodying the SEC's proposal to amend the 1940 Act. Referring to testimony on behalf of the investment advisors, he said:

They also made the point that the investment adviser creates the fund, and operates it in effect as a business. Many of them stated that "It is our fund, we run it, we manage it, we control it," and I don't think there is anything wrong in them saying it. They were just admitting what is a fact of life.

The investment adviser does control the fund.<sup>80</sup>

Quite naturally, the investment advisor does not provide such a broad range of skills to the mutual fund gratis. The remuneration received by the advisor, called the management fee, is most commonly calculated on the basis of a percentage of the mutual fund's total net assets. The fee rate is often a flat one-half per cent of the average total net assets managed,<sup>81</sup> though many funds have begun to utilize sliding scales in the computation of the management fee, which results in a lowering of the fee rate as the asset size of the fund increases.<sup>82</sup> In addition, some funds now base a portion of the advisory fee on the fund's investment performance, adding to or deducting from the advisory fee depending on how the net asset value of the fund's shares compares to a pre-selected market index.<sup>83</sup>

The median annual fee rate of the fifty-seven "externally managed" mutual funds (those employing investment advisors), which had average net assets

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<sup>79</sup> PUBLIC POLICY STATEMENT 91. A table representing the various types of extra-advisory services rendered by a selected group of advisors is presented in Part VI. See text accompanying note 1048-49 *infra*.

<sup>80</sup> *Hearings on H.R. 9510, H.R. 9511 Before the Subcomm. of Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 90th Cong., 1st Sess., pt. 2, at 674 (1967)* [hereinafter cited as *1967 House Hearings*].

<sup>81</sup> PUBLIC POLICY STATEMENT 46.

<sup>82</sup> *Id.*

<sup>83</sup> For example, the advisory contract between IVEST Fund, Inc. (a mutual fund), and IVEST, Inc. (its advisor), provides for an annual base fee of one-half per cent of the fund's average total net assets (based on end of month totals), subject to a decrease of one-eighth per cent if the fund's investment performance is two per cent or more below that reflected by the Dow Jones Industrial Index. If the fund "out-performs" the index by more than two per cent, the one-half per cent management fee would be increased to five-eighths per cent. The investment performance of the fund is measured by the net percentage change in the net asset value of a fund share. IVEST FUND, INC., PROSPECTUS, January 2, 1969, at 5, 6.

The fund combines the performance fee with a sliding base fee scale which results in the one-half per cent base fee being reduced to .48 per cent of net assets in excess of \$250 million. *Id.* at 6. For a more detailed discussion of performance fees see notes 1023-46 *infra* and accompanying text.

of over \$100 million was .48 per cent in 1965.<sup>84</sup> Ten of those companies, taken individually, had assets greater than those managed by the entire mutual fund industry in 1940,<sup>85</sup> and in 1940 the average advisory fee rate was .5 per cent.<sup>86</sup> Thus, while the management fee rate declined roughly four per cent between 1940 and 1965, the tremendous growth of the mutual fund industry has caused the basis for the computation of that fee, the net assets of the mutual fund industry, to rise by over 11,000 per cent.

This situation has led some to wonder whether, in light of the proven economies of size present in the mutual fund industry,<sup>87</sup> the fees paid by the fund to its investment advisor, who "runs it, manages it, and controls it," are justified. Lending credence to the position of those who pursue this line of inquiry is the fact that the fees charged the mutual fund for investment advice by the advisor are commonly far in excess of those charged the advisor's non-fund clients,<sup>88</sup> and also far greater than those management costs incurred by mutual funds which utilize internal sources to provide their management skill.<sup>89</sup>

As noted, the advisor generally pays the salary of, or is associated with, virtually all of the fund's officers and a substantial number of the fund's directors. As former Commissioner Cohen perceptively noted, "[t]he investment adviser does control the fund."<sup>90</sup> Since the advisory contract, which stipulates the method by which the advisor will receive his compensation, may be, and usually is, approved by the mutual fund's board of directors, several of whose members are commonly associated with or employed by the advisor, it is apparent that there may be a conflict of interest problem involved with the board's decision to maintain the existing fee rate.<sup>91</sup> This situation has been characterized as the "fundamental ambiguity concerning the locus of control as between the board of directors or trustees of the investment company and its presumptive agent employed to advise it or to manage its security portfolio under board supervision."<sup>92</sup> Put more bluntly: "[N]othing — but nothing — approaches the open end mutual fund [*sic*] for incestuous relationships."<sup>93</sup>

An extensive discussion of this "fundamentally ambiguous relationship," its legal ramifications, and the manner in which the proposed legislation is intended to cope with it is presented in Part VI of this Survey.

## 2. The Security Distribution Process

As has been pointed out, the shares issued by the closed-end companies

84 PUBLIC POLICY STATEMENT 99.

85 Compare *id.* at 98 with *id.* at 2.

86 1940 Senate Hearings 453.

87 This phenomenon is treated in detail in Part VI. See notes 1068-88 *infra* and accompanying text.

88 PUBLIC POLICY STATEMENT 120.

89 *Id.* at 102-11.

90 See note 80 *supra* and accompanying text.

91 However, section 15(e) of the Investment Company Act of 1940, 15 U.S.C. § 80a-15(e) (1964), does attempt to introduce a measure of independence to a board's vote. For a treatment of the effectiveness of this section, see notes 382-86 *infra* and accompanying text.

92 WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 2274, 87th Cong., 2d Sess. 51 (1962) [hereinafter cited as WHARTON REPORT].

93 Statement of A. Pomerantz, *University of Pennsylvania Law School Conference on Mutual Funds*, 115 U. PA. L. REV. 659, 739 (1967).

are traded on the stock exchanges or the over-the-counter markets while the mutual fund must itself stand ready to redeem its shares. The result of this situation is that while the asset size of the closed-end company is only capable of shrinkage from a decrease in the market value of the portfolio securities (assuming the company does not pay dividends to its shareholders out of capital), a mutual fund's assets are susceptible to shrinkage from redemptions as well. The threat of being forced to liquidate the portfolio to meet an onrush of redemptions is one reason why the vast majority of the mutual funds choose to constantly issue shares to the public.<sup>94</sup> A more important reason for the funds to continuously offer their shares is linked to the earlier discussed fact that the investment advisor "runs the fund" and is compensated by a fee directly related to the fund's size. An increase in the fund's net assets obviously serves to benefit the advisor, and is probably the major explanation for the fact that mutual fund shares are aggressively marketed. This viewpoint was impliedly accepted by the SEC in the *Public Policy Statement*:

The industry's emphasis on sales has been viewed as a byproduct of redeemability. This position was expressed by one industry executive who recently stated:

The inexorable law of this business is that when assets rise, redemptions rise proportionately so that the more you succeed, the harder you have to sell, just to keep your place on the treadmill.

But sales of new fund shares have enabled the fund business to do more than just keep its "place on the treadmill." *Such sales account for most of the increase in mutual fund assets since 1940.*<sup>95</sup> (Emphasis added.)

To credit the sale of fund shares with the major portion of a \$50 billion increase in mutual fund assets is to pay no mean tribute to the salesmanship ability of the mutual fund dealer.

Although some mutual funds market their shares to the public at a price which reflects the share's net asset value, "at cost,"<sup>96</sup> most funds retail their securities at a price which includes a sales charge in addition to the net asset value of the share. The sales charge, known as the "load," is used to compensate those who work in the fund's distribution chain: the principal underwriter<sup>97</sup> who "wholesales" the shares, the dealer who operates the "retail outlet," and the salesman who sells the shares to the public.

<sup>94</sup> The Act contains no provision which would require a mutual fund to continuously offer its shares to the public.

<sup>95</sup> PUBLIC POLICY STATEMENT 202.

<sup>96</sup> As of June 30, 1968, over ninety mutual funds of this type were registered with the SEC and actively engaged in business. See SEC, LIST OF COMPANIES REGISTERED UNDER THE INVESTMENT COMPANY ACT OF 1940 (as of June 30, 1968) 52-65 (1968).

<sup>97</sup> It should be noted that the underwriter in the mutual fund's securities distribution process is not an underwriter within the common meaning of the word, since he assumes no risk. The underwriter undertakes only to use his best efforts to sell the mutual fund's securities, but unlike the common "best efforts" underwriter, there is no specific time limit within which the fund underwriter must dispose of the securities. Typically the function of underwriter is fulfilled by the investment advisor or one of his wholly owned subsidiaries. Although the underwriting task is often a money losing proposition for the advisor, the income to be gained by a rise in the management fee resulting from an increase in the fund's assets serves, no doubt, as a powerful incentive for him to accept the position. See PUBLIC POLICY STATEMENT 55 n.137, 209, 213.

The funds that sell their shares to the public at net asset value, without charging a sales load, are called, logically enough, no-load funds. The no-loads are accorded special treatment by the 1940 Act, and are permitted to distribute their shares to the public without paying for the services of an underwriter.<sup>98</sup> There are about ninety no-load funds in operation and most have been organized by brokerage houses or investment counsel firms as a service to customers whose accounts cannot be profitably handled on an individual basis.<sup>99</sup>

The great majority of the mutual fund shares sold are those of the load funds. The load funds have more in common with each other than the use of the underwriter-dealer-salesman relationship—they generally charge the same sales loads. The following schedule<sup>100</sup> is the one most commonly used by the dealer when determining the load to be paid by the investor:

Cash outlay	Sales load	Sales charge (as a percent of net asset value of shares received)
	<i>Percent</i>	
Less than \$12,500 .....	8.50	9.29
\$12,500 to under \$25,000 .....	7.50	8.11
\$25,000 to under \$50,000 .....	5.75	6.10
\$50,000 to under \$100,000 .....	4.00	4.17
\$100,000 to under \$250,000 .....	3.25	3.36
\$250,000 to under \$1,000,000 .....	2.50	2.56
\$1,000,000 and over .....	1.00	1.01

In 1966, the median purchase made by a mutual fund shareholder was estimated to be \$1,240.<sup>101</sup> Using the above schedule the amount invested would be \$1,134.60 with \$105.40 deducted as a sales load. The sales charge would commonly be divided between the fund's underwriter, dealer, and the salesman as follows:

Position	Concession as a percentage of the amount invested <sup>102</sup>	Concession in dollars
Underwriter	2.00	\$ 24.80
Dealer	3.25	40.30
Salesman	3.25	40.30
	8.50	\$105.40

It should be noted that although brokerage houses commonly serve as dealers in the mutual fund distribution process, there is virtually never a redemption fee connected with the liquidation of a mutual fund share. The fund typically

98 Investment Company Act of 1940 § 12(b), 15 U.S.C. § 80a-12(b) (1964).

99 1967 Senate Hearings 215. See also PUBLIC POLICY STATEMENT 58-59.

100 The schedule is given at PUBLIC POLICY STATEMENT 210.

101 *Id.*

102 *Id.* at 207.

redeems the share at its net asset value, making the initial sales load a "one time" affair.

While a majority of the load funds sell their securities through independent dealers, a sizeable minority utilize sales organizations that are directly controlled by the underwriter. This distribution system, referred to as a "captive sales force," is used by a group of funds that account for over forty per cent of the industry's assets.<sup>103</sup> The use of a captive sales force frees the underwriter from his two most difficult tasks: convincing the independent dealer to recommend mutual fund shares instead of common stocks, and persuading the dealer to "push" the underwriter's fund. Investors Diversified Services, Inc., the largest mutual fund complex,<sup>104</sup> had a sales force of approximately 4,000 full time salesmen on August 3, 1967.<sup>105</sup> Its asset value on that date was roughly \$6 billion, or nearly fifteen per cent of the total assets of the mutual fund industry.<sup>106</sup>

Because of the high sales load imposed on the sale of most mutual fund shares, coupled with the fact that the portfolios of most funds consist of equity securities traded on the NYSE, it is usually far more expensive for an investor to invest indirectly in the stock market by buying a mutual fund share than it would be for him to invest directly — by purchasing one share of stock in each of a mutual fund's portfolio companies "on the market." For example, the average mutual fund investor in 1966 paid a sales load that amounted to 9.3 per cent of the net asset value of the mutual fund shares he received.<sup>107</sup> Had he invested that money directly in securities listed on the NYSE, he would have paid a sales charge of only 1.8 per cent (assuming he engaged in an odd lot transaction and that the market value of the shares acquired was \$40.00 per share).<sup>108</sup> The total commission paid by the investor to buy *and* sell those securities would have aggregated only 3.5 per cent of the amount invested.<sup>109</sup> Hence, an investor who chooses to invest in the stock market indirectly, by purchasing an interest in a mutual fund, pays a sales charge that is 264 per cent greater than he would have incurred had he invested in the market directly by purchasing the portfolio stocks *seriatim*.

The huge popularity of the load funds relative to other similar investment vehicles is evidenced by the fact that they outnumber the no-load funds by four to one, accounting for over ninety-two per cent of the fund industry's assets,<sup>110</sup> and also by the lack of investor demand for the shares issued by the closed-end companies that often results in the sales of their shares at discounts. The ability

103 *Id.* at 207 n.28.

104 A mutual fund complex is a group of investment companies which have different investment policies but share a common management. *See id.* at 47-49.

105 1967 *Senate Hearings* 773.

106 *Id.* at 771.

107 This conclusion is based on the assumptions that: (1) the investor made the average purchase of mutual fund shares during that year (\$1,240); (2) he purchased shares in the largest class of fund, the load fund; and (3) the sales load on the shares purchased was that most commonly charged by such funds. *See* text accompanying notes 98-100 *supra*.

108 PUBLIC POLICY STATEMENT 210 Table v-3.

109 *Id.*

110 34 SEC ANN. REP. 113 (1968).



of the load funds to thrive despite the presence of the other, far less expensive, investment vehicles able to provide the same services gives cause to admire the merchandising abilities of the load funds' sales system.

### 3. Dividend and Capital Gains Reinvestment

Another factor accounting for the increase in the size of the mutual fund industry's total assets, in addition to appreciation in the value of the funds' portfolio securities and the sale of new shares through the mutual fund distribution system, is the practice adopted by the vast majority of the funds of permitting their shareholders to automatically plow the dividend income and capital gains distributions which they receive from the fund back into the fund, thereby acquiring additional shares. This form of shareholder thrift is actively encouraged by the funds, an enthusiasm that is, no doubt, at least partially attributable to the manner in which the investment advisor employed by most mutual funds receives his compensation.

At year end 1965, roughly sixty per cent of the mutual fund industry's total number of shareholder accounts provided for the regular investment of dividend income and reinvestment of capital gains distributions.<sup>111</sup> Although no mutual fund charges its shareholder a sales load on capital gains reinvestment, a sizeable number of the funds indulge in the practice of charging their shareholders a sales load on the dividend income invested.<sup>112</sup> This practice was vigorously criticized by the SEC in its *Public Policy Statement*. Among the imprecations heaped on the mutual funds by the SEC prior to its conclusion that "sales loads on dividend investments generally are neither related to nor justified by any special selling effort"<sup>113</sup> was one drawn by innuendo. Regarding the necessity of such loads to provide the incentive to "sell" mutual fund shareholders on dividend investment programs, the SEC observed that:

A sampling by the Investment Company Institute showed that 52.4 per cent of all dividends were invested in additional fund shares, but that the investment rate for the funds which charged a sales load on such investments was only 29.9 percent.<sup>114</sup>

The clear implication to be drawn from the SEC's observation is that sales loads on dividend investment programs stifle rather than promote the accomplishment of the goal sought — an increase in the fund's total asset value.

### 4. Systematic Purchase Plans

Not all mutual fund shares are sold on a "lump sum" basis. Two different plans, the voluntary accumulation plan and the contractual plan, are currently available to the load fund purchaser which enable him to purchase mutual fund shares systematically.

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111 PUBLIC POLICY STATEMENT 215.

112 *Id.*

113 *Id.* at 216.

114 *Id.*

### a. *Voluntary Accumulation Plans*

By using a voluntary accumulation plan, an investor may purchase mutual fund shares on a regular (commonly monthly) basis, through the fund's normal distribution system. The voluntary plan shareholder pays a sales charge, generally eight and one-half per cent,<sup>115</sup> on each share purchased. In this respect his position is identical to that of the typical lump sum purchaser; indeed, the position of the voluntary plan shareholder in relation to the lump sum purchaser is analogous to that of the bank Christmas Club depositor and the lump sum depositor — both depositors seek the same end, one just goes about it in a more roundabout or, if you will, "systematic" way.

The voluntary accumulation plan has its closed-end counterpart in the Monthly Investment Plan which enables an investor to regularly purchase the shares of those closed-ends listed on the NYSE.<sup>116</sup> The major difference between the two methods of acquiring management investment company shares is that, as pointed out, the brokerage cost on the stock exchange purchase would typically be far lower than the cost of purchasing the mutual fund shares.

### b. *Contractual Plans*

The other type of "plan" method of investing in mutual fund shares is that offered by the so-called "contractual plan." Participation in a contractual plan is achieved by the purchase of a security issued by a unit investment trust (plan company), called a periodic payment plan certificate. The asset structure of the plan company typically varies vastly from that of a mutual fund. Instead of a diversified portfolio of equity securities à la mutual fund, the plan company's assets almost invariably consist of mutual fund shares. Eighty-seven of ninety plan companies operating in 1966 used this arrangement.<sup>117</sup> The three exceptions were companies that invested the proceeds received from the sale of their securities in equal amounts of a preselected and fixed list of equity securities. With these exceptions, the contractual planholder, in substance if not in form, actually holds an interest in the underlying mutual fund.

An investor who purchases a contractual plan undertakes to purchase the plan company's certificates on a regular basis; the ten year, 120 payment plan is the one most commonly utilized.<sup>118</sup> Purchase of the certificate does not result in immediate ownership of the shares issued by the underlying fund — the shareholder has only a beneficial interest in the undivided assets of the plan company which are held in trust for the planholder by a custodian bank. For performing this service, the custodian bank commonly receives two per cent of the amount invested by the planholder.<sup>119</sup> Actual ownership of the shares is not achieved

115 *Id.* at 224.

116 INVESTMENT COMPANIES 1968, at 21 (L. Wessmann ed. 1968).

117 On June 30, 1966, ninety contractual plans were registered with the SEC, and only three operated as "pure unit trusts." PUBLIC POLICY STATEMENT 226 nn. 100, 103.

118 It was noted by the SEC that as of 1966 over two-thirds of the plans adopted this schedule. *Id.* at 227.

119 REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES EXCHANGE COMMISSION, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt. 4, 177 (1963) [hereinafter cited as SPECIAL STUDY IV].

until the certificates are redeemed by the plan company. At that time the planholder is entitled either to cash, or, if he prefers, the shares of the underlying fund equivalent in value to his pro rata interest in the plan company's assets. Since the planholder may present his certificate for redemption at any time he chooses, the description of the arrangement as a "contractual" plan is a misnomer. The planholder is *never* under a binding legal obligation to fulfill his payment schedule.

It is apparent that the plan company-underlying fund relationship is a closely knit one. The intimacy of that relationship is apparent in the manner in which the plan company and the fund impose their fees on the planholders. While the underlying fund charges the plan company a management fee, the plan company does not charge its investors an additional one since, by purchasing the shares of the mutual fund, the plan company has effectively abdicated any management responsibilities upon which it might justify the imposition of such a fee.<sup>120</sup> However, the fund does permit the plan company to purchase its shares at net asset value, *i.e.*, without the imposition of a sales load.<sup>121</sup> As distinguished from a management fee, the plan company does charge its investors a sales load, and it is the type of sales load imposed which is the contractual plan's distinctive feature. The type of sales charge levied on its investors by the plan company is called the "front-end load." The term is descriptive of the practice common among the contractual plans of deducting the major portion of the sales charge to be paid by the planholder over the plan's life — the load — during the early years of the plan's life — the "front-end."

Although the total amount deducted for sales charges over the life of a voluntary plan and a contractual plan is often equal, usually amounting to eight and one-half per cent of the total price paid by the investor, the practice followed by most of the contractual plan companies of deducting one-half of the first thirteen payments made by the planholder for sales charges results in his having considerably less of his net investment "working for him" during the life of the plan than would be had by the lump sum investor or voluntary planholder. In addition to the large front-end load deduction, the contractual plan company's investors must foot the bill for the custodial service rendered by the plan company's trustee bank. The voluntary plan shareholder, on the other hand, deals directly with a mutual fund, and incurs no custodial fee.

The effect of the front-end load and custodian fee charges of the contractual plan is to burden the investor with a risk element and a fee charge that other types of fund investors do not encounter. While there is a "built in" risk element in any type of mutual fund investing — the risk that the value of the share when redeemed will be less than the price paid for it — the front-end load of the contractual plan serves to make that risk more acute by making it not just a function of the fund's performance but also of the shareholder's perseverance. This is so because a planholder who redeems his periodic payment plan certificate immediately after making the first year's payments will normally receive only fifty per cent of the sum he contributed (disregarding any rise or decline in the

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120 PUBLIC POLICY STATEMENT 226.

121 *Id.*

net asset value of his equity interest).<sup>122</sup> In essence, during the first year of the plan's life the planholder pays the contractual plan company's sales machine one dollar for each dollar the plan company invests for him.

Although the sales charge imposed by the contractual plan company does taper off in the plan's later years,<sup>123</sup> it is abundantly clear that the purchase of such a plan entails the substantial risk that an economic emergency may force the planholder to liquidate his holdings early in the plan's life, after a meager equity investment and a strikingly high sales load. The combination of the front-end load with the custodial fee paid annually by the planholder serves to make the contractual plan the most expensive and risk fraught method of acquiring mutual fund shares.

These considerations have led several states to question the utility of the contractual plan as a means of mutual fund investment. Three states, Illinois,<sup>124</sup> Wisconsin,<sup>125</sup> and California,<sup>126</sup> either sharply limit or prohibit the sale of contractual plans within their boundaries.<sup>127</sup> Federal legislation designed to cope with the contractual plan's front-end load is now pending before Congress.<sup>128</sup> The scope and intent of the legislation is discussed in Part IV of this Survey.

#### D. Four Unique Mutual Funds

As the reader has no doubt noticed, the breadth of the mutual fund industry precludes the use of bald assertions. Modifiers such as "most," "nearly all," "commonly," "the vast majority," and "some" are liberally used, substituting

122 The fifty per cent front-end load deduction, the maximum deduction legally permissible under section 27 of the 1940 Act, 15 U.S.C. § 80a-27(a)(2) (1964), was employed by "most" contractual plans analyzed by the SEC in 1966. PUBLIC POLICY STATEMENT 230.

123 As it must, since section 27(a)(1) of the 1940 Act makes it unlawful for any plan company to sell a certificate if "the sales load on such certificate exceeds 9 per centum of the total [scheduled] payments to be made thereon." Investment Company Act of 1940 § 27(a)(1), 15 U.S.C. § 80a-27(a)(1) (1964).

124 ILL. REV. STAT. ch. 121½, § 137.7 D.(2) (1960).

125 Wisconsin's State Department of Securities banned the sale of contractual plans in the State by promulgating Rule 2.03 pursuant to WIS. STAT. ANN. §§ 189.13(3)(a),(b),(e),(f) & 189.13(b). The Director of the State's Department of Securities stated the reason for the ban:

Pursuant to these statutory provisions and our rules, this department has always taken the position that the high commissions involved in front-end load transactions are contrary to public policy and against the public interest and the interest of investors. SPECIAL STUDY 185.

126 See CAL. CORP. CODE § 25508 (West 1955), as amended, CAL. CORP. CODE § 25141 (West. Supp. 1969). Section 25508 permitted the State Commissioner of Corporations to "impose conditions . . . limiting the expense in connection with the sale [of securities]," and the Commissioner utilized that power to ban the sale of contractual plans in California. Apparently the prohibition of the "contractuals" did not adversely affect the sale of mutual fund shares in the state, since the SEC has observed that California leads the nation in mutual funds sales, on both an aggregate and per capita basis. PUBLIC POLICY STATEMENT 225. For the year ended December 31, 1966, mutual fund sales in California amounted to \$55.08 per capita compared with the national average of \$23.08 per capita. 1967 Senate Hearings 530.

127 Ohio recently reversed its position of restricting the sale of contractual plan shares. Compare PUBLIC POLICY STATEMENT 225 with 1967 Senate Hearings 430.

128 S. 34, 91st Cong., 1st Sess. § 16 (1969); S. 296, 91st Cong., 1st Sess. §§ 12(a) & 16 (1969). S. 34 proposes to limit the front-end load by prohibiting a plan company from deducting a sales load of more than twenty per cent during any one year of the plan's life. S. 296 would abolish the front-end load entirely by making it unlawful for a plan company to vary the sales load provision. S. 34 would not change the existing nine per cent sales load ceiling, while S. 296 would repeal it. For a more detailed treatment of the effects of S. 34 and S. 296, see text accompanying notes 854-65 *infra*.

an artistic literary style for substantive accuracy. Still, not all types of mutual funds lend themselves to the generalized treatment so far received by the garden variety fund. For this reason, special attention will now be given to four distinct and fairly new forms of open-end companies: the tax free exchange funds, the go-go funds, the variable annuity plans, and the fund holding companies or "super funds."

### 1. The Tax Free Exchange Funds

The first tax free exchange fund or "swap" fund was organized in 1959,<sup>129</sup> and began offering its shares publicly in 1960.<sup>130</sup> The swap funds were unique because they exchanged their shares with investors in return for marketable securities rather than selling them for cash.<sup>131</sup> In order to "swap into" the fund, an investor had to tender securities worth a certain market value, commonly \$25,000, that were acceptable to the fund's management. In return the investor received an equivalent value of the fund's shares, less, of course, a sales load.

The swap fund's unique advantage as an investment vehicle was that it offered an investor the opportunity to diversify his portfolio holdings by swapping his block of securities for a slice of the fund's potpourri of castoffs (and stocks bought on the market by the fund), without realizing an immediately taxable capital gain. This delayed capital gains tax aspect found much favor among those who could meet the \$25,000 minimum entrance requirement, and by mid-1966 the more than twenty swap funds then in operation held assets of roughly \$750 million.<sup>132</sup>

In 1966, Congress recognized the swap fund scheme for what it was — the exploitation of a tax loophole that enabled the more affluent American investor to dispose of his securities without paying a capital gains tax. Accordingly, legislation in the form of section 203 of the Foreign Investors Tax Act of 1966<sup>133</sup> was enacted to plug the loophole. The effect of the section was to bar the formation of new swap funds, and to prospectively strip the existing funds of their delayed capital gains feature, making them, in one commentator's words "of only historical interest,"<sup>134</sup> except to those investors who held swap fund shares prior to the effective date specified in the Act, May 1, 1967.

### 2. Funds à Go-Go

The ill-starred swap fund has its antithesis in what have become known as the go-go funds. Seeking to provide their shareholders with a feisty performance by attempting to capitalize on short-term market movements, the go-go funds

129 SEC, *supra* note 96, at 5.

130 BUSINESS WEEK, Jan. 19, 1963, at 97.

131 For a discussion of the rise of the swap fund industry and the advisability of the law drafted to eliminate them, see Shechtman, *Economic and Equity Implications of the Recent Legislation Concerning Swap Funds*, 45 TAXES 550 (1967).

132 *Id.* at 553.

133 Foreign Investors Tax Act of 1966 § 203, 80 Stat. 1539, 26 U.S.C. § 351 (Supp. III 1967).

134 INVESTMENT COMPANIES 1967, at 96 (L. Wessmann ed. 1967).

aim for investment in stocks with capital appreciation possibilities. Of course, investment in this type of stock involves a greater than average risk element. The go-go's emphasis on short-term market fluctuation results in its most distinctive feature—abnormally high portfolio turnover rates.<sup>135</sup> While the average mutual fund “turns over” about forty per cent of its portfolio annually,<sup>136</sup> it is not uncommon for a go-go to achieve a turnover rate of ten per cent *per month*.<sup>137</sup> Indeed, one fund with assets of about \$600 million was recently noted to be trading at the monthly rate of roughly \$100 million.<sup>138</sup>

While the objectives of the go-go funds are both clear and noble, their manner of achieving them has been questioned both from within and outside the mutual fund industry. Specifically bothersome to many is the rise of the “performance cult,” a relatively new phenomenon caused by investors vicariously speculating in the stock market by purchasing the go-gos' shares. One mutual fund executive, David L. Babson, made his views on the rise of the performance cult known when, speaking at the First Annual Institutional Investors Convention, he said:

I firmly believe that those of you who have joined this performance cult, first, are responsible indirectly, if you aren't responsible directly, for the speculative orgy which is sweeping the country, particularly among un-knowledgeable investors.

And, second you are following a policy that may disrupt the whole economy and which is sure to win no Brownie points for institutional investors in the long run.

When, on average, mutual funds churn their holdings at an annual rate of 40 percent and some turn them two or three or four times faster than the average, when even pension funds shift their assets at 20 percent a year, can anyone seriously call this investing? In plain language, the securities markets are being turned into a gigantic crap game. Yet, here we are, hundreds of experienced and responsible portfolio managers, euphemistically discussing what is going on as investment performance.<sup>139</sup>

Concern over the rapid growth of mutual funds and other institutional investors, as well as doubts regarding the efficacy of the trading practices alluded to above, led to the enactment during the Ninetieth Congress of Public Law 90-438 which amended the Securities Exchange Act of 1934.<sup>140</sup> Public Law 90-438 amends section 19 of the 1934 Act and authorizes and directs the SEC

135 The portfolio turnover rate is determined by comparing the average value of the securities owned by the fund over a period of time with the dollar volume of market trading in which it engaged over the same span.

136 114 CONG. REC. H6736 (daily ed. July 16, 1968).

137 See Louis, *Those Go-Go Funds May Be Going Nowhere*, FORTUNE, Nov. 1967, at 143.

138 *Id.* As the following table shows, the portfolio turnover rate for the mutual fund industry has been on the upswing:

Year	1957*	1964**	1965**	1966*	1967*
Portfolio Turnover Ratio (Per cent)	13.9	16.6	19.2	30.8	38.7

\* 114 CONG. REC. H6736 (daily ed. July 16, 1968).

\*\* PUBLIC POLICY STATEMENT 304 n.67. (Average of quarterly turnover rates listed therein.)

139 Statement of David L. Babson, OFFICIAL PROCEEDINGS, FIRST ANNUAL INSTITUTIONAL INVESTORS CONFERENCE 87-88 (1968).

140 Securities Exchange Act of 1934 § 19(e)(1), 15 U.S.C.A. § 78s(e)(1) (Supp. 1969).

to make a study and investigation of the purchase, sale, and holding of securities by institutional investors of all types (including . . . mutual funds . . .) in order to determine the effect of such purchases, sales, and holdings upon (A) the maintenance of fair and orderly securities markets, (B) the stability of such markets, both in general and for individual securities, (C) the interests of the issuers of such securities, and (D) the interests of the public, in order that the Congress may determine what measures, if any, may be necessary and appropriate in the public interest and for the protection of investors.<sup>141</sup>

While the results of the SEC's study have not as yet been reported to Congress, it may be surmised that the rise of the performance cult, as exemplified in the mutual fund industry by the go-go funds, will receive a healthy measure of scrutiny.

### 3. The Variable Annuity Plans

The insurance industry's rejoinder to the mutual fund is a unique form of investment company called the variable annuity plan.<sup>142</sup> Participation in the fund-style variable annuity plan involves the purchase by the annuitant, not of mutual fund shares or periodic payment plan certificates, but of "units" which represent an undivided interest in the plan company's assets which are held primarily in the form of securities. The value of these units fluctuates with the market value of the plan company's portfolio securities. Although an investor who purchases such a variable annuity plan receives an undivided interest in a portfolio of diversified securities, similar to a mutual fund investor, the imposition of the sales commission common to the plans closely resembles the front-end load of the contractual plan style of mutual fund investment.

Like the contractual planholder who endeavors to purchase periodic payment plan certificates for a specified period of time, the annuitant engages in the systematic acquisition of units during a predetermined span of years (the "pay-in period"). The maturity date of the plan marks the termination of the pay-in period, and a computation is then made of the asset value of the accumulated units purchased by the planholder. Another computation is made at that time based on the units' ascertained asset value and the use of a standard annuity table (including a specified interest assumption) to determine the dollar amount due the planholder for the first pay-out period. The dollar amount thus derived is divided into the total asset value of the equity interest amassed by the planholder during the pay-in period. The quotient obtained from that calculation represents the number of units from which income is to be systematically paid to the annuitant by the plan company. Since the pay-out units represent an undivided interest in the plan company's pool of securities, which have a fluctuating market value, the fact that the number of units to be paid out is fixed at the plan's maturity date will have the effect of causing a fluctuation in the proceeds received by the planholder. It is this gyration in the value of the annuitant's maturity

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141 *Id.*

142 For a treatment of the insurance industry's entry into the mutual fund industry, see text accompanying notes 946-1005 *infra*.

interest which differentiates the variable annuity plan from the typical insurance annuity program, and makes it comparable to the ownership of an investment company's security.<sup>143</sup> If he chooses, the annuitant may liquidate his equity interest in the plan company's portfolio securities represented by the number of units he has accumulated. Upon redemption he is entitled to receive the approximate net asset value of the units tendered, subject to a surrender fee levied if redemption occurs during the plan's early years. In addition to the plan's front-end load, the planholder is also assessed an annual management fee, inevitable in any form of mutual fund investment.<sup>144</sup>

Despite the obvious similarities between the variable annuity plan and the conventional mutual fund, there was until recently some doubt whether the variable annuity plan was indeed an investment company within the meaning of the 1940 Act, and hence subject to the Act's regulatory provisions. The reason for the uncertainty centered on section 3 of the Act which defines an investment company.<sup>145</sup> According to that section, an investment company is, *inter alia*, any issuer which "proposes to engage primarily, in the business of investing, reinvesting, or trading in securities . . ." <sup>146</sup> While that definition would arguably be broad enough to encompass an insurance company that issues units in a variable annuity plan, it is qualified by subsection (c)(3) which excludes "[a]ny . . . insurance company"<sup>147</sup> from the Act's coverage. An insurance company within the purview of the Act is any

company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; or any receiver or similar official or any liquidating agent for such a company, in his capacity as such.<sup>148</sup>

The availability of the section 3(c)(3) exclusion to insurance companies issuing variable annuity plans was tested in *Prudential Insurance Company of America v. SEC*.<sup>149</sup> While few organizations in the United States would seem capable of fulfilling the Act's definition of an insurance company as ably as Prudential, the Third Circuit adopted the "ectoplasmic theory"<sup>150</sup> and held that the issuer of the variable annuity contracts written by Prudential was required to register as an investment company under the Act.

The "ectoplasmic theory," which, noted one financier, "must be a source

143 For discussions of the operational characteristics of the variable annuity plans, see *SEC v. Variable Annuity Life Ins. Co. of America*, 359 U.S. 65, 72 n.14 (1959); 1 L. Loss, *SECURITIES REGULATION* 498-99 (1961).

144 See *SEC v. Variable Annuity Life Ins. Co. of America*, 359 U.S. 65, 82-84 (1968), for a discussion of the loads and fees charged in connection with the purchase of one company's plan.

145 Investment Company Act of 1940 § 3, 15 U.S.C. § 80a-3 (1964). For a brief discussion of that section, see notes 25 & 27 *supra*.

146 *Id.* § 3(a)(1), 15 U.S.C. § 80a-3(a)(1) (1964).

147 *Id.* § 3(c)(3), 15 U.S.C. § 80a-3(c)(3) (1964).

148 *Id.* § 2(17), 15 U.S.C. § 80a-2(17) (1964).

149 326 F.2d 383 (3d Cir.), *cert. denied*, 377 U.S. 953 (1964).

150 The term "ectoplasmic" relates to the ethereal phenomenon whereby movement in an object is effected by an outside source without physical contact. See *WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY* 721 (1961).



of constant joy to those whose wit conceived it,<sup>151</sup> follows the practice of ignoring the corporate identity. Under the theory, the operation of the investment fund is completely independent of the insurance company's normal operation — writing insurance. The SEC argued that since the interest of the planholder is limited solely to his interest in the investment fund, an account "completely separate" from the company's regular insurance accounts, it is the ectoplasmic fund and not the insurance company that issues the variable annuity plan's units. The court wholeheartedly agreed with the SEC's position:

As the Commission observed, "Prudential would in fact be the writer of the *contracts* — the insurance and annuity promises and the obligation to set up the investment fund. But the investment fund, the 'company' to which the investment interests relate, is the 'issuer' of those interests."<sup>152</sup>

While the upshot of the *Prudential* decision was to require the registration of variable annuity plans in accordance with the 1940 Act, that requirement has certainly not stifled the propagation of such plans by insurance companies. During the period between June 30, 1967 and June 30, 1968, the number of variable annuity plans registered as open-end companies under the Act nearly doubled, accounting for over ten per cent of all mutual fund registrations during that year. The entry of the life insurance companies into the equity investment arena via the mutual fund route moved one commentator to gush: "It's as if the Pope had *endorsed* the pill[!]"<sup>153</sup> Surprising or not, the variable annuities promise to give the more conventional mutual funds some healthy competition for the investor's dollar in the years to come.

#### 4. The Super Funds

The development of "super funds" — the mutual funds that furnish professional management of a diversified portfolio of *mutual fund shares* — was inevitable. Making their appearance in the early 1960's,<sup>154</sup> the super funds, referred to legislatively as fund holding companies, were apparently spawned as a result of the rapid propagation of mutual funds and the ability of some members of a class of funds having homogeneous investment objectives to outperform others.<sup>155</sup> The theory underlying the super fund seems to be that if the diversification offered by the ownership of a share in one mutual fund is good, then multiplication of that diversification by holding a variety of mutual fund shares *must* be better. Added to that viewpoint is the argument that the rapid proliferation

151 Testimony of Robert D. Ferguson, Executive Vice President, Pittsburgh National Bank, *Hearings on S. 2704 Before a Subcomm. of the Senate Banking and Currency Comm.* 89th Cong., 2d Sess. 34 (1966).

152 326 F.2d 383, 388 (3d Cir. 1964).

153 Sheehan, *Life Insurance's Almighty Leap into Equities*, *FORTUNE*, Oct. 1968, at 142.

154 See PUBLIC POLICY STATEMENT 311-12.

155 During 1968 the change in the net asset value per share of twenty-two mutual funds—each of which had total assets in excess of \$300 million and stressed capital appreciation as its investment objective—varied greatly. Assuming reinvestment of capital gains, a share in Enterprise Fund would have increased 44.3 per cent in net asset value during 1968, while an investment in another of the twenty-two funds, IVEST, would have resulted in a decrease in net asset value per share of 2.2 per cent. INVESTMENT COMPANIES 1968 (L. Wessmann ed. Supp. Dec. 31, 1968).

of new funds, more than one hundred in fiscal 1968 alone,<sup>156</sup> makes it difficult, if not impossible, for the average investor to predict the basket in which his eggs will best multiply. In short, the super funds seem to be designed to take the "guesswork" out of mutual fund investing.

The largest super fund, Fund of Funds, Ltd., is headquartered in Geneva, Switzerland and incorporated in Ontario, Canada. On December 31, 1967, Fund of Funds had assets of approximately \$620 million.<sup>157</sup> Like many super funds, it is organized as a foreign investment company, and as such it is not required to register under the Investment Company Act of 1940.<sup>158</sup> The ability of the foreign super funds to avoid regulation under the 1940 Act has the important consequence of enabling them to achieve unlimited ownership of the shares issued by domestic mutual funds. Such freedom is denied regulated companies by section 12(d)(1) of the Act which provides that a registered investment company cannot own more than five per cent of the total outstanding voting stock of any other investment company which concentrates its investments in a particular industry or group of industries, or more than three per cent of the total outstanding voting stock of any other investment company.<sup>159</sup> As a result of its ability to avoid the section 12(d)(1) limitations, Fund of Funds, on December 31, 1967, held thirty per cent of the outstanding voting stock of Fund of America, a domestic mutual fund registered under the 1940 Act.<sup>160</sup> The 12(d)(1) requirement has not, however, prevented the birth of American super funds. Two such funds, First Multifund of America, Inc. (formerly First American Fund of Funds, Inc.), and Pooled Funds, Inc., registered under the Act in 1967, and had total net assets of \$1.1 and \$.1 million respectively on June 30, 1968.<sup>161</sup>

The growth of super funds has been closely watched by the SEC. In its *Public Policy Statement* the SEC examined the utility of the function performed by the super funds, the value of that function to their shareholders, and the effects which the concentration of mutual fund shares in the super funds' portfolios might have on the portfolio funds, their shareholders, and the securities markets generally. The SEC concluded:

1. Investment in a super fund subjects the investor to double management and administrative fees — those charged by the super fund and those levied by the portfolio fund on their shareholders — and, with the exception of the no-load super funds, the chance of a double sales load.<sup>162</sup>

156 See 34 SEC ANN. REP. 114 (1968).

157 The actual figure was \$617,798,800.00. The authorities are not agreed whether the sum reflects Canadian or American dollars. Compare MOODY'S BANK AND FINANCE MANUAL, April 1968, at a54 (F. St. Clair ed. 1968) (Canadian) with INVESTMENT COMPANIES 1968 389 (L. Wessmann ed. 1968) (American).

158 The registration provisions of the Act apply only to companies "organized or otherwise created under the laws of the United States or of a State . . ." Investment Company Act of 1940 § 7, 15 U.S.C. § 80a-7 (1964). Among the other foreign super funds in existence in 1966 were: Capital Growth Fund (Bahamas); Capital Security Fund (Bahamas); North American Investment Fund N.V. (Netherlands Antilles); Selected American Funds Enterprise (Luxembourg). PUBLIC POLICY STATEMENT 312 n.20.

159 Investment Company Act of 1940 § 12(d)(1), 15 U.S.C. § 80a-12(d)(1) (1964).

160 INVESTMENT COMPANIES 1968 197 (L. Wessmann ed. 1968).

161 NUVEEN CORP., MUTUAL FUNDS PANORAMA (1968).

162 PUBLIC POLICY STATEMENT 318-20.

2. The value of the diversification advantage to the investor does not outweigh the increased cost, since: "To argue that diversification of investments is effected through the medium of the subsidiary is merely to question the necessity for the holding company."<sup>163</sup>

3. Most importantly, the unlimited power of foreign super funds to buy mutual fund shares, coupled with the combined power of domestic super funds to concentrate their holdings, could result in a demand by the super funds that a particular portfolio fund redeem a huge block of its shares, causing the portfolio fund to liquidate its holdings at possibly unfavorable prices — to the damage of its remaining shareholders and, not inconceivably, the market generally.<sup>164</sup> This problem is particularly acute in the case of the foreign super funds which, as noted, are presently permitted to concentrate their holdings in whatever companies they choose, without any form of restriction. This unlimited concentration of control could well result in dire consequences for domestic portfolio funds if, for instance, a foreign monetary crisis made it expedient for the foreign super funds to convert their equity holdings to cash.

The SEC's recommendation made at the conclusion of its analysis of the value of the super funds to the American investor was unequivocal: "The Commission . . . recommends that section 12(d)(1) of the Act be amended so as to prevent the creation and operation of fund holding companies."<sup>165</sup>

The Commission's proposal was legislatively adopted in three identical bills, S. 1659,<sup>166</sup> H.R. 9510,<sup>167</sup> and H.R. 9511,<sup>168</sup> which were introduced before the Ninetieth Congress on May 1, 1967. The provision in those bills that would have prevented "the creation and operation of [super funds]"<sup>169</sup> was opposed by Mr. Milton Mound, one of the domestic super fund's representatives, at both the Senate and House hearings on the bills. At the House hearings he argued:

If Congress should accede to [the] SEC's demand for prohibition — it is not unlikely [that] this law will be cited in the future as a precedent for prohibiting the sale of cigarettes, wines, liquors and oleo; and also all services which some regulatory agency believes are not worth the prices charged, as for example; tickets to football games, theatre, opera, ladies' beauticians, dress designers, etc.<sup>170</sup>

Whether Congress was swayed by such ineluctable augury is indeterminable; however, the provision was altered in the amended version of those bills,

163 *Id.* at 320. The Commission was quoting with approval a statement made in the text of a previous SEC report regarding the justification for pyramided capital structures in the investment company industry. See INVESTMENT TRUSTS III 2730. The pre-Act practice of pyramiding is discussed at text accompanying notes 300-08 *infra*.

164 PUBLIC POLICY STATEMENT 314-18.

165 *Id.* at 323.

166 S. 1659, 90th Cong., 1st Sess. § 7 (1967).

167 H.R. 9510, 90th Cong., 1st Sess. § 7 (1967).

168 H.R. 9511, 90th Cong., 1st Sess. § 7 (1967).

169 PUBLIC POLICY STATEMENT 323.

170 Testimony of Milton Mound, 1967 *House Hearings* 388. For Mr. Mound's testimony before the Senate Committee which studied proposed legislation see 1967 *Senate Hearings* 882-85.

S. 3724,<sup>171</sup> to permit registered super funds that charge a sales load of one and one-half per cent or less to remain in operation provided they limit their holdings in the assets of other investment companies to no more than three per cent of such other companies' outstanding voting stock. S. 3724 would also have prohibited any *unregistered* investment company from investing more than ten per cent of its assets in the outstanding voting stock of any *registered* investment company, and any *registered* investment company from holding as assets more than ten per cent of the outstanding voting stock of *any other* investment company.<sup>172</sup>

The net effect of the alteration made in S. 3724 to the SEC's original proposal would have been to allow the domestic super funds, First Multifund of America, Inc., and Pooled Funds, Inc., to remain in operation, subject to the three per cent diversification limitation,<sup>173</sup> while forcing Fund of Funds, Ltd., to elect between registering under the Act, thereby subjecting itself to the Act's expansive regulatory provisions *and* reducing its maximum sales load, presently eight and one-half per cent<sup>174</sup> to a less lucrative three per cent, *or* limiting its holdings in registered investment companies to ten per cent of its total assets. With the exception of the "low or no-load" super funds which registered with the SEC under the 1940 Act, the S. 3724 proposal would effectively stymie the formation and growth of the super funds.

Although S. 3724 was passed by the Senate on August 26, 1968, the bill never reached the floor of the House and hence was not enacted during the Ninetieth Congress. Its provisions are nonetheless of extreme current importance, because two bills now pending before Congress<sup>175</sup> have incorporated S. 3724's super fund provisions in toto.<sup>176</sup>

In view of the obvious validity of the SEC's criticisms of the super fund

171 S. 3724, 90th Cong., 2d Sess. § 7 (1968).

172 *Id.*

173 This is so because Pooled Funds, Inc., is a no-load fund, and First Multifund of America, Inc., charges a maximum sales load of one and one-half per cent. *See* NUVEEN CORP., *supra* note 161. For the text of a proposed amendment to S. 1659, H.R. 9510, and H.R. 9511 which was designed to permit First Multifund and Pooled Funds to remain in operation, see 1967 *House Hearings* 398. The proposal was submitted on behalf of First Multifund and was incorporated (with a few slight variations) into S. 3724.

174 *See* PUBLIC POLICY STATEMENT 319 n.35.

175 S. 34, 91st Cong., 1st Sess. § 7 (1969); S. 296, 91st Cong., 1st Sess. § 7 (1969).

176 By adopting verbatim the super fund provisions in section 7 of S. 3724, the pending bills incorporated a typographical error that became engrafted onto the copied section of the older bill between the time that the bill was reported from the Senate's Banking and Currency Committee and its post-passage referral to the House Committee on Interstate and Foreign Commerce. As reported from the Senate Committee, the initial clause of the section read: "Section 12(d) of the Investment Company Act of 1940 (15 U.S.C. 80a-12.(d)) is amended to read as follows . . ." S. 3724, 90th Cong., 2d Sess. § 7 (1968) (as reported from the Senate's Banking and Currency Committee, July 1, 1968). The attested version of the bill after Senate passage reads slightly differently: "Section 12(b) [*sic*] of the Investment Company Act of 1940 (15 U.S.C. 80a-12.(d)) is amended to read as follows . . ." S. 3724, 90th Cong., 2d Sess. § 7 (1968) (as referred to the House Committee on Interstate and Foreign Commerce, July 29, 1968).

On March 13, 1969, Congressman Stuckey introduced H.R. 8980 in the House of Representatives. 115 CONG. REC. H1764 (daily ed. March 13, 1969). Like the two pending Senate bills, H.R. 8980 deals with the regulation of the mutual fund industry and has a section designed to cope with the super funds. *See*, H.R. 8980, 91st Cong., 1st Sess. § 7 (1969). Unlike S. 34 and S. 296, however, the super fund provisions in the House bill differ slightly from those of S. 3724. Nonetheless, the typographical error discussed above is repeated in Congressman Stuckey's bill. The substantive provisions of H.R. 8980, including those dealing with the super funds, are discussed in Appendix C *infra*.

concept there seems to be no reason, other than one founded upon purely political motives, for the preferential treatment accorded to the low or no-load funds under the proposed regulatory framework designed to cope with the super funds. Still, it is the foreign super funds that present the most serious threat to the fiscal stability of the domestic mutual funds, their shareholders, and our securities markets. In this respect the proposed amendment represents a significant advance, since it introduces a modicum of regulation designed to protect the investing public from the unbridled use of power wielded by an alien interest group.

At present, except for a recent decision<sup>177</sup> that holds the foreign super funds subject to the short-swing profits limitation in section 16 of the Securities Exchange Act of 1934,<sup>178</sup> the might of the foreign super funds is unchecked. The view expressed by the SEC, after careful deliberation, is that remedial legislation is needed.<sup>179</sup> If the needed regulatory legislation is not soon in forthcoming, can the super-super funds be far behind?

### III. The Development of the Investment Company Industry

#### A. Introduction

The major emphasis of the preceding discussion centered on the functional characteristics of management investment companies, particularly mutual funds. This Part is devoted to a perusal of the developmental stages of investment company growth in the United States, from the relative infancy of the industry prior to 1921 through the passage of the Investment Company Act of 1940.<sup>180</sup>

The Anno Domini period of the investment company industry's development began with the enactment of the Investment Company Act of 1940. Because the Act stands as a bench mark — a reflection of all that preceded it and a mold that casts the shape of the industry which now operates under it — a brief discussion of the Act's background and philosophy will be helpful in adding perspective to the study that follows.

The Act's philosophy was shaped by the climate in which it was drafted and the industry's ills it was crafted to cure. It would not be an overstatement to say that the attitude of Congress toward the investment company industry during the period when the need for legislation was being considered was one of restrained hostility, and the tenor of the resultant legislation mirrors that disaffection. For instance, section 17(h) of the Act makes a nullity of any exculpatory clauses used by an investment company's directors or officers to

177 Roth v. Fund of Funds, Ltd., 405 F.2d 421 (2d Cir. 1968), *cert. denied*, 37 U.S.L.W. 3395 (U.S. April 22, 1969) (No. 1122). Roth was a derivative suit brought on behalf of Dreyfus Corp., a mutual fund investment advisor whose shares are traded on the NYSE.

178 Securities Exchange Act of 1934 § 16, 15 U.S.C. § 78p (1964). That section, in relevant part, provides that

any profit realized by [the beneficial owner of more than ten per cent of the outstanding shares of the issuer] from any purchase and sale . . . of any equity securities of such issuer . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer, irrespective of the intention on the part of such beneficial owner . . . .

179 See text accompanying note 165 *supra*.

180 Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -52 (1964).

avoid liability in cases of "willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of [their] office."<sup>181</sup>

The inclusion of such a provision was manifestly not the result of mere congressional hyperzealousness. As will be seen, the organizational structures adopted and the management practices followed by some of the less scrupulous operators in the industry during the "boom years" that preceded the depression provide an instructive insight into man's ability to flimflam his fellow man. Terms such as "looter," "embezzler," "maladministrator," and "predatory promoter" were used to describe such people.<sup>182</sup> The American public contributed roughly \$7 billion to the pre-Act industry<sup>183</sup> and incurred a capital shrinkage, over and above the effects of the crash, of "at least \$1,100,000,000 . . . attributable to mismanagement, looting, or improper actions of managements in their own interest to the detriment of shareholders."<sup>184</sup>

Alarm over the possibility of management malfeasance among the members of the investment company industry was officially registered when Congress enacted the Public Utility Holding Company Act of 1935.<sup>185</sup> In the course of the investigations and hearings which preceded that Act, concern was expressed that the financial malpractice prevalent among the holding companies in the electrical and retail gas industries might also exist in the investment company industry.<sup>186</sup> Accordingly, section 30 of the 1935 Act authorized and directed the SEC

to make a study of the functions and activities of investment . . . companies, the corporate structures, and investment policies of such . . . companies, the influence exerted by such . . . companies upon companies in which they are interested, and the influence exerted by interests affiliated with the management of such . . . companies upon their investment policies, and to report the results of its study and its recommendations to the Congress on or before January 4, 1937.<sup>187</sup>

The study made by the SEC in compliance with that directive was extensive. The record of the hearings conducted by the SEC consists of 33,000 pages of testimony and 4,800 exhibits.<sup>188</sup> The Commission's report to Congress was submitted in five parts<sup>189</sup> over the span of three years, and it was supplemented by six additional reports.<sup>190</sup> Part Three of the SEC's report was entitled *Abuses and*

181 *Id.* § 17(h), 15 U.S.C. § 80a-17(h) (1964).

182 *See, e.g., 1940 Senate Hearings* 61-66, 332, 334; Note, *The Investment Company Act of 1940*, 50 *YALE L.J.* 440, 451 (1941).

183 S. REP. NO. 1775, 76th Cong., 3d Sess. 3 (1940).

184 *1940 Senate Hearings* 797.

185 Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (1964).

186 PUBLIC POLICY STATEMENT 64.

187 Public Utility Holding Company Act of 1935 § 30, 15 U.S.C. § 79z-4 (1964).

188 S. REP. NO. 1775, 76th Cong., 3d Sess. 5 (1940).

189 SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, (Part One), H.R. DOC. NO. 707, 75th Cong., 3d Sess. (1938) [hereinafter cited as INVESTMENT TRUSTS I]; INVESTMENT TRUSTS II, *supra* note 45; INVESTMENT TRUSTS III, *supra* note 4; SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES PARTS FOUR AND FIVE, H.R. DOC. NO. 246, 77th Cong., 1st Sess. (1941).

190 SEC, INVESTMENT TRUSTS IN GREAT BRITAIN, H.R. DOC. NO. 380, 75th Cong., 3d Sess. (1939) [hereinafter cited as BRITISH INVESTMENT TRUSTS]; SEC, INVESTMENT COUNSEL, INVESTMENT MANAGEMENT, INVESTMENT SUPERVISORY AND INVESTMENT ADVISORY SERVICES, H.R. DOC. NO. 477, 76th Cong., 2d Sess. (1939); SEC, COMMINGLED OR COMMON TRUST FUNDS ADMINISTERED BY BANKS AND TRUST COMPANIES, H.R. DOC. NO. 476,

*Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies.* It is a very thick volume.

So comprehensive was the Commission's report that Parts Four and Five were not submitted to Congress until June 9, 1941, nearly one year after the 1940 Act became law and more than four years beyond the deadline stipulated in section 30 of the 1935 Act.<sup>191</sup> Perhaps the major reason for the delay in the report's publication was that "there was no ultimate scarcity of examples of shocking abuses"<sup>192</sup> of the use of managerial discretion by a segment of the industry's entrepreneurial factions, some of the worst of which occurred while the report was being prepared. Said one SEC official: "I thought every day, 'Thank God, I am through with hearings,' and then I would get a telephone call. Somebody was looting another investment trust by some other method, and we had to start all over again."<sup>193</sup>

The Act was drafted with such malfeasances in mind. Senator Robert Wagner, who was instrumental in securing the passage of the 1940 Act, left little doubt concerning its intent: "All of this legislation . . . is because of abuses that exist by reason of irresponsible operators, and it is those abuses that we want to prevent."<sup>194</sup> The investment company industry, matured and newly aware of its duty to the American investor, worked diligently with the SEC in drafting the legislation, and strongly endorsed the final product.<sup>195</sup> Congressional passage of the bill was achieved with virtually no debate, a feat which one commentator noted was probably without precedent for so comprehensive a piece of legislation.<sup>196</sup>

The philosophy of the Act differs markedly from that expounded in the Securities Act of 1933,<sup>197</sup> and in the Securities Exchange Act of 1934.<sup>198</sup> Those Acts are primarily disclosure statutes, founded upon the premise set forth by Louis D. Brandeis in his book *Other People's Money* that "[p]ublicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."<sup>199</sup> The need for *regulatory* rather than disclosure-oriented legislation was noted by SEC counsel Schenker when testifying before the subcommittee of the Senate Banking and Currency Committee that was considering the merits of the proposed legislation. Referring to Brandeis's famous quote, he said: "[T]here is no greater

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76th Cong., 2nd Sess. (1939); SEC, COMPANIES SPONSORING INSTALLMENT INVESTMENT PLANS, H.R. DOC. NO. 482, 76th Cong., 2d Sess. (1939) [hereinafter cited as *INSTALLMENT PLAN STUDY*]; SEC, FIXED AND SEMI-FIXED INVESTMENT TRUSTS, H.R. DOC. NO. 567, 76th Cong., 3d Sess. (1940); COMPANIES ISSUING FACE AMOUNT INSTALLMENT CERTIFICATES, H.R. DOC. NO. 659, 76th Cong., 3d Sess. (1940).

191 See text accompanying note 187 *supra*.

192 1940 Senate Hearings 40.

193 *Id.* at 53. See also *id.* at 38.

194 *Id.* at 661-62.

195 H.R. REP. NO. 2639, 76th Cong., 3rd Sess. 5 (1940).

196 This viewpoint was taken by Alfred Jaretzki, Jr., who served as counsel to the investment company industry's representatives during the congressional hearings and the negotiations with the SEC concerning the Act's substantive provisions. Jaretzki, *The Investment Company Act of 1940*, WASH. U.L.Q. 303, 310-11 (1941). For an overview of the genesis of the 1940 Act, see North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME LAWYER 677 (1969).

197 Securities Act of 1933, 15 U.S.C. §§ 77a-aa (1964).

198 Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-jj (1964).

199 L. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* 93 (1914).

believer in the prophylactic effect of sunlight than I am; but the unfortunate thing is that unless there is an agency that goes in with a flashlight, the stockholder never gets the publicity."<sup>200</sup> The regulatory nature of the 1940 Act gave the SEC the flashlight it needed.

The primary concentration of the discussion which follows will be focused on the malpractices once prevalent in the investment company industry which the 1940 Act was drafted to cure, the way the Act dealt with those problems, and the effect that the Act's passage has had on the industry. Those evils and abuses were not hatched on moonless nights in dark places, nor did they affect all investment companies. They were rather the result of a largely unregulated evolutionary development which saw what was a handful of relatively small, heterogeneous enterprises burgeon into a full-fledged industry within the space of ten years.

Accordingly, the next topic of discussion will be the first stage of the investment company industry's development, the period prior to 1921.

### *B. Stage One — The Pre-1921 Industry*

#### 1. The Alexander Fund

Of the forty enterprises determined by the SEC to be investment companies that did business during the pre-1921 period of the investment company industry's development,<sup>201</sup> only a few bore any resemblance to the modern diversified management investment company that now dominates the industry. Indeed, the SEC noted that the origin and growth of that small, dissimilar agglomeration of early investment companies was "to a large extent fortuitous or often the result of motives little related to the concept of an independent financial vehicle intended to offer to the general public participation in the ownership of a diversified portfolio of securities."<sup>202</sup> For example, it has been theorized that the Boston Personal Property Trust, founded in 1893, and now registered as a mutual fund,<sup>203</sup> was organized not as an investment company, but as a device whereby the original trustees evaded a Massachusetts restriction on corporate real estate holdings.<sup>204</sup>

Another management-type investment company, the Alexander Fund, was established in 1907, when three individuals entrusted a total of \$1,200.00 to a Mr. W. Wallace Alexander. Since each of the individuals who made capital contributions was ignorant of the participation of the others, it would appear

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200 1940 Senate Hearings 259. See also text accompanying notes 347-69 *infra*.

201 INVESTMENT TRUSTS I 42.

202 *Id.* at 113.

203 The company was founded as a trust and was operated as a closed-end company until January 23, 1967, when its shares became redeemable at net asset value, less a redemption fee of \$8 per redemption or two per cent of asset value, whichever is less. On that date the presence of redeemable securities in its capital structure caused the Trust to become a mutual fund. See INVESTMENT COMPANIES 1968 368 (L. Wessmann ed. 1968).

204 H. BULLOCK, *supra* note 4, at 15. Mr. Bullock did not cite a Massachusetts statute to support the hypothesis. He was probably referring to MASS. GEN. LAWS ch. 106, § 23 (1882), which prohibited corporations from conveying or mortgaging real estate, or executing leases of more than a one year duration, "unless authorized by a vote of the stockholders at a meeting called for the purpose."



that Mr. Alexander's son was correct when, referring to the establishment of the fund, he said, "[i]ts founding was largely, shall I say, by chance."<sup>205</sup>

The significance of the Alexander Fund for the purpose of this discussion lies not, however, in its charmingly fortuitous conception or its admittedly informal method of operation, which led one author to characterize the fund as "a one-man organization."<sup>206</sup> Rather, the fund is important since it was the prototype mutual fund, the initial, though unwitting, venture in what was to evolve into a \$55 billion industry.

Not a corporation, association, or trust, the Alexander Fund was merely a descriptive name given to the commingled funds pooled by the group of persons who employed Mr. Alexander, and later his corporate successor, as their agent for the purpose of investing and managing their money. From its coincidental origin the fund grew steadily, if not spectacularly, and by early 1928, its 883 shareholders had a combined equity interest in excess of \$2.6 million.<sup>207</sup> Despite its increased size, the fund still retained an air of informality, leading one author to describe it as "the investment trust in its simplest or most primitive form."<sup>208</sup>

The "mutual fund-like" nature of the Alexander Fund flowed from its possession of that singular characteristic common to all mutual funds—the redeemable security. The fund issued securities called "units" to its shareholders. The units were engraved receipts, similar in form to stock certificates, which entitled the holder to "the asset or liquidating value for [his share], less 10 per cent of any increment of such asset value over the original cost of [the share]"<sup>209</sup> when he chose to withdraw from the fund by presenting his security for redemption. The ten per cent redemption fee, or, if you will, the "rear-end load," charged by the fund on the capital appreciation of the shareholder's unit, was paid to Mr. Alexander and, later, his corporate successor. The rear-end load supplemented the annual management fee charged the unit-holder, which amounted to ten per cent of the fund's distributions to its shareholders, whether in the form of income or a return of capital.

It has been noted by one author that the Alexander Fund "had definite characteristics of the unit trusts of the 1920s and even greater similarities to the mutual funds of today."<sup>210</sup> It is submitted that such an appraisal, although technically correct, does not go far enough. The Alexander Fund *was* a mutual fund, and it registered as such under the Investment Company Act of 1940, on July 11, 1941.<sup>211</sup> The fund ceased operations shortly thereafter, on October 19, 1943.<sup>212</sup>

205 INVESTMENT TRUSTS I 45.

206 T. GRAYSON, INVESTMENT TRUSTS 255 (1928).

207 THE ALEXANDER FUND, TWENTY-FIRST ANNUAL STATEMENT (1928), reprinted in T. GRAYSON, INVESTMENT TRUSTS 255-58 (1928).

208 L. ROBINSON, INVESTMENT TRUST ORGANIZATION AND MANAGEMENT 308 (1926).

209 INVESTMENT TRUSTS I 46. No sales charge was levied at the time the shares were purchased. *Id.*

210 H. BULLOCK, *supra* note 4, at 16.

211 SEC, LIST OF COMPANIES REGISTERED UNDER THE INVESTMENT COMPANY ACT OF 1940 (as of June 30, 1968), at 32.

212 On August 8, 1941, less than one month after the fund registered under the Act, it filed an application with the SEC for a suspension of the redemption privilege enjoyed by its shareholders preliminary to dissolution. The Alexander Fund, 9 S.E.C. 860 (1941). The re-

Despite its rather truncated existence as a registered open-end management company, there can be no doubt that the Alexander Fund was the archetype mutual fund, actively engaged in business seventeen years before the organization of Massachusetts Investors Trust [MIT], on whose prospectus is emblazoned the claim: "AMERICA'S FIRST OPEN-END INVESTMENT COMPANY."<sup>213</sup> Suffice it to say that the unique character of the Alexander Fund, "entirely informal"<sup>214</sup> and "primitive,"<sup>215</sup> has not received the attention it properly merits.

## 2. History of Investment Companies in Great Britain

The paucity of investment companies that operated in the United States prior to 1921 is striking when compared with the investment company history of Great Britain. According to some authorities, the investment company is of English origin.<sup>216</sup> While it is uncertain whether it was Great Britain or Belgium<sup>217</sup> that was the homeland of the first investment company, it is clear that it was England where the companies enjoyed their most enthusiastic European reception.<sup>218</sup>

The degree to which the early English companies prospered in comparison to what was a fledgling American industry is exhibited by the fact that there were more English companies formed prior to 1900 *which were still in existence* in 1935, than the total number of American investment companies *formed* during the pre-1921 period.<sup>219</sup> The greatest period of expansion during the early years of the English investment company industry was between 1887 and 1890, when twenty-six companies were organized.<sup>220</sup> The rapid expansion during those years was largely due to a combination of a substantial amount of "investable" funds in the hands of the British public, low domestic interest rates, and the unprecedented industrial expansion in the United States which made foreign securities investment attractive.<sup>221</sup>

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quest was granted, dissolution followed, and on October 19, 1943, the Commission issued an order, at the Fund's request, declaring that it had ceased to be an investment company. The Alexander Fund, 14 S.E.C. 489 (1943).

213 MASSACHUSETTS INVESTORS TRUST, PROSPECTUS, April 8, 1968, *as amended*, October 9, 1968.

214 W. STEINER, INVESTMENT TRUSTS: AMERICAN EXPERIENCE 207 (1929). It has been noted that the distinction between the closed-end and open-end investment companies seems to have escaped Mr. Steiner. *See*, INVESTMENT COMPANY INSTITUTE, MANAGEMENT INVESTMENT COMPANIES 3 n.5 (1962).

215 L. ROBINSON, INVESTMENT TRUST ORGANIZATION AND MANAGEMENT 308 (1926).

216 *See* H. BULLOCK, *supra* note 4, at 2; W. DURST, ANALYSIS AND HANDBOOK OF INVESTMENT TRUSTS 7 (1932).

217 Some authorities believe that the first investment company was the "Société Générale des Pays-Bas pour favoriser l'industrie nationale," later named the "Société Générale de Belgique," founded in Brussels in 1822 by William I of the Netherlands. *See, e.g.*, W. STEINER *supra* note 214, at 17. It has further been reported that "[t]he investment company concept is as old as the history of commerce, going back, in rudimentary form, to the mercantile community of Phoenicia." INVESTORS ADVISORY INSTITUTE INC., FORBES GUIDE TO MUTUAL FUND PROFITS 2 (1959).

218 *See* H. BULLOCK, *supra* note 4, at 8-9.

219 *Compare* BRITISH INVESTMENT TRUSTS 2 *with* INVESTMENT TRUSTS I 42.

220 H. BULLOCK, *supra* note 4, at 9.

221 *See* T. GRAYSON, *supra* note 206, at 12-16; H. BULLOCK, *supra* note 4, at 4-5; L. ROBINSON, *supra* note 215, at 190-92.

If a speculative fever was extant among the British financial community just prior to 1890, it was definitely chilled by the "Baring crisis," the name given England's 1890 crash. The crisis was precipitated by the collapse of Baring Brothers, one of England's oldest and most honorable investment banking firms.<sup>222</sup> The company became overextended as a result of the depression at that time in Argentina, and was forced to liquidate its holdings. The firm's collapse triggered a period of depression in Great Britain which was so serious that one writer noted it "could only have been exceeded if the Bank of England itself had suddenly passed into a condition of insolvency."<sup>223</sup>

The Baring crisis serves as a demarcation point in the English investment company industry's developmental pattern. The rapid growth enjoyed by the English industry during the years just preceding the 1890 crash was not to be duplicated until the 1920's. By that time the importance of the British industry was insignificant in comparison to the swiftly developing investment company movement in the United States.

### 3. The Influence of the Holding Company

Surprisingly, what little growth there was in the pre-1921 American investment company industry does not appear to have been the result of, or stimulated by, the popularity of the companies in England. While the "success" of the British investment "trusts," as they were called, was later touted by their American counterparts,<sup>224</sup> it is apparent that the financial institution that exercised the greatest influence on the development of the American industry was the domestic holding company.

The emergence of the holding company and the genesis of the corporate form of investment company were both the direct result of legislation, first enacted by New Jersey in 1888,<sup>225</sup> which removed the restrictions on intercorporate security holdings. The removal of that barrier by New Jersey, and later by the remainder of states, enabled the holding company to cast off the "trust" identity it had been forced to assume, and also paved the way for the formation of the corporate investment company which was later to dominate the industry.

The SEC's study disclosed that it was the public utility holding company industry that "probably had the greatest effect upon and closest relation to the growth of investment companies."<sup>226</sup> A general influence was exerted merely by force of the example of companies holding securities of other corporations, particularly common stocks. Indeed, in retrospect, the relationship between the public utility holding company industry and the investment company industry resembles that of a teacher and his impressionable pupil. Many of the management practices prevalent among investment companies during the late 1920's which were later condemned by the SEC, the Congress, and the industry were

222 H. BULLOCK, *supra* note 4, at 10.

223 T. GRAYSON, *supra* note 206, at 17.

224 *E.g.*, "Investment trusts are one of the most practical forms yet devised of affording the investor a secure channel for profitable investment, as . . . proved by the 50-year record of trusts in England and Scotland." Advertising brochure reprinted in INVESTMENT TRUSTS I 60.

225 Law of April 4, 1888, ch. 269, [1888] Laws of N.J. 385.

226 INVESTMENT TRUSTS I 40.

"borrowed" from the experience of the holding companies. Among these practices were: the use of voting trusts, unequal shareholder voting rights, and interlocking directorates to maintain control of the company; the use of pyramided capital structures to broaden the reach of the control thus obtained; and the purchase of property from corporate insiders in excess of its reasonable value.<sup>227</sup>

The effect that these and other management techniques had on the financial welfare of investment company shareholders will be considered shortly. For present purposes it is sufficient to note that the obvious parallels between the control devices utilized by the holding companies, and later by the investment companies, are cogent indications of the degree to which the development of the investment company industry was influenced by the holding companies.

### C. Stage Two — 1921 to 1927

The sporadic formation of, and local character common to the early investment companies changed significantly during the next period of investment company growth, the years between 1921 and 1927. This second stage of the industry's development may be typified as a period of rapid expansion, both in terms of investor participation and investment company formation. The increasingly frequent organization of new companies during the years between 1921 and 1927 was primarily prompted by the presence of a happy combination of economic and psychological conditions which predisposed the investing public to seek participation in the comparatively new investment vehicles.

#### 1. Rise in Investor Participation

The unprecedented strength and growth of the American economy during the second stage of the industry's development was probably the major factor which led to the spurt in investment company popularity. The following table,<sup>228</sup>

Year	National income (millions of dollars)	Index of industrial production (1923-5=100)	Number of issues listed on the New York Stock Exchange (Jan. 1)		Volume of trading on the New York Stock Exchange		Stock prices (90 stocks, 1926=100)	Corporation profits (millions of dollars)	Corporate capital issues (millions of dollars)		
			Stocks	Bonds	Stocks (millions of shares)	Bonds, par value (millions of dollars)			New capital	Refunding	Total
1921	58,343	67	756	1,115	173	1,367	53.6	458	1,823	568	2,391
1922	59,706	85	792	1,156	261	1,945	64.6	4,570	2,336	737	3,073
1923	69,706	101	778	1,234	236	1,994	67.0	6,308	2,703	530	3,233
1924	70,369	95	889	1,262	284	2,927	72.7	5,363	3,322	516	3,838
1925	74,846	104	927	1,332	460	2,723	89.9	7,621	4,101	637	4,738
1926	79,477	108	1,043	1,367	452	2,266	100.0	7,505	4,357	943	5,300

which lists indices of the more important economic indicators, clearly shows that the years between 1921 and 1927 were a time of substantial financial and economic progress.

Accompanying the emergence of the United States as a creditor nation following the First World War, and the thirty-seven per cent rise in national income between 1921 and 1927,<sup>229</sup> which provided a pool of funds ripe for investment, was a developing public awareness of the investment returns offered through the purchase of securities. The increase in the public's interest is commonly attributed to the Liberty Bond and Victory Loan drives during the War and immediately thereafter.<sup>230</sup>

The newly receptive mood of the small investor to the investment possibilities inherent in the ownership of equity securities was quickly noted by the investment houses. Many new firms were formed to capitalize on a rising public interest, and together with the established houses, they organized branch offices throughout the country.<sup>231</sup> The brokers and investment bankers were not alone in their desire to exploit a rising demand—investment company sponsors and salesmen were likewise anxious to reap the whirlwind.<sup>232</sup> The effect of the financial community's expansion was the establishment of a widespread network of investment centers ideally suited for the mass distribution of investment company shares.

Avidly seeking public support, the investment company industry became more aggressive in taking its message to the public. While most of the public discussion concerning the merits of investment company share ownership was originally confined to discussions of the English investment companies in the financial journals, the emphasis soon shifted to less technical fare published in "family" magazines.<sup>233</sup>

Supplementing the discussions that appeared in periodicals was sales literature prepared to aid in overcoming investor inertia. The brochures and pamphlets usually stressed the growth possibilities inherent in the purchase of shares in an investment company, and the relative safety of such a form of investment obtained through the principle of diversification of risk. Unfortunately, the information thus disseminated to the public did not always present a truly accurate picture of the correlative risks involved in the purchase of the securities. O. M. W. Sprague, a member of the advisory board of Massachusetts Investors Trust, one of the earliest mutual funds, noted that such literature is "apt to contain things which may be apt to make one's hair curl a little bit."<sup>234</sup>

227 REPORT OF NATIONAL POWER POLICY COMM., H.R. DOC. NO. 137, 74th Cong., 1st Sess. 4-5 (1935).

228 The table appears at INVESTMENT TRUSTS I 57.

229 See chart accompanying note 228 *supra*.

230 E.g., L. ROBINSON, *supra* note 215, at 332: "The person of modest means came into his own during the nation-wide Liberty Loan drives, and the salutary habit of clipping coupons has continued with the American people." *Id.* As the SEC noted: "The change thereafter by gradual steps from ownership of government bonds to other bonds and finally to ownership of preferred and common stocks was perhaps only natural." INVESTMENT TRUSTS I 58.

231 INVESTMENT TRUSTS I 58.

232 *Id.*

233 *Id.* at 59.

234 1940 Senate Hearings 862.

## 2. Structural Development of Modern Investment Companies

The increase in investor awareness was coupled with, and no doubt aided by, the development of sponsor interest which resulted in the creation of new investment companies. A substantial number of those companies were formed by houses of issue, brokers, security distributors, and investment counsel, who looked upon the benefits to be gained from the operation of such companies as a valuable adjunct to their existing businesses.<sup>235</sup> Other investment companies were organized by individuals intent on purchasing securities issued by companies engaged in a particular industry,<sup>236</sup> or for the purpose of holding foreign securities,<sup>237</sup> and some investment companies were formed as the result of a change in the asset structure and business purpose of an already existing corporation.<sup>238</sup>

It has been pointed out that investment bankers and brokers looked upon investment companies as valuable adjuncts to their normal operations. The brokerage fees to be earned from the sale and purchase of portfolio securities on the company's behalf, the commissions earned through the sale of the company's shares, and the fees derived from managing the company proved to be a healthy incentive for the formation of new companies by such financiers. Since those profits could be derived only by the interest group that controlled the company, control schemes were devised by which an investment company could be controlled through a minimal investment of risk capital.<sup>239</sup>

Initial control over the investment company by the sponsoring interest was of course obtained merely by virtue of the company's organization, since the sponsor invariably selected the company's first managing board.<sup>240</sup> More permanent control could be, and was, achieved in a variety of ways: issuing stock carrying unequal voting rights;<sup>241</sup> eliminating stockholder preemptive rights by charter provision;<sup>242</sup> establishing voting trusts;<sup>243</sup> or entering into long term management contracts with a management company operated by the sponsor.<sup>244</sup>

### a. *The Leveraged Closed-ends and Control*

U.S. & Foreign Securities Corporation [U.S. & Foreign] was the first closed-

235 INVESTMENT TRUSTS I 76. By the end of 1929, more than sixty per cent of the industry's assets were held by companies sponsored by houses of issue, broker dealers, and investment counsel. INVESTMENT TRUSTS II 124.

236 See INVESTMENT TRUSTS I 69-76.

237 *Id.* at 65-69.

238 See, e.g., *id.* at 66-67, 84. One company, American International Corp., just "grew," Topsylike, into an investment company, without amending its articles of incorporation, obtaining shareholder consent, or, in the words of one of the company's officers, knowing "we were changing ourselves." *Id.* at 67. Among the members of the company's original board of directors were: J. Ogden Armour of Armour & Co.; Charles A. Coffin of General Electric Corp.; Albert H. Wiggin of The Chase National Bank; Percy A. Rockefeller; and Joseph P. Grace. *Id.* at 66.

239 For a discussion of the manners by which control of investment companies was achieved and perpetuated prior to the passage of the 1940 Act, see INVESTMENT TRUSTS III 1874-1936.

240 *Id.* at 1875.

241 For an example of this practice, see text accompanying notes 247-48 *infra*.

242 INVESTMENT TRUSTS III 1908.

243 *Id.* at 1912.

244 *Id.* at 1921. See text accompanying notes 375-77 *infra*.

end company organized as a large, diversified investment enterprise to publicly offer its shares. Its establishment in 1924 by Dillon, Read & Co., then the most active banking house in the United States, made U.S. & Foreign the first large scale venture on the part of the investment banking industry into the investment company industry. U.S. & Foreign is significant in two respects: first, its formation by the reputable Dillon, Read & Co. initiated a trend toward the formation of investment companies by members of the investment banking industry; and second, it possessed a remarkable capital structure that enabled sponsor Dillon, Read & Co., and its associates, to combine the use of leverage with control of the company — while making only a minimal (sixteen per cent) capital contribution. That feat was accomplished by the issuance of three classes of securities: \$25 million of no-par first preferred; \$5 million of no-par second preferred; and one million shares of no-par common stock.<sup>245</sup> The first preferred was sold to the public, who also received 250,000 shares of common stock as a "bonus."<sup>246</sup> The second preferred, carrying with it the right to 750,000 shares of common, was sold to Dillon, Read & Co. The common stock carried the exclusive voting power, and Dillon, Read & Co.'s ownership of seventy-five per cent of that stock cemented them into the controlling position, despite their relatively small investment.<sup>247</sup>

In October of 1928, Dillon, Read & Co. and U.S. & Foreign jointly organized a second investment company, U.S. & International Securities Corporation [U.S. & International], as a subsidiary of U.S. & Foreign. U.S. & International's capital structure was similar to that of its parent. The public purchased a total of \$50 million in first preferred, accompanied by 500,000 shares of voting common plus warrants for an additional 500,000 shares of common, exercisable at \$25 per share. The entire \$10 million issue of second preferred was sold to U.S. & Foreign, who also received 2,000,000 shares of voting common stock and outright control.<sup>248</sup> The net result of the formation of U.S. & Foreign, and the "pyramiding" of it on U.S. & International, was the achievement by Dillon, Read & Co. of complete control over two companies in which the public had invested \$75 million compared with Dillon, Read & Co.'s \$5 million capital contribution.

#### *b. Mutual Funds and Control*

While the desire of those sponsoring investment companies to acquire and retain control of the sponsored companies' assets resulted in some fairly sophisticated control schemes, such as that employed by Dillon, Read & Co., the means used by the sponsors of MIT, the first mutual fund to sell its shares on a large scale,<sup>249</sup> was simpler than most methods and as effective as any control technique

<sup>245</sup> INVESTMENT TRUSTS I 78.

<sup>246</sup> *Id.*

<sup>247</sup> *Id.* J. FLYNN, INVESTMENT TRUSTS GONE WRONG! 39-40 (1931).

<sup>248</sup> See J. FLYNN, *supra* note 247, at 41.

<sup>249</sup> It will be remembered that the Alexander Fund's shares were not widely held during MIT's infancy. In fact, the Fund had less than 900 shareholders in 1928, more than twenty years after its founding. See text accompanying note 207 *supra*.

could be. Organized as a Massachusetts trust, MIT's original board of trustees<sup>250</sup> was made self-perpetuating and given the power "in their absolute and uncontrolled discretion" to invest the company's funds.<sup>251</sup> The original trust agreement was quite explicit in delineating the freedom of action of the trustees. They were to be "free from the control of the shareholders"; responsible only for their personal "willful default or neglect"; and "any trustee, notwithstanding his fiduciary position, [was permitted to] deal with the trustees in relation to the trust estate as freely as if he were not a trustee hereunder."<sup>252</sup> Most of the trust-style investment companies followed MIT's lead and made the original board of trustees self-perpetuating.

The organization of U.S. & Foreign and MIT in 1924 was probably the most important occurrence during the second stage of the investment company industry's development. By the end of 1927, fifty-six other closed-end companies had adopted U.S. & Foreign's leverage feature, and thirteen management investment companies had incorporated MIT's open-end capital structure.<sup>253</sup> The

250 MIT, like U.S. & Foreign, was organized by experienced financiers. The members of the original board were Charles H. Learoyd and Hatherly Foster, Jr., partners in the Boston brokerage house of Learoyd, Foster & Co., Sherman Adams, and Edward G. Leffler who originated the open-end theory upon which the trust was based. The genesis of the mutual fund concept, adopted by MIT in 1924 when it first issued redeemable securities, was explained by Mr. Leffler:

[I]t was a question of providing a medium for the investor. I believed it could grow into a tremendously large business, because if you were going to ask the average individual the simple question: "What can I do for you?" that you would more than anything else be convinced that he would probably answer, "Help me to get somewhere financially." So it seemed to me that I had at least a very large potential market. Out of that idea grew the Massachusetts Investors Trust.

Question. How long did it take you before you could get anybody interested?

Answer. Three or four years.

Question. Then who picked up the idea?

Answer. Learoyd, Foster & Co.

Question. As a result of that the Massachusetts Investors Trust was formed? Is that right?

Answer. That is right. INVESTMENT TRUSTS I 102.

Mr. Leffler's belief that helping the average individual "get somewhere financially" "could grow into a tremendously large business" was certainly justified, as is indicated by the following figures:

	Massachusetts Investors Trust		
	Shareholders	Shares Outstanding	Assets
1924	200*	32,296*	\$ 392,000*
1967	214,238**	133,492***	2,358,159,213***

\* D. ROBINSON, JR., MASSACHUSETTS INVESTORS TRUST 13 (1954).

\*\* INVESTMENT COMPANIES 1968 229 (L. Wessmann ed. 1968).

\*\*\* MASSACHUSETTS INVESTORS TRUST, *supra* note 213, at 4, 10.

It should be observed that the great growth and huge popularity which MIT has enjoyed through the years among the investing public may in large part be attributable to the foresight of its founders and the sound management policies which they established. The early adoption by the company of a policy of full disclosure, "a pointed departure from established practice," D. ROBINSON, MASSACHUSETTS INVESTORS TRUST 15 (1954), among the investment company industry, as well as the diligent efforts of several MIT executives to insure that the needed regulatory legislation of the industry was enacted are but two of many possible examples of the leadership role assumed by MIT during the mutual fund industry's formative years. However, they still suffice to show that the modern fund industry owes much to MIT's guiding influence during those crucial early years.

251 INVESTMENT TRUSTS I 101.

252 *Id.* at 101-02.

253 INVESTMENT TRUSTS II 115.



majority of the new companies had been sponsored, like U.S. & Foreign and MIT, by investment houses or brokerage firms.<sup>254</sup> It is clear that by the end of the second stage of its growth, the investment company industry had begun to assume its modern form.

#### *D. Stage Three — 1927 to October 24, 1929*

During the third stage of the development of the investment company industry, the number of investors holding investment company securities increased tenfold, from 38,000 to 380,000,<sup>255</sup> and the number of investment companies in existence more than doubled.<sup>256</sup> By the end of the period investment companies had become a financial fad.

Motivating the rapid increase in investor participation during the pre-depression period were all the economic and psychological factors extant between 1921 and 1927, plus a greatly increased awareness on the part of the financial community of the profits and power available through investment company sponsorship and control. The fact that the monetary rewards to be gleaned were attainable without the risk of a significant personal investment on the sponsor's part served to feed the desire to create new companies. Of the more than 590 investment companies that were formed between 1927 and 1930, nearly sixty per cent were of the management investment company variety, the type that offered the most lucrative management rewards.<sup>257</sup>

This rapid propagation of investment companies, organized to exploit the public's growing demand for a form of "institutional investment," took place during a period when the investor was virtually unprotected against managerial overreaching on the part of those operating investment companies. Federal regulation of investment company practices was nonexistent, the ability of the common law to deal with injuries arising from the mismanagement of investment companies was limited at best and, California and Utah notwithstanding, the state Blue Sky Laws, still in the embryonic stage, wanted much in terms of providing adequate investor protection.<sup>258</sup>

254 *Id.* at 58.

255 *Id.* at 374.

256 *Id.* at 115.

257 *Compare id.* at 30 with *id.* at 111.

258 California and Utah were the only states that required registration of investment companies prior to the crash. *See CAL. GEN. LAWS* at 3814 (Deering 1927); *Law of March 23, 1929, ch. 79, [1929] Laws of Utah.*

One pre-crash author, Mr. William Steiner, noted the scarcity of effective Blue Sky Laws capable of dealing with the problems raised by the rapid proliferation of investment companies. *See W. STEINER, supra* note 214 at 301-09.

Mr. Steiner showed himself to be an astute observer of the investment company scene. Writing in 1928, the author mentioned several weaknesses in the industry which were already apparent:

1. The existence of a considerable number of small, weak trusts, organized under boom conditions. A few trusts are undoubtedly dishonest; somewhat more are organized by salesmen with little knowledge of finance; and still more by well intentioned incompetents with inadequate backing.

2. The rearing of corporate capital structures which fully exploited the remarkable profit making possibilities through turnover of portfolios existing during the rapidly rising security markets of recent years. This creates a considerable burden of charges, whether fixed or contingent, the margin above which is supplied largely if not entirely by turnover profits.

3. The existence of a speculative attitude, rather than an investment attitude,

New York's experience in attempting to enact state legislation to protect the investing public's interest against possible investment company malpractices is especially instructive. In 1927, a survey conducted under the auspices of the New York Attorney General's office examined the operations of the investment companies then doing business in the state.<sup>259</sup> Following the study a report was prepared and submitted to the New York State Department of Law. The report recommended that legislation be adopted which would: permit investment companies to incorporate under the laws of New York; provide that supervisory control over those companies be given to the New York Superintendent of Banks; and empower the Superintendent to inquire into the managerial competence of, and bookkeeping procedures employed by such investment companies.<sup>260</sup>

Particularly cogent were the remarks of Mr. Timothy Shea, who supervised the study and transmitted the report to the state's Department of Law. Considering the advisability of the study's proposals, which he felt were "wise, reasonable, and constructive,"<sup>261</sup> he observed that:

The history of all state regulation shows that there is a tendency on the part of the people to permit individual enterprise to flourish until some great public evil or catastrophe occurs and then restrictive and drastic legislation is made effective, locking the barn door after the horse has been stolen.

The legislation I suggest proposes to lock the barn door while the horse is in the stable.<sup>262</sup>

The bill which embodied those proposals died in the state's Assembly.<sup>263</sup>

By the end of 1929, the value of assets held by investment companies totaled

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towards investment trust securities on the part of the public. With a lack of understanding of trust management problems, and looking only to the records of past years in appreciation, any disillusionment in [the] future is likely to cause sharp revulsion from the trusts as a group.

4. Variety of trust practice with respect to almost every phase of operation. This makes it difficult to judge various trusts, and makes many represent a curious combination of virtues and vices. It likewise means that those most intimately informed have as yet reached no agreement as to the field of use of various practices. While no single form of trust or policy is perhaps ideal, and various trusts are adapted to various needs, surely no such profusion as exists today is either necessary or desirable.

5. Lack of understanding on the part of the general public. An uncritical snap judgment is apt to espouse the bad, tempted by catchwords and rash promises, while condemning the good, honestly prepared and presented in more conservative fashion. At the same time, it is apt no less to be suspicious, and, where unjustified, easily stamped. *Id.* at 313-14.

Looking toward the future, Steiner saw:

1. The careful study by and of investment companies;
2. Widespread disclosure of company data; and
3. "A measure of regulation, coupled with assumption of responsibility by trust managers." *Id.* at 315-16.

259 For a discussion of the study and a sample of the questions directed at the investment trusts, see T. GRAYSON, *supra* note 206, at 288 n.8. See also W. STEINER, *supra* note 214, at 305-08.

260 See A. OTTINGER & T. SHEA, INVESTMENT TRUSTS, A SURVEY OF THE ACTIVITIES AND FORMS OF INVESTMENT TRUSTS WITH RECOMMENDATIONS FOR STATUTORY REGULATION BY THE N.Y. STATE DEPARTMENT OF LAW 100 (1927).

261 *Id.* at 101.

262 *Id.* at 100.

263 W. STEINER, *supra* note 214, at 302. Apparently some felt that the "high standards prevailing" in the pre-crash era justified the avoidance of "unnecessarily restrictive State legislation." N.Y. Times, July 2, 1929, at 43, cols. 4-5.

more than \$6 billion.<sup>264</sup> Twenty-two years were to pass before the industry's assets again reached that figure.<sup>265</sup>

*E. Stage Four — October 24, 1929 to August 22, 1940*

1. Effects of the Crash on Investment Companies

Black Thursday, October 24, 1929, marks the beginning of the fourth period of industry growth, a stage of development for investment companies that did not terminate until August 22, 1940, the date that President Roosevelt signed the Investment Company Act of 1940.

That the depression years were unkind to most investors is so well established as to be eligible for judicial notice; yet the market crash was not alone among the causes of many investment company shareholders' woes during the depression years. A "fringe of thoroughly dishonest"<sup>266</sup> investment company managements plagued the infant industry during those years, costing the investing public an estimated<sup>267</sup> \$1.1 billion, and evoking a public outcry that was loud and poignant:

The title of a battle-scarred but veteran institution of Scotland and England, the Investment Trust, was imported to the United States; but its unsavory early history on the other side (with honorable exceptions of course) and its present accession to repute over there through tribulation and experience, were ignored. We divided the American translation of this institution into two kinds: blind speculative pools called Management Trusts, the faults in the way of operating which Great Britain had largely eliminated, and myopic speculative pools called Fixed Trusts, which Great Britain had never known. Into these two kinds of coöperative offense against the principles of investment during the five years 1925-1929 we poured two billion American dollars in a crescendo of folly that outdid the Mississippi Bubble, the South Sea Bubble and the oversea's orgy that ended in the Baring crisis.

Nor was this all. Under the title of the British institution, which in these days for the most part lives up to its signification: Investment Trust, American banks, stock exchange firms and general investment houses affiliated with themselves, and conferred their very names on these blind pools and myopic pools that in numbers of cases have brought dishonor on their sponsors and great loss to their certificate holders.

. . . It is not the aggregate of bank and commercial failures that best records the price of such a business collapse. The greatest part of that price can never be known or measured. . . . In acute cases, where the mind has become weakened, it is marked by bodies fallen from high windows and by the crack of revolvers in secluded places of reckoning.

We all know cases. Does religious persecution or war furnish starker tragedy or sublimer sacrifice than that of our two friends, partners in an honored, conservative investment business that failed in this stress? Their lives, insured in favor of their business to an amount exceeding their debts

264 INVESTMENT TRUSTS II 31.

265 34 SEC ANN. REP. 115 (1968).

266 Note, *Investment Company Act of 1940*, 50 YALE L.J. 440, 441 (1941).

267 See text accompanying note 184 *supra*.

to customers and others, were snuffed out separately within the limits of a weekend.

Therefore whether we are moved more by these poignant experiences or by the revelations of mathematics, we defenders of an old investment faith have a right to urge with Browning "The truth for God's sake, lest men should believe a lie."<sup>268</sup>

In 1929, the leveraged closed-end companies led the management investment company industry in every category. In number of companies, shareholders, and total assets managed, the leveraged closed-ends easily exceeded the combined totals of the open-end and non-leveraged closed-end companies.<sup>269</sup> Roughly eighty per cent of the management investment company industry's shareholders held stock in the leveraged closed-end companies,<sup>270</sup> and it was they who bore the brunt of the mischief visited by the market's decline. One dollar invested in the stock of the average leveraged closed-end company in July of 1929 would have netted the stockholder two cents if he sold it in June of 1932, and a nickel if he waited until the end of 1937 to dispose of his interest.<sup>271</sup>

To be sure, the market decline was precipitous, and as will be seen, more than a few leveraged closed-end shareholders were subjects of faithless managements; however the plunge in the market value of the leveraged closed-end's shares cannot be fully explained by the drop in stock prices or managerial infidelity. The leveraged closed-end investor's travails were due, in part at least, to the functioning of two leveraged closed-end characteristics: reverse leverage, and the premium discount phenomenon.<sup>272</sup>

Although the non-leveraged closed-end company's shareholders were affected by the premium discount phenomenon, their freedom from the effects of reverse leverage enabled them to weather the tempest fairly well. The dollar invested in 1929 that would have netted the leveraged closed-end company's shareholder a nickel at year end 1937, would have returned him forty-eight cents had he

268 L. CHAMBERLIN & W. HAY, INVESTMENT AND SPECULATION 4-6 (1931). Management investment companies were commonly referred to as "blind pools." See W. STEINER, *supra* note 214, at 78.

The fixed trusts or "myopic pools," as the authors refer to them, were forms of "unmanaged" investment companies — companies which sold the public shares representing an undivided interest in a fixed group of pre-selected stocks. The portfolio stocks generally remained the same. See INVESTMENT TRUSTS I 2.

269 The relevant figures are as follows:

	Number of companies <sup>a</sup>	Per cent of companies <sup>a</sup>	Total assets (billions) <sup>a</sup>	Per cent of assets <sup>a</sup>	Shareholder accounts (thousands) <sup>b</sup>	Per cent of accounts <sup>b</sup>
Leveraged						
Closed-ends .....	118	65	2.25	74	448	77
Non-leveraged						
Closed-ends .....	44	24	.64	21	85	14
Open-ends .....	19	11	.14	5	49	9
Totals .....	181	100	3.03	100	582	100

<sup>a</sup> INVESTMENT TRUSTS II 115.

<sup>b</sup> Estimate based on number of shares per investment company. *Id.* at 373.

270 See note 269 *supra*.

271 INVESTMENT TRUSTS II 314.

272 See text accompanying notes 55-58 and 71-73 *supra*.

invested in the non-leveraged closed-end instead.<sup>273</sup> Such a return, amounting as it does to a fifty-two per cent shrinkage in the value of the original investment, is not to be scoffed at. Had that dollar been invested in an index which reflected the performance of the market generally, it would have returned only thirty-nine cents at the end of the same period.<sup>274</sup>

The ability of the non-leveraged closed-ends to outperform the market was primarily due to the practice indulged in by many of the companies of repurchasing their shares from their shareholders at discounts of sixty-five to seventy per cent below net asset value.<sup>275</sup> By repurchasing its shares in that manner, the non-leveraged closed-end company was able to materially improve the net asset value of the shares held by the remaining stockholders. For example, assume a non-leveraged closed-end company had 1,000 shares of common stock outstanding with a net asset value of \$10 per share. The repurchase of 300 shares issued by the company at \$5 per share would result in an increase in the net asset value of the remaining shares to \$12.14. To obtain the same effect through stock market investment, the value of the company's portfolio securities would have had to appreciate 21.4 per cent over the short span of time it would take to make the repurchases, a rare occurrence during the depression.

Between 1929 and 1935 the net amount of stock repurchased by the closed-end investment companies totaled nearly one-half billion dollars.<sup>276</sup> Such repurchases not only enabled the close-end companies to make "paper profits," but also permitted them to peg the market price of the securities at what company management considered a proper value. While some of the reacquired stock was purchased from "insiders,"<sup>277</sup> the majority of such transactions involved the *undisclosed* repurchase of stock by the company from the general public.

Seldom was the selling stockholder aware that he was selling his stock to the investment company, or even that he was selling his shares at a discount. In its study of the investment company industry, the SEC noted the industry's attempted justification for the practice, but was obviously unimpressed:

Even more important, however, is the fact that these repurchases were justified upon the ground that at the time these securities were reacquired they were the "best buys" for the investment companies as investments in which the companies could make immediate and substantial "profits." Yet the managements, who were employed by the stockholders to safeguard their interests, did not advise liquidating shareholders that their securities were selling at discounts, that they would lose upon such sale the difference between the asset value and the market value (the amount of the discount), and that the company itself was repurchasing the securities, *which it considered a good investment*.<sup>278</sup> (Emphasis added.)

Little need be said about the effect of the crash upon the equity interest of mutual fund shareholders. Freed from the machinations of the premium-dis-

273 INVESTMENT TRUSTS II 314.

274 *Id.*

275 *Id.* at 314 n.63.

276 INVESTMENT TRUSTS III 953.

277 Repurchases from "insiders" accounted for roughly eight per cent of all investment company repurchases. *Id.* at 977.

278 INVESTMENT TRUSTS III 967.

count phenomenon by virtue of the redeemability of their shares, and generally unaffected by reverse leverage, mutual fund shareholders fared relatively well during the depression, if one accepts doing as well as the market generally as faring relatively well.<sup>279</sup> Between July, 1929 and year end 1937, the price of an average stock listed on the NYSE declined approximately sixty per cent.<sup>280</sup>

Had the losses suffered by the industry's investors during the depression years, particularly the leveraged closed-end investors, been solely attributable to the effect of the declining market, the 1940 Act might never have been enacted and most certainly not in its final form. What stirred Congress was not the \$1.9 billion investment loss caused by the drop in stock prices during that period, but rather the \$1.1 billion capital shrinkage which resulted from dishonest and irresponsible management practices employed by a segment of those controlling some of the industry's companies.

## 2. Effects of the Crash on the Structure of the Industry

Because it was the closed-end shareholders that suffered most from the effects of the declining market and managerial maladministration, it was only natural for those investors preferring to purchase investment company shares to shy away from the closed-ends and look for some other form of investment vehicle. Investors were attracted to three different investment mediums: mutual funds, contractual plans, and the fixed or "unit" trusts.

### a. Growth of Mutual Funds

Mutual funds offered their shareholders the right to redeem their shares at the security's approximate net asset value, a feature highly valued by investors who appreciated the capricious nature of the closed-end's premium-discount phenomenon. In addition, the funds enjoyed a special exemption from the provisions of the Revenue Act of 1936,<sup>281</sup> which enabled them to avoid taxation on their investment income, providing certain criteria were met.<sup>282</sup> The closed-ends

279 See INVESTMENT TRUSTS II 890-91.

280 This assumes that the Standard Statistics Company's index of ninety stocks was an accurate market index. *Id.* at 314.

281 49 Stat. 1648 (1936).

282 Revenue Act of 1936 § 48(e), 49 Stat. 1669 (1936) required that an investment company meet the following specifications in order to be eligible for preferential tax treatment:

(e) MUTUAL INVESTMENT COMPANIES.—

(1) GENERAL DEFINITION.—The term "mutual investment company" means any corporation (whether chartered or created as an investment trust, or otherwise), other than a personal holding company as defined in section 351, if—

(A) It is organized for the purpose of, and substantially all its business consists of, holding, investing, or reinvesting in stock or securities; and

(B) At least 95 per centum of its gross income is derived from dividends, interest, and gains from sales or other disposition of stock or securities; and

(C) Less than 30 per centum of its gross income is derived from the sale or other disposition of stock or securities held for less than six months; and

(D) An amount not less than 90 per centum of its net income is distributed to its shareholders as taxable dividends during the taxable year; and

(E) *Its shareholders are, upon reasonable notice, entitled to redemption of their stock for their proportionate interests in the corporation's properties, or the cash equivalent thereof less a discount not in excess of 3 per centum thereof.*

were not similarly favored until 1942.<sup>283</sup> The "tax break" enjoyed by the funds doubtless made their shares more attractive to the investing public.

### *b. Growth of Contractual Plan Companies*

The second type of investment company which became increasingly popular during the depression was the periodic payment plan, now known as the "contractual plan." The first plan was offered publicly in 1929, and by 1937 there were forty-five plan companies in operation.<sup>284</sup> While the vast majority of the portfolio securities currently held by the plan companies are mutual fund shares, the early contractual plans preferred to purchase shares issued by fixed trusts or to hold their own diversified portfolio of securities. Mutual fund shares were the underlying securities in only seven of the fifty-five plan companies studied by the SEC.<sup>285</sup>

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(2) LIMITATIONS.—Despite the provisions of paragraph (1) a corporation shall not be considered as a mutual investment company if, subsequent to a date thirty days after the date of the enactment of this Act, at any time during the taxable year—

(A) More than 5 per centum of the gross assets of the corporation, taken at cost, was invested in stock or securities, or both, of any one corporation, government, or political subdivision thereof, but this limitation shall not apply to investments in obligations of the United States or in obligations of any corporation organized under general Act of Congress if such corporation is an instrumentality of the United States; or

(B) It owned more than 10 per centum of the outstanding stock or securities, or both, of any one corporation; or

(C) It had any outstanding bonds or indebtedness in excess of 10 per centum of its gross assets taken at cost; or

(D) It fails to comply with any rule or regulation prescribed by the Commissioner, with the approval of the Secretary, for the purpose of ascertaining the actual ownership of its outstanding stock. (Emphasis added.)

Section 13 of the 1936 Revenue Act, 49 Stat. 1655 (1936), permitted enterprises which qualified as mutual investment companies under section 48(e) to subtract the dividends paid their shareholders (out of current earnings) from the company's net income in determining the company's net *taxable* income.

283 Section 361 of the Revenue Act of 1942, 56 Stat. 878 (now INT. REV. CODE of 1954, § 851), modified the definition of the 1936 Act to permit any investment company registered under the Investment Company Act of 1940 to avail itself of preferential tax treatment provided the section's other requirements were complied with:

(a) IN GENERAL.—For the purposes of this chapter, the term "regulated investment company" means any domestic corporation (whether chartered or created as an investment trust, or otherwise), other than a personal holding company as defined in section 501, which at all times during the taxable year is registered under the Investment Company Act of 1940 (54 Stat. 789, 15 U. S. C., 1940 ed., secs. 80 a—1 to 80 b—2), or that Act, as amended, either as a management company or as a unit investment trust, or which is a common trust fund or similar fund excluded by section 3 (c) (3) of such Act from the definition of "investment company" and is not included in the definition of "common trust fund" by section 169.

No solid reason has been given for the preferential treatment received by the open-ends but denied the closed-ends during the years between 1936 and 1942. However, David Schenker, SEC counsel, volunteered his personal opinion while testifying before the Senate subcommittee which conducted hearings on the need for regulation in the investment company industry:

I think it was [President Roosevelt] who said in some address that he could visualize if you had a simple company which was made available to small investors, a mutual company, then it might be entitled to some tax exemption.

Now, the so-called mutual company, or open-end company, was designated as the type of company which would be entitled to the tax exemption, although in my opinion the only difference between an open-end company and a closed-end company is the shareholder's right to redeem. 1940 Senate Hearings 802.

284 INSTALLMENT PLAN STUDY 9.

285 *Id.* at 19.

The plans were originated and developed to appeal to the "small investor" — wage earning men and women who could afford to periodically set aside small sums of money from their earnings. To provide an investment vehicle for such people, the plans offered certificates which could be purchased on the installment basis for as little as \$5 or \$10 per month. The plans, designed to carry the "advantages" of investment company ownership to such investors were marketed aggressively by the plan company's sales force, and with good reason — the purchase and completion of such a plan assured the plan company no mean amount of revenue.

The average sales load charged the contractual planholder by the plan company, assuming the investor completed the plan, was 15.56 per cent of the amount he invested.<sup>286</sup> In addition, the planholder was often assessed a double management fee, payable to the plan company and to the underlying investment company. The contractual plan's distinctive sales commission feature, the front-end load, was used to a fare-thee-well. Unfettered by effective state or federal regulation, the plan companies exploited their "customers" by commonly deducting sixty per cent of the amount paid in by the planholder for the sales load, and a front-end load of one-hundred per cent was not unknown.<sup>287</sup> The built-in penalty effect of the front-end load was seldom explained to the shareholder by the plan company's salesmen. After receiving a number of complaints, the SEC conducted an examination of sales practices used by the periodic payment plan companies. That investigation "revealed that less than 5 per cent of the hundreds of subscribers who were examined really had any idea as to the nature of their investment."<sup>288</sup>

One of the major manifestations of the periodic payment plan investors' ignorance concerning the effect of the front-end load on the size of their net investment was the high number of lapsed accounts among the plan companies. By the end of 1935, approximately forty per cent of the plans purchased since 1930 had lapsed.<sup>289</sup> The average loss to those investors, caused in large part by the effect of the front-end load, was thirty-five per cent of the amount paid into the plan.<sup>290</sup> No doubt the losses incurred by those investors were a source of great disillusionment, particularly in light of the grandiose claims made in the plan companies' sales literature. For example:

Commonwealth Fund Provides Living Assurance by Enabling You Now to —  
 Create a Living Trust for the education of your children.  
 To buy your own home or establish a business.  
 To provide a sinking fund or business reserve.  
 To meet an emergency or an opportunity.  
 For travel and comfort in your later years.  
 LIVING ASSURANCE means peace of mind — security and  
 freedom from financial worry.<sup>291</sup>

286 *Id.* at 47.

287 *Id.* at 76-77.

288 *1940 Senate Hearings* 166.

289 *INSTALLMENT PLAN STUDY* 65.

290 *Id.*

291 *Id.* at 167.



As will be seen, the sales practices and loading charges used by the plan companies met with little congressional approval.

### c. Growth of Fixed Trusts

Fixed trusts represent the investment vehicle that gained most in popularity during the early years of the depression.<sup>292</sup> The trusts offered the investor certificates which evidenced a beneficial ownership of an undivided interest in a pool of securities held by the trust as assets. In contrast to the other types of investment companies, the discretionary range of the trust's management bloc was extremely narrow since the trust's assets — the portfolio securities — were literally "fixed" and could be changed only in limited instances.

This curtailment of management control appealed to investors who had seen their closed-end shares evidence an undivided interest in, *inter alia*, construction of the Mississippi Valley Barge Line.<sup>293</sup> The fixed trust investment companies boomed between 1930 and 1931, and the value of their shares rose from two to seven and one-half per cent of the industry total.<sup>294</sup> The trusts declined in value thereafter, in part due to redemptions and also because of a management malpractice called switching, which will be treated in the next section.<sup>295</sup>

## 3. Investment Company Abuses

### a. Illiquid Investments

By attaining and preserving control of an investment company, a group of individuals had at their disposal a large pool of liquid wealth. In most instances, the utility of that wealth to those in control was virtually unlimited — many of the corporate investment companies copied the "corporate powers" section of United States Steel's articles of incorporation.<sup>296</sup> The use of those broad powers enabled some investment companies, organized ostensibly to provide expert management of a diversified portfolio of securities, to commit the company's assets to ventures in which the company had a less than liquid position. Among such ventures were the purchase of a subway located in Buenos Aires, Argentina,<sup>297</sup> the acquisition of control of the Venezuela Oil Company,<sup>298</sup> and the financing of the construction of a Mississippi River barge line.<sup>299</sup>

### b. Pyramiding

Because of the broad discretionary powers conferred on many investment company managements, the size of the liquid pools of assets controlled could

292 The trust's peak years were 1930 and 1931. During those years roughly \$600 million of their certificates were sold, representing two-thirds of all such sales between 1927 and 1936. INVESTMENT TRUSTS II 39.

293 See text accompanying notes 297-99 *infra*.

294 INVESTMENT TRUSTS II 39-40.

295 See text accompanying notes 315-18 *infra*.

296 1940 Senate Hearings 183. By copying United States Steel's corporate powers provisions, an investment company was entitled, *inter alia*, "[t]o plan, design, construct, alter, repair, remove or otherwise engage in any work upon bridges, railroads, dams, canals, piers, etc." *Id.*

297 *Id.* at 125.

298 *Id.* at 184.

299 *Id.* at 229.

easily be increased by investing in the securities issued by other investment companies. This practice, referred to as "pyramiding" and encountered previously in the discussion of U.S. & Foreign,<sup>300</sup> enabled a management group to expand its field of power by organizing subsidiary investment companies, having them issue stock with unequal voting rights and then sell the choice (and controlling) stock to an investment company already controlled by the group. Pyramiding also made it possible for a company whose policies prevented the purchase of speculative issues to vicariously speculate in the market by purchasing the stock of an established investment company that traded only in speculative stocks.<sup>301</sup> Such an investment not only ran counter to the spirit of the investing company's stipulated investment policy, but also involved an unwarranted delegation of management's responsibility by, in effect, putting its investor's money in the hands of a second management team. This also resulted in the uneconomic duplication of management fees and sales charges, paid ultimately by the investing company's shareholders.

The classic example of pyramiding resulted from the combined exploits of thirteen companies known as the Founders Group. The first member company was established in 1922 when two individuals, one of whom was a bankrupt, made a combined capital investment of \$500.<sup>302</sup> By 1929, the public's capital investment in the pyramided interests controlled as a result of that venture exceeded \$500 million.<sup>303</sup> At its peak, the Founders Group controlled or had a dominant interest in companies whose combined resources totaled over \$2 billion.<sup>304</sup> Perhaps the major reason for the astounding growth rate of the Founders Group was the investor interest generated by the handsome return its shareholders received on their invested capital. It has been theorized that the Group's outstanding investment performance was aided in no small part by the unique accounting technique they employed which resulted in expenses being deferred or capitalized, not charged to income.<sup>305</sup>

The crash collapsed the Founders' pyramided capital structure, and the total loss to the public exceeded \$390 million. One of the Group's companies, the United States Electric Power Corporation, which had an original paid in capital of over \$133 million, had a net worth in 1940 of \$132.00.<sup>306</sup> The collapse of the

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300 See text accompanying notes 245-49 *supra*.

301 Precisely the same ploy has been used by a foreign super fund, Fund of Funds, Ltd., to circumvent one of its prospectus's investment restrictions, that "the Fund may not borrow money, purchase any securities on margin, or sell securities short." The Fund has not engaged in any of these activities, but some of its wholly owned subsidiaries have. PUBLIC POLICY STATEMENT 322. For a discussion of the problems caused by the existence of super funds in general, and foreign super funds such as Fund of Funds, Ltd. in particular, see notes 154-76 *supra* and accompanying text.

302 1940 Senate Hearings 82.

303 *Id.*

304 *Id.* at 83.

305 *Id.* at 87. Because of its pyramided structure, the Group was also able to employ a devious technique to generate "profits." The mechanics of that practice may be seen in this simplified example: Founder X issues \$100 worth of securities to Founders Y and Z who pay \$50 each. Founders Y and Z then issue or "resell" those securities to the public, receiving \$100 each. The \$100 surplus over the price paid for the securities would be picked up by Y and Z as investment "profit." See INVESTMENT TRUSTS III 2795.

306 1940 Senate Hearings 83.

Founders was so complete, and its management practices so corrupt (“[t]hey did shocking things and stole plenty”<sup>307</sup>), that there can be no doubt of investment company industry spokesman Arthur H. Bunker’s sincerity when he told the Senate subcommittee that was hearing testimony on industry management practices: “I would not be caught defending Founders for anything, Senator.” Replied Senator Wagner, “I know that.”<sup>308</sup>

### c. *Self-dealing Transactions*

While pyramided capital structures permitted an investment company to increase its field of control and profits, the management of even one investment company was not without the capacity of providing rich rewards. This was especially so in the case of those companies sponsored by houses of issue, investment bankers, and brokers. Such companies constituted approximately sixty per cent of the industry’s organizations,<sup>309</sup> and were an extremely valuable source of management fees and brokerage income.<sup>310</sup> In addition, they provided their sponsors with a ready supply of funds which could be conveniently borrowed at a low interest rate,<sup>311</sup> and the companies were occasionally used as “dumping grounds” for their sponsors’ distressed securities, which the sponsors sold to the controlled company at fictitious prices.<sup>312</sup>

### d. *Looting*

Perhaps the crudest way in which those in control of an investment company were able to profit from their position was simply by looting the company. One such instance occurred in October of 1937 while the SEC’s report on abuses by management in the investment company industry was being prepared. The looting was accomplished by a group that purchased control of the Continental Securities Corporation for \$580,000, although the shares purchased by the looters had a *negative* net asset value of \$638,000.<sup>313</sup> The purchasers quickly elected a new board of directors, raided the company’s portfolio, and absconded with securities worth \$3.25 million before a trustee in bankruptcy was appointed, five months after the looters assumed control.<sup>314</sup>

### e. *Switching*

Switching was a device used by those who were connected with the management of investment companies to generate sales commissions. In its simplest

307 Statement of Arthur H. Bunker, *id.* at 334.

308 1940 Senate Hearings 334.

309 INVESTMENT TRUSTS II 124.

310 An investment company manager who doubled as the company’s broker could easily supplement the management fees he received with brokerage commissions earned on the company’s portfolio transactions if he rapidly turned over an investment company’s portfolio. This helps explain why the portfolios of some investment companies were turned over as often as fifteen times per year. 1940 Senate Hearings 191.

311 See, e.g., INVESTMENT TRUSTS III 2648-49.

312 *Id.* at 2589-624.

313 1940 Senate Hearings 59.

314 *Id.* at 57-70.

form, switching occurs when a mutual fund salesman, purely in the interest of generating a sales commission, induces an investment company's shareholders, particularly those owning mutual fund shares, periodic payment plan certificates, or fixed trust certificates, to "switch" their investment from one company to another. The purchase price of the company's share naturally includes the salesman's commission, which he pockets.<sup>315</sup>

Another form of switching was used by investment company managements during the depression to generate commissions for their salesmen. By the use of recurrent promotions — the continuous formation of investment companies by one management group — those in control were able to switch investors in and out of the various companies, thereby generating sales commissions. The most complex form of switching, called the "preferential bid," was used, mainly in 1933, to switch investors from fixed trusts to open-end companies which were often under identical control. In the case of one fixed trust—open-end switch, the fixed trust's certificate holders were offered a three per cent premium above the net asset value of their securities as an inducement to "swap" them for a pro rata amount of mutual fund shares.<sup>316</sup> The price of the mutual fund shares included a nine and one-half per cent sales load.<sup>317</sup> The effect of the switch was, therefore, to generate a net sales load of six and one-half per cent.<sup>318</sup>

#### *f. Dilution*

Another sales practice utilized by the mutual funds and found by the SEC to be abusive was a direct result of the "two price system" used in valuing mutual fund portfolio securities. Because the purchase price of mutual fund shares was based on the value of the fund's portfolio stocks, which fluctuated daily, the net asset value of the outstanding shares had to be continuously recomputed. The fund's total net asset value and the net asset value of the fund's outstanding securities were commonly determined shortly after the close of the NYSE. However, the net asset value per share calculated at that time was seldom put into effect by the funds until ten o'clock the following morning. In the interim there existed two known prices for the security, and an order to purchase a mutual fund share could be, and usually was, executed at the lower of the two known prices. The effect of this practice was called "dilution," a reference to the impact of the practice on the equity interest of those holding fund shares at the time the sale was made. The effect of such a sale on the interest of those shareholders may readily be seen in this exaggerative example:

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<sup>315</sup> For recent cases which in part dealt with switching by mutual fund salesmen, see Paine, Webber, Jackson & Curtis, SEC Release No. 8501 (January 22, 1969), [Current Binder] CCH FED. SEC. L. REP. ¶ 77,651, at 83,412 (SEC 1969); Shearson, Hammill & Co., SEC Release No. 7743 (November 12, 1965), [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,306, at 82,509 (SEC 1965).

<sup>316</sup> See INVESTMENT TRUSTS III 832-33.

<sup>317</sup> *Id.*

<sup>318</sup> Investment company managements defended the use of the preferential bid to accomplish a switch, on the basis that the shares thus acquired represented valuable additions to the company's portfolio, and that their purchase on the market would entail greater cost due to brokerage fees. Despite this rationale, the acquired shares were, prior to the enactment of the Investment Bankers Code in 1934, generally treated as temporary investments by such companies. *Id.* at 832-33.

1. Assume on day 1 that Mutual Fund X has 10 shares outstanding and that the net asset value per share is \$10:

Assets = Securities	\$100.
Ten Shares — Net asset value	\$10.

2. On day 2 the value of the securities held in the fund’s portfolio skyrockets 50 per cent. If no dilution occurred, the net asset value of Mutual Fund X’s shares would be \$15, a reflection of the rise in the value of the portfolio stocks:

Assets = Securities	\$150.
Ten Shares — Net asset value	\$15.

3. However further assume that Mr. A, aware that the value of Mutual Fund X’s portfolio securities has risen dramatically, purchases 10 shares from Fund X’s dealer at the day 1 price, before the day 2 price becomes effective:

Assets = Securities	\$150
+ Cash	100
	_____
Total	\$250
Twenty Shares—Net asset value	\$12.50.

4. Because of Mr. A’s purchase the net asset value of the original shareholders which should have been \$15, has been diluted to \$12.50, 50 per cent of the increase in the value of the Fund’s assets having been soaked up by Mr. A.

The use of the two price system in this manner was one of the principal selling arguments used by mutual fund salesmen to encourage a prospect to purchase fund shares.<sup>319</sup> By being able to sell a product at the lower of two known prices the salesman was in the enviable position of being able to instantly benefit his customer.

i. Overnight Dilution

Because of the imposition of the mutual fund’s sales load, the difference between the two prices had to be fairly high before it would profit an investor to buy at the “day 1” price, hold the share until the “day 2” price became effective, and then redeem his shares at the higher net asset value. But fund insiders, who were usually able to purchase the shares at a price “close to net asset value,” were easily able to profit from such shenanigans.<sup>320</sup>

ii. Underwriter-Dealer Dilution

Mutual fund purchasers were not the only beneficiaries of the two price system. The fund’s underwriter and dealer were also able to profit from it by filling orders at the higher of the two known prices with shares purchased at

319 1940 Senate Hearings 138. See also *id.* at 844-46.  
 320 *Id.* at 142, 842.

the lower price.<sup>321</sup> The only effective action which the SEC could take against this form of riskless insider trading was to demand that the fact that such a practice was engaged in be disclosed in the dealer or underwriter's registration statement filed pursuant to section 5 of the Securities Act of 1933.<sup>322</sup> In the event the company failed to disclose the practice, the Commission's sole recourse was to issue a stop order under section 8(d) of the 1933 Act,<sup>323</sup> suspending the registration and forcing the firm to amend its statement or cease making sales.<sup>324</sup> The effectiveness of even that weapon was severely retarded by the fact that the majority of those engaging in the practice were not required to register under the Act.

### iii. Effects of Dilution

Although the piecemeal effect of the dilution caused by selling to the public at the lower of two known prices, or selling to the investor at the higher price and pocketing the difference, was miniscule, the aggregate dilution caused by such practices was determined by the SEC to "have a very, very material effect on what the average person buys as an investment and into which the man of small means puts his savings."<sup>325</sup>

### g. Other Abuses

Other practices engaged in by those in control, if less aesthetically offensive than looting or diluting, were nonetheless effective in exploiting the investing public. Insiders were commonly able to purchase the investment company's securities at "cut rate prices."<sup>326</sup> The undisclosed payment of dividends from capital was a common industry practice, and in some cases involved including the amount to be paid for a "dividend" in the price paid for the security by the investor. A sales charge based on the total price was paid by the investor, meaning that the shareholder had paid a commission to the salesman on his dividend. This practice was indulged in by many mutual funds. The president of one mutual fund, on record as testifying that it takes "[j]ust brains"<sup>327</sup> to start an investment company, explained why his fund chose not to disclose the fact that the purchase price of the share included the cost of the first dividend:

[Mr. Parker] I would never have put that into any sales literature, circular, or quarterly report, because I don't believe any of my stockholders would understand it.

321 See *id.* at 144-45 for a discussion of this practice, referred to as "taking positions."

322 Compare Securities Act of 1933 § 5, 15 U.S.C. § 77(e) (1964) with T.I.S. Management Corp., 3 S.E.C. 174 (1938).

323 Securities Act of 1933 § 8(d), 15 U.S.C. § 77(h)(d) (1964).

324 See T.I.S. Management Corp., 3 S.E.C. 174 (1938).

325 1940 Senate Hearings 151-52.

326 See *id.* at 799; INVESTMENT TRUSTS III 2635.

327 INVESTMENT TRUSTS I 104. The colloquy went as follows:

[SEC examiner] I was just interested in the fact that it doesn't take much money to start one of these trusts.

[Mr. Parker] Just brains.

Q They would not understand?  
 [Mr. Parker] And further than that, it would have given them a false idea of what had happened.

Q Isn't that all the more reason to put it in?

\* \* \* \* \*

[Mr. Parker] Were you in the business, you wouldn't say that. It is not practical to educate your stockholders to the point that they would understand that.<sup>328</sup>

#### 4. The Adequacy of Disclosure in the Pre-Act Investment Company Industry

MIT's former Chairman, Dwight P. Robinson, Jr., was absolutely correct when he noted that the adoption by MIT of a policy of "full disclosure" a decade before it was legally required "was a pointed departure from [the investment company industry's] established practice."<sup>329</sup> The undisclosed repurchase of securities by closed-end companies at a discount<sup>330</sup> and the undisclosed payment of dividends from capital were common industry practices.<sup>331</sup>

The merger or consolidation of investment companies was commonly carried through without the affected shareholders being informed that they had appraisal rights.<sup>332</sup> Counsel for one investment company testified before the SEC that since a shareholder could ascertain his appraisal rights merely by consulting the dealer who had sold him the shares, he was "negligent" if he failed to do so.<sup>333</sup> In addition, the SEC noted that the

solicitation literature prepared by management in many cases, whether from design or for other reasons, may omit to disclose material facts essential to an intelligent determination by a stockholder of the merits of a plan for consolidation, merger, or the sale of the assets of his corporation.<sup>334</sup>

Perhaps the ultimate in nondisclosure was achieved by a member of the Founders Group, Founders General Corporation, which published no financial statements for six years.<sup>335</sup>

The effectiveness of federal legislation in compelling investment company managements to disclose information of a material nature to their shareholders was, at best, limited. The reach of the two federal disclosure statutes, the Securities Act of 1933 and the Securities Exchange Act of 1934, was truncated by the ability of many investment companies to continue in operation without the necessity of registering their securities with the Commission in compliance with either Act.<sup>336</sup> Of the 650 investment companies in existence in 1940, only

328 INVESTMENT TRUSTS III 816.

329 D. ROBINSON, JR., MASSACHUSETTS INVESTORS TRUST 15 (1954).

330 See INVESTMENT TRUSTS III 953-55.

331 *Id.* at 816-17.

332 *Id.* at 1507-09.

333 *Id.* at 1508.

334 *Id.* at 1509-10.

335 See *id.* at 2306-07.

336 The provisions of the Securities Act of 1933 apply only to companies that issued securities after July 26, 1933. Securities Act of 1933 § 3(1), 15 U.S.C. § 77(c)(1) (1964). Hence, it was possible for a company to avoid registration under the 1933 Act merely by not offering shares after the July deadline. Indeed, it was impossible for those closed-end com-

130, mainly mutual funds, had registered under the 1933 Act, and not all of those companies were actively selling securities.<sup>337</sup> Although the SEC vigorously policed the disclosure policies of the registered companies — to the point of issuing over forty stop orders<sup>338</sup> — the ability of a large number of companies to continue in operation free from any measure of SEC scrutiny necessarily hampered the Commission's ability to protect the interests of the investment company shareholder.

## 5. The Need for Regulation

Although the SEC made it clear that an industrywide policy of full and complete disclosure was essential for the protection of the investing public, it was quick to point out that mere disclosure was an inadequate cure. Former SEC Commissioner Healy emphasized this point at the Senate hearings on legislative proposals designed to cope with the industry's maladies: "The mere recital of the abuses which have occurred since 1933 and 1934, tends to prove that the Securities Act of 1933 and the Securities Exchange Act of 1934, valuable as they are in most fields, are inadequate here."<sup>339</sup>

The SEC was not alone in that belief. As early as November, 1936, the *New York Times* had editorialized on the merits of disclosure in relation to the investment company industry:

Many investment trust officers would stop here [publicity], holding that "bright sunlight" is all that is needed, and that once this is brought to bear on trust affairs the investor himself must make his choice. But the experience of the last decade indicates that more than this is needed. . . . Regulation has been long overdue.<sup>340</sup>

On March 14, 1940, Senator Robert Wagner introduced S. 3580, Title I of which was amended and incorporated into a later bill, H.R. 10065, which eventually became the Investment Company Act of 1940.<sup>341</sup> The regulatory nature of Senator Wagner's proposed legislation was clearly spelled out in the explanatory statement which accompanied the bill's introduction:

[C]onsidering the investment-company industry as a whole, fundamental deficiencies and abuses actually or potentially exist in all classes of investment companies and, in the absence of legislative *regulation*, will continue

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panies whose shares were selling at a discount to issue any equity securities, since such an issuance would automatically dilute the equity interest of its shareholders.

Since the open-end companies were not bothered by the discount phenomenon, many of them chose to issue shares and comply with the Act's registration provisions. Consequently, mutual fund registrations under the Act exceeded those by closed-ends by nearly three to one, although there were almost three times as many closed-end companies doing business during that period. *Compare INVESTMENT TRUSTS II 757 with id.* at 115.

<sup>337</sup> 1940 *Senate Hearings* 135.

<sup>338</sup> *Id.* at 157. A stop order may be issued by the Commission under section 8(d) of the 1933 Act, 15 U.S.C. § 77(h)(d) (1964), if it appears that the registration statement filed by the company is materially misleading. If the Commission issues a stop order, it becomes unlawful for any person to make use of the mails or interstate commerce to sell the securities.

<sup>339</sup> 1940 *Senate Hearings* 38.

<sup>340</sup> *N.Y. Times*, Nov. 12, 1936, at 26, col. 2.

<sup>341</sup> S. 3580, 76th Cong., 3d Sess. (1940). H.R. 10065, 76th Cong., 3d Sess. (1940), an amended version of S. 3580, was signed into law by President Roosevelt on August 22, 1940.



or recur. The problem of the protection of the investor and the national economy is too vital to permit of haphazard voluntary solutions.<sup>342</sup> (Emphasis added.)

The hearings held on S. 3580 disclose an acute awareness on the part of the Congress, the SEC, and the investment company industry of the need for constructive regulatory measures designed to prevent the recurrence of past misdeeds and to provide a solid foundation for future industry development. The cooperative attitude of both the SEC and the industry during the preparation of the Act provides a valuable insight into the harmony that can exist between a governmental agency and the financial community when the welfare of the investing public is at stake. By the close of the hearings, even the Senate subcommittee's members were impressed:

Senator DOWNEY. Do I understand that the representatives of the investment trusts and the Securities Exchange Commission are virtually in agreement now?

Senator WAGNER. Not virtually but actually in agreement.

Senator DOWNEY. That is a most amazing thing in this chaotic world right now.

Senator WAGNER. I think it is.

Senator DOWNEY. It is really the first encouraging thing I have heard in several weeks. How was this miracle brought about?

Mr. SCHENKER. I think I might fairly say that a great deal of it is attributable to the cooperative spirit of the industry.

Senator DOWNEY. I am glad to hear that and hope it is an index of what we may expect from now on.<sup>343</sup>

President Roosevelt expressed similar sentiments in a statement issued on the occasion of his signing of the Act:

There is no necessity of reviewing in detail the many unhealthy practices which this legislation is designed to eliminate. It is enough to point out that the investment trusts have themselves actively urged that an agency of the Federal Government assume immediate supervision of their activities. This attitude on the part of the investment trust industry and investment advisers is most commendable.

.....  
This in itself is enough to demonstrate that we have come a long way since the bleak days of 1929, when the market crash swept away the veil which up to then had hidden the "behind the scenes" activity of our high financiers and showed all too clearly the sham and deceit which characterized so many of their actions.<sup>344</sup>

The Investment Company Act of 1940 was drafted to eliminate and prevent the propagation of management malpractices such as those discussed above. David Schenker, one of the Act's draftsmen, and once described by a leading mutual fund spokesman as the "[m]ost colorful of all the SEC team,"<sup>345</sup> cap-

342 86 CONG. REC. 2845 (1940) (statement of Senator Wagner).

343 1940 Senate Hearings 1130.

344 86 CONG. REC. 5230-31 (1940) (statement of President Roosevelt).

345 H. BULLOCK, *supra* note 4, at 77.

tured the thrust of the Act's provisions when, referring to one of the most blatant instances of managerial malfeasance, he said:

We did not intend to mess with people who were trying to do a good job, those who had a real interest in the industry of investment, but look to special situations like Continental Securities. And that is all that this bill contemplates.<sup>346</sup>

## 6. The Investment Company Act of 1940

The following discussion of the Act's key provisions, primarily designed to eliminate the "special situations" which Mr. Schenker referred to, is organized by correlating the relevant sections of the Act with the managerial malpractices which they were designed to eradicate. The primary focus will be on those sections which affect management investment company disclosure policies, control practices, structural requirements, and security distribution processes as well as the regulation of the periodic payment plan companies.

### a. Disclosure

It has been noted that the lack of complete and accurate disclosure of material information was one of the pre-Act industry's major shortcomings. Feeling, no doubt, that had investment company managements been required to keep their shareholders informed regarding company practices and policies the travails of the industry's shareholders might have been eased, the Act's draftsmen included a series of important disclosure provisions in section 8 of the Act.<sup>347</sup>

#### i. Management Policies

That section, which defines the registration procedure for investment companies, demands that every registered company disclose in detail:

1. the policy of the company in relation to a series of enumerated activities, *e.g.*, "borrowing money . . . making loans to other persons . . .";<sup>348</sup>
2. any policies not required by law to be disclosed, but "which the registrant deems a matter of fundamental policy and elects to treat as such";<sup>349</sup>
3. the identity and addresses of those persons affiliated with the company, and "a brief statement of the business experience for the preceding five years of each officer and director of the registrant";<sup>350</sup> and
4. "the information and documents which would be required to be filed in order to register under the Securities Act of 1933 and the

<sup>346</sup> 1940 *Senate Hearings* 125-26. The looting of Continental Securities Corp. was discussed earlier. See text accompanying note 313 *supra*.

<sup>347</sup> Investment Company Act of 1940 § 8, 15 U.S.C. § 80a-8 (1964).

<sup>348</sup> *Id.* § 8(b)(1), 15 U.S.C. § 80a-8(b)(1) (1964).

<sup>349</sup> *Id.* § 8(b)(2), 15 U.S.C. § 80a-8(b)(2) (1964).

<sup>350</sup> *Id.* § 8(b)(3), 15 U.S.C. § 8a-8(b)(3) (1964).

Securities Exchange Act of 1934, all securities (other than short-term paper) which the registrant has outstanding or proposes to issue.<sup>351</sup>

The obvious intent of the "management policies" provisions in section 8 was to clip the discretionary wings of investment company management. Section 13 of the Act put "teeth" into the section 8 disclosure provisions by making it unlawful for any registered company to deviate from its specified management policies without having first received the approval of those holding a majority of the company's outstanding voting securities.<sup>352</sup>

#### ii. Undisclosed Repurchases

The abuse related to the surreptitious repurchase of closed-end shares which were selling at discounts was eliminated by section 23(c) which requires a pre-acquisition disclosure of management's intention, the submission of tenders to the affected class of security holders, or acquisition of the shares in conformance with whatever "rules and regulations or orders [the SEC elects to promulgate] for the protection of investors in order to insure that such purchases are made in a manner . . . which does not unfairly discriminate against any holders of the class . . . of securities to be purchased."<sup>353</sup>

#### iii. Undisclosed Payments of Dividends from Capital

The practice of paying dividends from capital was not banned by the Act, but section 19 makes it illegal for an investment company to pay dividends out of capital "unless such payment is accompanied by a written statement which adequately discloses the source or sources of such payment."<sup>354</sup> The section empowered the SEC to prescribe the "form of such statement."<sup>355</sup>

#### iv. Sales Literature

The sales literature distributed by some investment companies, particularly those selling periodic payment plans, which seemed to vary in tenor from exuberant optimism to outright misrepresentation, was subjected to SEC scrutiny by section 24(b).<sup>356</sup> It should be noted that in 1950, the SEC supplemented the disclosure philosophy of section 24(b) with a list of guidelines.<sup>357</sup> The guidelines were promulgated, in the Commission's words, "so that issuers, underwriters and dealers may understand certain of the types of advertising and sales literature which the Commission considers may be violative of statutory standards."<sup>358</sup>

The permissible range of sales "puffing" was narrowed somewhat by section 35 of the Act, which outlaws the use of representations by those engaged in the issuance of investment company securities that the security issued, or the com-

351 *Id.* § 8(b)(4), 15 U.S.C. § 80a-8(b)(4) (1964).

352 *Id.* § 13(a)(3), 15 U.S.C. § 80a-13(a)(3) (1964).

353 *Id.* § 23(c), 15 U.S.C. § 80a-23(c) (1964).

354 *Id.* § 19, 15 U.S.C. § 80a-19 (1964).

355 *Id.*

356 *Id.* § 24(b), 15 U.S.C. § 80a-24(b) (1964).

357 15 Fed. Reg. 5468 (1950).

358 *Id.*

pany issuing it, has been in any way approved by "the United States or any agency or officer thereof."<sup>359</sup> Subsection (d) of that section permits the SEC to obtain an injunction prohibiting a company from using a name that a court determines to be "misleading."<sup>360</sup>

#### v. Accounting Practices and Procedures

In order to supplement and strengthen the Act's disclosure provisions, section 31 grants the SEC the power to supervise industry accounting practices and policies in the interest of achieving a reasonable degree of consistency between the form of the statements issued by the various companies in the industry.<sup>361</sup>

Section 30,<sup>362</sup> the second of the Act's three accounting sections, requires the registered company to continually update its financial statements on file with the SEC, and to transmit, at least semi-annually, certain specified information and financial statements to its shareholders, *e.g.*, "a balance sheet accompanied by a statement of the aggregate value of investments on the date of such balance sheet . . . ."<sup>363</sup> The section also empowers the Commission to require that an independent public accountant certify the financial statements contained in the annual reports filed under the section.<sup>364</sup> In 1962 the SEC exercised its section 30 power, and amended Rule 30d-1, previously promulgated under that section, to require certification of the annual reports made by the investment company to its shareholders.<sup>365</sup>

Insurance that the "independent public accountants" mentioned in section 30 and demanded by Rule 30d-1 are in fact "independent" of management is provided by section 32 of the Act.<sup>366</sup> That section enumerates a series of steps which must be taken regarding the appointment of the accountant. Among the requirements of section 32 is annual shareholder ratification or rejection of the firm selected by the company's board of directors to conduct the audit. Although the section prohibits members of the board who are investment advisors, affiliates of investment advisors, or officers and employees of the investment company from voting on the matter, that restriction was modified by the SEC in 1941, when it promulgated Rule 32a-1<sup>367</sup> which permits most investment companies to select the accounting firm by vote of a majority of the entire board. The board's selection pursuant to Rule 32a-1 remains subject, however, to annual shareholder approval.

#### vi. Disclosure — Summary

The Commission's position regarding the need for timely, comprehensive, and consistent financial statements, which accurately reflect the financial position of the industry's member companies, was unequivocally expressed by Commissioner Healy at the Senate hearings on the proposed legislation: "[I]f this Commission

359 Investment Company Act of 1940 § 35 (a)(b), 15 U.S.C. § 80a-34(a)(b) (1964).

360 *Id.* § 35(d), 15 U.S.C. § 80a-34(d) (1964).

361 *Id.* §§ 31, 15 U.S.C. § 80a-30 (1964).

362 *Id.* § 30, 15 U.S.C. § 80a-29 (1964).

363 *Id.* 30(d)(1), 15 U.S.C. § 80a-29(d)(1) (1964).

364 *Id.* 30(e), 15 U.S.C. § 80a-29(e) (1964).

365 17 C.F.R. § 270.30d-1 (1969).

366 Investment Company Act of 1940 § 32, 15 U.S.C. § 80a-31 (1964).

367 17 C.F.R. § 270.32a-1 (1968).

is not going to be allowed to have some real power with regard to accounting, it is better to tear the bill up. Accounting is at the heart of the whole thing."<sup>368</sup> The sections of the Act which deal with the preparation, certification, and filing of the various specified financial statements clearly provided the Commission with the "real power" it sought.<sup>369</sup> Teamed with the other disclosure provisions, the Act's accounting requirements go far toward remedying the inequities foisted upon unwary pre-Act investors which were attributable to the clandestine manner in which some early investment companies were operated.

### b. Control

If the predatory promoter was not commonplace in the pre-Act industry, he at least left his mark on it. The use of, *inter alia*, voting trusts and long term management contracts, coupled with the unlimited discretion generally bestowed on the management bloc, enabled those controlling other people's money to wheel and deal with impunity. The Act uses a three-pronged attack in its attempt to curb the abuses which resulted from the wielding of such unbridled power: it discourages the formation of fly-by-night companies; it attempts to introduce some modicum of "arm's length bargaining" to the negotiation of management contracts between the company and its investment advisor; and it prohibits management from engaging in certain self-dealing transactions.

### i. Company Formation

In order to discourage insecurely financed organizations from preying on the public, the Act's draftsmen included a minimum capital requirement provision in section 14(a).<sup>370</sup> Clearly mindful that the disastrous collapse of the Founders flowed from an initial capital investment of \$500, that subsection demands that a registered company have a minimum net worth of \$100,000 before publicly offering its shares.

The intent of the minimum net worth requirement of section 14(a) is complemented by section 9,<sup>371</sup> which makes it illegal for certain persons to serve as officers, directors, members of an advisory board, investment advisors, or depositors for any registered investment company, or as underwriter for registered mutual funds, unit investment trusts, or face-amount certificate companies. The thrust of the provision was well captured by one of the Act's draftsmen, Mr. David Schenker:

<sup>368</sup> 1940 Senate Hearings 934.

<sup>369</sup> Investment Company Act of 1940 §§ 30-32, 15 U.S.C. §§ 80a-29 to -31 (1964).

<sup>370</sup> *Id.* § 14(a), 15 U.S.C. § 80a-14(a) (1964). Mr. Baldwin B. Bane, chief of the SEC's registration division, had this to say about fly-by-night companies when testifying before the Senate subcommittee:

These investment trusts are as easy to form as they are to disappear. In fact, it is probable that they are too easy to form. Practically all you have to do is draw up a so-called trust indenture or agreement, setting up a so-called trustee who, in reality, is little more than a custodian, granting powers to the managers and sponsors, limited only by the consciences of those managers and sponsors. Then you start manufacturing your securities and peddling them to the public. 1940 Senate Hearings 135.

<sup>371</sup> Investment Company Act of 1940 § 9, 15 U.S.C. § 80a-9 (1964).

Section 9 says what? A person who is an officer, director, manager, or distributor should not be in the position of having uncontrolled discretion with the management of other people's savings, if (1) he is a jailbird who has been convicted in connection with a securities fraud, or (2) if he has been subject to an injunction in connection with a securities fraud.<sup>372</sup>

## ii. Arm's Length Bargaining Over Management Contracts

In its report on investment companies, the SEC noted that management contracts were used "in a great many instances" by investment companies in their attempt to secure managerial talent.<sup>373</sup> Such a practice comports with that presently engaged in by a majority of the mutual funds.<sup>374</sup> The retention of managerial talent was not the sole motivating factor that induced the majority of the pre-Act industry to turn to external sources for managerial expertise, however. The use of management contracts also furnished an investment company's sponsor with an uncomplicated and extremely effective tool with which he could dominate every segment of the investment company's sphere of operation.

Such an arrangement was quite simple to implement. Since the sponsor invariably controlled the company's original managing board, it was a fairly easy matter for him to arrange a management contract between the investment company and a firm controlled by the sponsor to serve as an investment advisor. A long term management contract was obviously to the advisor's advantage, and the SEC noted that ten years was "the usual provision."<sup>375</sup> Retention of the control thus obtained by the sponsor-advisor was effected by the use of automatic renewal clauses<sup>376</sup> or provisions which empowered the manager "to nominate several or all of the directors and officers of the investment company, or [which required] approval by the manager of the directors elected by the stockholders."<sup>377</sup> In practice, the results obtained by the use of automatic extension clauses, or vote by the board of dummy directors or impotent shareholders on the advisability of a continuation of the existing management arrangement, were identical.

Because of concern that the terms of such management contracts might perchance be more beneficial to the sponsor-advisor than a prudent judgment made by a disinterested board of directors would permit, the Act contains restrictions designed to subject the approval of management contracts to the process of arm's length bargaining, and to hamper the ability of those controlling an investment company to stock its board with their hand-picked stooges.

Section 10<sup>378</sup> of the Act represents an attempt by the draftsmen to insure that some degree of independence is maintained by the company's board of directors. To that end, the section requires that an investment company have no less than a specified quota of "independent" directors on its board. For present

372 1940 Senate Hearings 201.

373 INVESTMENT TRUSTS III 1918.

374 PUBLIC POLICY STATEMENT 45.

375 INVESTMENT TRUSTS III 1921.

376 The use of these clauses was quite common. The SEC found them in twenty-seven of forty-three management contracts that were to run for a specified duration. *Id.*

377 *Id.* at 1919.

378 Investment Company Act of 1940 § 10, 15 U.S.C. § 80a-10 (1964).

purposes the term independent director means a person who is not a registered company's investment advisor, affiliated with an investment advisor, or an officer or employee of the company.<sup>379</sup> The quota of independent directors demanded by the section varies from one person — in the case of a no-load mutual fund — to forty per cent of the board for all other companies. The quota system was devised, in draftsman Schenker's words, to "provide the independent directorships where you have a management contract."<sup>380</sup>

To further strengthen the section's intent — that the company's board would be free from interest ridden domination — provision is made that if an investment banker, the investment company's broker or underwriter, or any person affiliated with such financiers is a board member (or an officer or employee of the company), a majority of the board must be composed of persons who do not share the same vocation.<sup>381</sup>

The purpose of section 10 was advanced somewhat by the provisions of section 15.<sup>382</sup> That section requires that all management contracts entered into after March 15, 1945 be initially approved by those holding a majority of the company's outstanding voting securities. Additionally it requires that the contract either terminate at the end of two years or be annually approved, either by stockholder or board vote. In the case of board approval, the board's majority vote must include that of a majority of those directors who are neither the company's investment advisor nor affiliated with the advisor.<sup>383</sup>

If sections 10 and 15 were designed to prevent the board's vote on the renewal of the advisory contract from being little more than a "rubber stamp's" reflection of management's wishes, they were inartfully drafted because, in most cases, affiliates of the investment advisor are entitled to at least sixty per cent of the investment company's directorships. In effect then, the Act enables the affiliates to "hand-pick" those who are required to occupy the independent directorships. Although section 16(a) requires that their selections must receive shareholder approval,<sup>384</sup> the fact that the "interested directors" are in control of the proxy machinery makes shareholder ratification a virtually automatic procedure. As one attorney has noted: "The men who need to be watched pick the watchdogs to watch them."<sup>385</sup> In short, there is nothing in the Act which prevents the son of a leading stockholder of an investment company's

379 *Id.* § 10(a), 15 U.S.C. § 80a-10(a) (1964).

380 1940 *Senate Hearings* 1113.

381 Investment Company Act of 1940 § 10(b), 15 U.S.C. § 80a-10(b) (1964). Subsection (c), 15 U.S.C. § 80a-10(c) (1964), limits "officers or directors of any one bank" to a minority of investment company directorships, with the exception that

if on March 15, 1940, any registered investment company shall have had a majority of its directors consisting of persons who are directors, officers, or employees of any one bank, such registered company may continue to have the same percentage of its board of directors consisting of [such] persons . . . *Id.*

Subsection (g), 15 U.S.C. § 80a-10(g) (1964), makes the section's directorship requirements applicable to an investment company's advisory board.

382 Investment Company Act of 1940 § 15, 15 U.S.C. § 80a-15 (1964).

383 *Id.* § 15(c), 15 U.S.C. § 80a-15(c) (1964).

384 *Id.* § 16(a), 15 U.S.C. § 80a-16(a) (1964). That section, in relevant part, provides that "[n]o person shall serve as a director of a registered investment company unless elected to that office by the holders of the outstanding voting securities of such company . . ." *Id.*

385 Statement of Abraham Pomerantz, *University of Pennsylvania Law School Conference on Mutual Funds*, 115 U. PA. L. REV. 659, 739 (1967).

investment advisor from sitting on the company's board as an independent director. Such instances are not unknown.<sup>386</sup> The ramifications of the sections 10 and 15 independence requirements, and the extent to which the arm's length dealing envisioned by the Act's draftsmen has been stunted to palm's length size, are examined in detail in Part VI *infra*.

### iii. Self-dealing Transactions

The Act's most overt attack on the misuse of investment company assets by those in control of the company is represented by section 17.<sup>387</sup> While sections 10 and 15 were designed to close the corridor of control that led to incestuous advisor-company relationships, section 17 represents a far more direct approach. In Mr. Schenker's words:

These provisions prohibit self-dealing between the officers and directors and the investment trust. They cannot knowingly purchase from such registered company or from any company controlled by such registered company, any security or other property, except securities of which the seller is the issuer . . . .<sup>388</sup>

The section also outlaws the borrowing of "money or other property" from the investment company by insiders;<sup>389</sup> empowers the SEC to demand that the company's officers and employees be "bonded by a reputable fidelity insurance company against larceny and embezzlement,"<sup>390</sup> which power was exercised in 1947 when the SEC promulgated Rule 17g-1;<sup>391</sup> and strikes down the use of broad exculpatory clauses by company management which are designed to "protect such person against any liability to such company or its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith or gross negligence . . . ." <sup>392</sup> That the Congress found it necessary to include the self-dealing prohibitions of section 17 in the Act which was designed to serve as the industry's regulatory framework is, in itself, a stinging indictment of the ethical level at which a portion of the infant industry's business had been transacted.

### c. Structure

Clearly mindful of the financial folly wrought by the disintegration of the Founders Group's pyramided capital structure, and also of the fact that a dollar invested in the average leveraged closed-end in July of 1929 would have netted the investor a nickel if he liquidated at the end of 1937, Congress sharply circumscribed the use of leverage and the practice of pyramiding in the investment company industry.

386 *Id.* See also Klaw, *Abe Pomerantz is Watching You*, FORTUNE, Feb. 1968, at 144, 159.

387 Investment Company Act of 1940 § 17, 15 U.S.C. § 80a-17 (1964).

388 1940 Senate Hearings 1116.

389 Investment Company Act of 1940 § 17(a)(3), 15 U.S.C. § 80a-17(a)(3) (1964).

390 *Id.* § 17(g), 15 U.S.C. § 80a-17(g) (1964).

391 17 C.F.R. § 270.17g-1 (1968). The Rule was initially adopted as Rule N-17G-1. SEC, GENERAL RULES AND REGULATIONS UNDER THE INVESTMENT COMPANY ACT OF 1940 37 (1968).

392 Investment Company Act of 1940 § 17(i), 15 U.S.C. § 80a-17(i) (1964).



### i. Leverage

The permissible capital structure of a regulated investment company is detailed in section 18 of the Act.<sup>393</sup> That section does permit closed-end companies to borrow from a bank, or to issue bonds, debentures, and preferred stock in the interest of achieving leverage for their common stockholders. The amount of the senior capital thus obtained is limited, however, by the section's restrictions on asset coverage. If the closed-end achieves leverage through the issuance of bonds or debentures, or by "bank borrowing," the company must have a ratio of assets to debt of at least three to one; and, if preferred stock is issued, the ratio must be at least two to one.

Although leveraged mutual funds were, and still are, relatively rare, the Act's draftsmen were obviously aware of the plight in which a highly leveraged fund might be placed by a massive onslaught of redemptions, and severely restricted the use of leverage by open-end companies. Section 18 prohibits mutual funds from issuing bonds or debentures, and the use of bank loans is restricted by a three to one asset coverage requirement. The fund is permitted to issue one class of preferred or "special" stock, provided that

the only other outstanding class of the issuer's stock consists of a common stock upon which no dividend (other than a liquidating dividend) is permitted to be paid and which in the aggregate represents not more than one-half of 1 per centum of the issuer's outstanding voting securities.<sup>394</sup>

It is apparent from the regulatory treatment given leveraged companies that Congress was not at all enamoured with the investment opportunities bestowed on the public by the highly leveraged pre-crash closed-ends. In fact, section 18 is a watered down version of the proposal contained in S. 3580 which would have outlawed the use of leverage altogether.<sup>395</sup>

### ii. Pyramiding

The practice of purchasing substantial interests in other investment companies, which some companies, most notably the Founders Group, engaged in, was banned by section 12(d)(1).<sup>396</sup> That section restricts the holdings of the "acquiring" company to no more than five per cent of the "acquired" company's stock. Congress was so disenchanted with the practice that the Act's preamble states in part "that the national public interest and the interest of investors are adversely affected . . . when the control of investment companies is unduly concentrated through pyramiding . . . ."<sup>397</sup>

<sup>393</sup> *Id.* § 18, 15 U.S.C. § 80a-18 (1964).

<sup>394</sup> *Id.* § 18(f)(2), 15 U.S.C. § 80a-18(f)(2) (1964).

<sup>395</sup> S. 3580, 76th Cong., 3d Sess. § 18 (1940) provided in relevant part that

(a) It shall be unlawful for any registered management investment company to issue any security (other than short-term paper or periodic payment plan certificates), or to sell any such security of which it is the issuer, unless such security—

(1) is a common stock . . . ;

(2) has no preference as to distribution or dividends . . . ;

(3) is a voting security . . . . *Id.*

<sup>396</sup> Investment Company Act of 1940 § 12(d)(1), 15 U.S.C. § 80a-12(d)(1) (1964).

<sup>397</sup> *Id.* § 1(b)(4), 15 U.S.C. § 80a-1(b)(4) (1964). For the Commission's view on the efficacy of the "preamble" provisions, see 1940 *Senate Hearings* 176.

#### d. Securities Distribution

##### i. Dilution

More than fifty pages of the record of the Senate hearings on S. 3580 are devoted to the abusive practices engaged in by members of the mutual fund industry which diluted the net asset value of the shareholders' equity interest. SEC spokesman Baldwin B. Bane, chief of the Commission's Registration Division, asserted that practices which resulted in dilution had a "very, very material effect" on the equity interest of a mutual fund shareholder.<sup>398</sup> Industry spokesman Mahlon E. Traylor, president of the firm that served as MIT's underwriter, rebutted Mr. Bane's observation and argued that there were two causes for dilution: the mechanical operation of the pricing system, and the techniques which "a small fringe element may have practiced unethically to further their own selfish ends. "The former," according to Mr. Traylor, "[was] of negligible proportions. The latter [represented] unethical practice, pure and simple [which could be] eliminated entirely by the imposition of a few simple rules which most of the industry already observes in practice."<sup>399</sup>

Mr. Traylor apparently won out, because section 22(a)<sup>400</sup> gave the National Association of Securities Dealers [NASD], a voluntary securities association registered under the section 15A amendment to the Securities Exchange Act of 1934,<sup>401</sup> the power to establish rules "for the purpose of eliminating or reducing so far as reasonably practicable any dilution of the value"<sup>402</sup> of the equity interest of mutual fund or unit investment trust shareholders. The SEC was given concurrent jurisdiction over industry practices which led to dilution, commencing one year after the Act's effective date.

If Mr. Traylor's viewpoint won the battle — congressional approval — Mr. Bane's won the war, because on October 16, 1968, the SEC promulgated Rule 22c-1, effective January 13, 1969, which requires all registered mutual funds and unit investment trusts to

sell, redeem, or repurchase [their shares] *at a price based on the current net asset value of [the shares] which is next computed after receipt of a tender of [the shares] or of an order to purchase or sell [them].*<sup>403</sup> (Emphasis added.)

The Rule further demands that the companies affected by it calculate the net asset value of their shares at least "once daily as of the time of the close of trading on [the NYSE]."<sup>404</sup> The effect of the Rule is to make what had commonly been referred to as a "two-price system" a system having one price only. Since the Rule has the obvious effect of carrying out the manifested congressional intent of "eliminating or reducing so far as practicable"<sup>405</sup> the key malprac-

398 1940 Senate Hearings 151.

399 *Id.* at 515.

400 Investment Company Act of 1940 § 22(a), 15 U.S.C. § 80a-22(a) (1964).

401 Securities Exchange Act of 1934 § 15A, 15 U.S.C. § 780-3 (1964).

402 Investment Company Act of 1940 § 22(a), 15 U.S.C. § 80a-22(a) (1964).

403 17 C.F.R. § 270.22c-1(a) (1969), reprinted in SEC, GENERAL RULES AND REGULATIONS UNDER THE INVESTMENT COMPANY ACT OF 1940, at 43 (1968).

404 17 C.F.R. § 270.22c-1(b) (1969), reprinted in SEC *supra* note 403, at 43.

405 Investment Company Act of 1940 § 22(a), 15 U.S.C. § 80a-22(a) (1964).

tice that resulted in dilution, selling shares at the lower of two known prices, the only question raised by the SEC's promulgation is why the Commission waited so long.

## ii. Retail Price Maintenance

Section 22(d)<sup>406</sup> contains the Act's infamous retail price maintenance provision. In essence, that subsection makes it a federal crime for a securities salesman to sell either mutual fund or unit investment trust shares to the public at a price different from that specified in the company's prospectus. The effect of the subsection is to eliminate any semblance of competition between mutual fund and unit investment trust salesmen regarding the prices charged the public for the shares issued by such companies. Whether section 22(d) serves any purpose — other than providing a large segment of the investment company industry with a "built in" antitrust exemption — is a hotly debated topic. The opposing viewpoints are discussed in Part IV *infra*.

## e. Periodic Payment Plans

The sales practices of the periodic payment plan companies met with much congressional disfavor.<sup>407</sup> As a result, section 27<sup>408</sup> limits the maximum front-end load chargeable by a plan company to fifty per cent of the planholder's first annual payment. That section also abolishes the "\$5.00 plan," requiring that the company receive an initial payment of \$20.00, and no less than \$10.00 in regular installments thereafter.<sup>409</sup> The sales literature used by the contractual plan companies was, as pointed out earlier, required by section 24(b) to pass muster with the SEC.

The effect of the Act on the contractual plan industry was, no doubt, to modify its "gospel," which, according to testimony at the Senate hearings, consisted of just three words: "[S]ell, sell, sell."<sup>410</sup>

## f. Enforcement

Sections 36, 38 through 46, and 49<sup>411</sup> provide the SEC with the adminis-

406 *Id.* § 22(d), 15 U.S.C. § 80a-22(d) (1964).

407 *See, e.g.,* S. REP. No. 1775, 76th Cong., 3d Sess. 9 (1940). The Senate Committee was plainly displeased:

These periodic payment plan certificates, which were sold for as low as \$5 a month, were specifically designed to make their strongest appeal to wage-earning men and women who were not in a financial position to invest or speculate in common stocks. As a result, these certificates were sold to housewives, domestic workers, laborers, nurses, stenographers, clerks, and others who had little financial experience. Inasmuch as the refinement and technique of the operation of periodic payment plans are intricate, they were far beyond the comprehension of the class of persons to whom these certificates were sold.

In addition to the fact that persons unqualified to understand the intricacies of the plan were employed as salesmen, *the committee was impressed by the evidence that salesmen often flagrantly misrepresented these plans. . . . Id.* (Emphasis added.)

408 Investment Company Act of 1940 § 27, 15 U.S.C. § 80a-27 (1964).

409 *Id.* § 27(a)(4), 15 U.S.C. § 80a-27(a)(4) (1964).

410 1940 Senate Hearings 172. For the story of one contractual plan salesman who sold a plan to a minister by holding himself out as a "prospective convert into the minister's faith," see *id.* at 170.

411 Investment Company Act of 1940 §§ 36, 38-46, 49, 15 U.S.C. §§ 80a-35, 37-45, 48

trative and enforcement machinery to enable it to employ the powers and assume the duties vested in it by the Act. Judicial review of the Commission's actions is also provided for in section 43.

*g. Maximum Assets — A Compromise*

Before concluding this brief discussion of several of the Act's most important provisions and the effect they were designed to have on the industry, mention should be made of one proposal made by the SEC that was not enacted, and the compromise that was enacted in its stead.

Prompted mainly by concern over the possibility of a "run" on an open-end investment company, the SEC proposed that investment companies be prohibited from issuing securities once their total assets reached a certain maximum size.<sup>412</sup> The stated maxima, listed in section 14(a) of S. 3580,<sup>413</sup> varied among different classes of investment companies, but the effect of the provision would have been to require virtually all modern management investment companies to cease selling securities when the value of each company's total assets exceeded \$150 million.

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(1964). Section 37 makes larceny, embezzlement, or conversion of a registered investment company's property a federal crime. *Id.* § 37, 15 U.S.C. § 80a-36 (1964). The section will support a civil action as well. *See Brown v. Bullock*, 194 F. Supp. 207 (S.D.N.Y. 1961), *aff'd*, 294 F.2d 415 (2d Cir. 1961).

412 Draftsman Schenker's testimony before the Senate subcommittee indicates that the limit on size was intended to protect the funds from a spontaneous onslaught of redemptions:

Senator, we have no interest in size per se. But in the open-end company, the stockholder has the right at any time to tender his stock and get his asset value: If you were to have a run on that type of company—and it is no different from a run on a bank, Senator—you can see that if you had \$150,000,000 invested in large blocks of stocks, if the time comes when for some reason or other the stockholders in the company are dissatisfied with the management and they decide to tender their stocks for redemption, you will get a program of liquidation which may result in two things: In the first place, an undesirable effect upon the stock market in general. In the second place the stockholder who tenders his stock for redemption a little later may find himself with an illiquid stock and who may not be able to get his asset value. . . . 1940 *Senate Hearings* 247.

The following colloquy between former SEC Commissioner Healy and Senator Hughes indicates that at least two of the participants in the 1940 Senate hearings did indeed have an interest in size per se:

[Mr. HEALY] There is a phobia in connection with the American worship of size. You get to thinking sometimes that anything that is big must be wonderful. That is not so, in my opinion. Primo Carnera was big but he could not punch his way out of a paper bag. United Founders was big; it was \$500,000,000 big, but it was far from wonderful. Even in manufacturing concerns any good economist will tell you that there is a point at which size does not increase efficiency. There is a point where you begin to go down the other side of the hill.

Senator HUGHES. Judge, I have a more radical view than that. I think there ought to be a limit to the size of cities, especially when a city gets to a size where so many people have accumulated there that it makes it impossible to police them. I think, if it were possible, it would be a mighty good thing if we could limit the size of cities to, say, 500,000 people.

Mr. HEALY. Managing a big city is no more difficult than managing \$150,000,000 of common stocks. I think in some of these situations, certainly in the business world, it is not a question how big you are; it is a question of how good you are. If you can keep on being good and doing a good job, then I for one would be willing to have you grow as big as you want to, as long as you keep on doing a good job. My doubt is whether anybody who is not a double or triple Napoleon can run \$150,000,000 of common-stock investments and do a good job for the people who have entrusted \$150,000,000 to him. 1940 *Senate Hearings* 937.

413 S. 3580, 76th Cong., 3d Sess. § 14(a) (1940).

Mr. Merrill Griswold, chairman of MIT, then the largest mutual fund in America, challenged the need for such a restriction. In his view it was clearly unnecessary:

[A]n open-end trust could never be a billion dollar company or a five hundred million dollar company, because redemptions, which are a fixed percentage, around 8 or 10 percent, get to be so large, when your fund gets to those big proportions, that you could not resell that amount of shares; and we therefore claim that economic conditions absolutely take care of this situation, and that there never will be an open-end investment trust with assets like life insurance companies and large banks.<sup>414</sup> (Emphasis added.)

For the record, on December 31, 1967:

1. ten domestic mutual funds had net assets in excess of one billion dollars;<sup>415</sup>
2. the net assets of twenty-three registered funds exceeded five hundred million dollars;<sup>416</sup>
3. sixty-one domestic mutual funds had total net assets in excess of one hundred and fifty million dollars;<sup>417</sup>
4. the mutual fund that ranked last on a list of one hundred registered mutual funds, listed according to the size of their net assets, had a greater total *net* asset value than the total *gross* asset value of 280 insurance companies;<sup>418</sup> and
5. each of the ten largest domestic mutual funds held net assets in excess of the amount of the total capital of the largest bank in the United States.<sup>419</sup>

If Mr. Griswold was blessed with the gift of prophecy, it is not readily apparent.

Whether it was the force of Mr. Griswold's argument that persuaded Congress to discard the maximum size limitation is not known, but, after consultations between the SEC and the industry, Congress approved a compromise solution. That compromise is now section 14(b)<sup>420</sup> of the Act. Section 14(b) authorizes the Commission

at such times as it deems that any substantial further increase in size of investment companies creates any problem involving the protection of investors or the public interest, to make a study and investigation of the effects of size on the investment policy of investment companies and on security markets, on concentration of control of wealth and industry, and

414 1940 *Senate Hearings* 500. Other investment company industry objections to a statutory size maximum were: "competition will take care of [it]," *id.* at 484; "if you are fearing that power that goes with accumulations of capital, you may be taking a step that will increase that power, and not decrease it . . ." *id.* at 622; "We should stop look and listen before adopting anything so un-American as a measure to penalize success . . ." *id.* at 435; "the record shows that large size brings substantial benefits to shareholders in the form of lower operating costs . . ." *id.* at 457; "it is easy to agree that the maximum size proposed by the bill seems ample, but who knows?" *id.* at 688.

415 MOODY'S BANK AND FINANCE MANUAL April, 1968, at a53 (F. St. Clair ed. 1968).

416 *Id.*

417 *Id.*

418 *Compare id. with id.* at a47-48.

419 *Compare id.* at a53 with *id.* at a37.

420 Investment Company Act of 1940 § 14(b), 15 U.S.C. § 80a-14(b) (1964).

on companies in which investment companies are interested, and from time to time to report the results of its studies and investigations and its recommendations to the Congress.<sup>421</sup>

The ramifications of that subsection are, as will be seen, currently of extreme significance.

#### *h. Conclusion*

It is safe to say that the Act, which in Senator Wagner's words was "a very mild form of supervision to protect the American public,"<sup>422</sup> has served to benefit both the investment company industry and the public. This fact was recognized by the former Chairman of the SEC, Manuel F. Cohen, when he testified on the Commission's behalf before the Senate Banking and Currency Committee: "The purpose of [the 1940 Act's] regulatory pattern was primarily to deal with specific and then recognized abuses. This it has done successfully."<sup>423</sup>

In addition to the direct benefits reaped by both the investing public and the industry by virtue of the Act's achieving its designed mission — the elimination of the flagrant malpractices formerly present in the industry — the financial community also received an indirect benefit, the formation of the Investment Company Institute (formerly the National Association of Investment Companies). The Institute, which now represents the interests of a group of mutual funds that hold approximately ninety-five per cent of all fund assets, was a direct outgrowth of the investigations conducted by the SEC and the congressional scrutiny of industry practices. It was formed by the "informal group of individuals who cooperated with the SEC in drafting the Investment Company Act of 1940,"<sup>424</sup> and now serves to represent its member companies' viewpoint on state and federal legislation, functions as a clearing house for the industry's statistical data, and, most importantly, strives to promote high ethical standards within the investment company industry.

In short, the fourth stage of investment company growth was a period of rapid transition within the investment company industry. During the years between October 24, 1929, and August 22, 1940, the industry evolved from an unregulated hodge-podge of companies — operated by managements which ran the ethical gamut from ne'er-do-well to honest, intelligent businessman — into a resolute and unified economic power.

#### *F. Post-1940 Industry Growth*

In the SEC's extensive study prepared pursuant to section 30 of the Holding Company Act, it was noted that at its pre-crash peak, the total assets managed by the investment company industry probably exceeded \$8 billion.<sup>425</sup> As the following table<sup>426</sup> shows, many years elapsed before that figure was surpassed:

421 *Id.*

422 1940 Senate Hearings 204.

423 1967 Senate Hearings 3.

424 H. BULLOCK 103. Mr. Bullock was one of the Institute's founders. *Id.*

425 INVESTMENT TRUSTS III 4.

426 34 SEC ANN. REP. 115 (1968).

*Number of investment companies registered under the Investment Company Act and their estimated aggregate assets, in round amounts, at the end of each fiscal year, 1941 through 1968*

Fiscal year ended June 30	Number of companies				Estimated aggregate market value of assets at end of year (in millions) <sup>a</sup>
	Registered at beginning of year	Registered during year	Registration terminated during year	Registered at end of year	
1941 .....	0	450	14	436	\$2,500
1942 .....	436	17	46	407	2,400
1943 .....	407	14	31	390	2,300
1944 .....	390	8	27	371	2,200
1945 .....	371	14	19	366	3,250
1946 .....	366	13	18	361	3,750
1947 .....	361	12	21	352	3,600
1948 .....	352	18	11	359	3,825
1949 .....	359	12	13	358	3,700
1950 .....	358	26	18	366	4,700
1951 .....	366	12	10	368	5,600
1952 .....	368	13	14	367	6,800
1953 .....	367	17	15	369	7,000
1954 .....	369	20	5	384	8,700
1955 .....	384	37	34	387	12,000
1956 .....	387	46	34	399	14,000
1957 .....	399	49	16	432	15,000
1958 .....	432	42	21	453	17,000
1959 .....	453	70	11	512	20,000
1960 .....	512	67	9	570	23,500
1961 .....	570	118	25	663	29,000
1962 .....	663	97	33	727	27,300
1963 .....	727	48	48	727	36,000
1964 .....	727	52	48	731	41,600
1965 .....	731	50	54	727	44,600
1966 .....	727	78	30	775	49,800
1967 .....	775	108	41	842	58,197
1968 .....	842	167	42	967	69,732

<sup>a</sup> The increase in aggregate assets reflects the sale of new securities as well as capital appreciation.

It is also clearly apparent from a perusal of the above figures that the post-Act growth of the industry, particularly during the last fifteen years, has indeed been "dramatic." A large portion of the rapid growth rate enjoyed by the industry is attributable to the emergence of the mutual fund as a highly popular investment vehicle. Since 1940, the total assets held by the funds have advanced from \$450 million to over \$53 billion, and the percentage of the industry's assets held by the funds has increased from twenty to seventy-five per cent. By way of understatement, it may be noted that the passage of the 1940 Act does not appear to have deterred the industry's development.

As was pointed out in the Introduction to this Survey, the dramatic growth rate enjoyed by the industry, particularly its mutual fund segment, has attracted the attention of both the SEC and the Congress. Their concern is centered on the effects which the industry's rapid growth has had on the avowed objective of the 1940 Act: the protection of the American investor. The SEC's position, stated in 1967 by then Commissioner Cohen, is that "[the 1940 Act's] safeguards

no longer meet the needs of the investing public."<sup>427</sup> In arriving at that conclusion, embodied in the Commission's *Public Policy Statement*, the SEC utilized the reports prepared by two research teams which examined the operational structure of the mutual fund industry: the Securities Research Unit of the Wharton School of Finance [Wharton Group], and the SEC's own research unit which prepared the multi-volume *Special Study of the Securities Markets* [*Special Study*].<sup>428</sup>

The Wharton Group's investigation had its genesis in 1958, when the SEC's concern over the burgeoning size of the mutual fund industry caused it to use its section 14(b) power, and engage the Wharton Group to

make a study and investigation of the effects of size on the investment policies of investment companies and on security markets, on concentration of control of wealth and industry, and on companies in which investment companies are interested . . . .<sup>429</sup>

Accordingly, the Group conducted a study of the mutual fund industry, the most comprehensive examination of any aspect of the investment company industry since the SEC's monumental investigation which led to the passage of the 1940 Act. Through the use of two sets of detailed questionnaires, the Group compiled data on the functional characteristics and market impact of 189 mutual funds which operated during the study's target periods: from 1952 to October, 1958, and during 1960.

The information gathered by the Wharton Group dealt with four major areas: (1) the utility of the existing management fee rate structure in the mutual fund industry; (2) the effect which mutual fund portfolio trading has on the securities markets; (3) the investment performance records achieved by the funds; and (4) the effects which an increase in the size of a fund has on its ability to function efficiently. The Group's conclusions relative to these four topics of inquiry were presented to the SEC in August of 1962, and transmitted by the Commission to Congress shortly thereafter.

The major conclusions of the Wharton Group summarized in outline form were:

- (1) Management Fee Rates
  - (A) Approximately eighty per cent of all investment advisors were compensated by a fixed fee rate which did not vary with the asset size of the fund managed, although the operating expenses of the advisor "were generally lower per dollar of income received, and also lower per dollar of assets managed . . . ."<sup>430</sup>
  - (B) The advisory fee rates charged the mutual funds by investment advisors tended to be "substantially higher than those charged by the same advisers to the aggregate of their clients other

<sup>427</sup> 1967 Senate Hearings 3.

<sup>428</sup> REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES EXCHANGE COMMISSION, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pts. 1-6 (1963).

<sup>429</sup> Investment Company Act of 1940 § 14(b), 15 U.S.C., § 80a-14(b) (1964).

<sup>430</sup> A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 955, 87th Cong., 2d Sess. 29 (1962). See *id.* at 480-81.



- than investment companies, for comparable asset levels,<sup>431</sup> despite the fact that “the expenses involved in advising mutual funds are less than those incurred in advising other clients.”<sup>432</sup>
- (C) The mutual funds that used internal management to provide services comparable to those furnished other companies by investment advisors tended to have lower management costs.<sup>433</sup>
- (2) The Effect of Mutual Fund Trading on the Securities Markets
- (A) “[I]t seems likely that the growth in the funds’ net purchases of common stock [had] stimulated stock prices markedly during the last decade or so, during which the industry has expanded enormously.”<sup>434</sup>
- (B) “There [was] some but not strong evidence that net purchases by mutual funds significantly affect the month-to-month movements in the stock market as a whole.”<sup>435</sup>
- (3) Mutual Fund Investment Performance
- (A) For the five and three-fourths years covered by the Wharton Group study, the performance of Standard and Poor’s Composite Common Stock Index was “definitely superior to the performance of the funds.”<sup>436</sup>
- (B) “The average yield for all funds was lower than that of the Standard and Poor’s Index for every year prior to 1958.”<sup>437</sup>
- (4) Size
- (A) There was a positive relationship between the level of the sales load charged by the companies surveyed and the “inflow of new money” into the funds.<sup>438</sup>
- (B) The ratio of operating expenses incurred by a mutual fund (exclusive of the management fee) to the asset size of the fund tends to decrease if the size of the fund’s assets increases.<sup>439</sup>
- (C) “[T]he main problems affecting mutual funds do not seem to relate to the size of individual funds or companies but rather to the industry as a whole.”<sup>440</sup>

Because the Wharton Group’s study did not embrace the areas related to the manners in which mutual fund shares are distributed to the public, the Commission’s *Special Study* task force, which had been organized pursuant to section

431 *Id.* at 29; *see also id.* at 500-04, 508.

432 *Id.* at 29.

433 *Id.*

434 *Id.* at 21.

435 *Id.* *See also id.* at 371-73.

436 *Id.* at 17.

437 *Id.* at 21. *See also id.* at 351-53.

438 *Id.* at 6, 109-10.

439 *Id.* at 498-503.

440 *Id.* at 3.

19(d) of the Securities Exchange Act,<sup>441</sup> was directed by the Commission to examine the methods used to sell mutual fund shares.

Among the areas examined by the *Special Study's* research team were: mutual fund selling practices,<sup>442</sup> the utility of the contractual plan as a mutual fund sales technique,<sup>443</sup> the use of brokerage commissions to reward dealers engaged in the sale of mutual funds,<sup>444</sup> and the extent of insider transactions in fund portfolio securities.<sup>445</sup> The conclusions drawn by the task force as a result of that investigation were reported to Congress on August 8, 1963, in Chapter XI of the *Special Study*. Very briefly stated, the recommendations made in that report to Congress were: (1) A joint attempt to eliminate "undesirable selling practices"<sup>446</sup> which, the research unit indicated, may have been present in the mutual fund industry "to an unfortunate degree,"<sup>447</sup> should be undertaken by the SEC, the NASD, and the industry through the strengthening of existing ethical guidelines;<sup>448</sup> (2) congressional consideration should be given to the abolition of the contractual plan industry's distinctive feature, the front-end load;<sup>449</sup> (3) action should be taken by the SEC, the NASD, and the industry to promulgate guidelines to insure that the benefits gained through mutual fund portfolio transactions redound to the benefit of the fund's shareholders whenever possible,<sup>450</sup> and consideration should be given to modifying the NYSE's minimum commission rate structure to enable fund portfolio transactions to be executed at the lowest possible cost;<sup>451</sup> and (4) each registered investment company should formulate and implement guidelines designed to eliminate insider trading "which are satisfactory to the Commission."<sup>452</sup>

Because the recommendations and conclusions of both the Wharton Group and the Commission's research unit which prepared the *Special Study* served merely an advisory function — they were reports *to*, not reports *by* the Commission — they could only suggest courses of action which might be taken to cope with the problems created by the dramatic growth of the mutual fund industry. Late in 1966, however, the Commission did take a stance on the effects which the growth of the mutual fund industry has had on the need for additional safeguards designed to protect the investing public from management and sales practices which tend toward a form of exploitation unenvisioned by those who drafted the Investment Company Act of 1940.

The Commission's position, expounded in the *Public Policy Statement*, was

that the Investment Company Act of 1940 has substantially eliminated the serious abuses at which it was aimed, but that the tremendous growth of the industry and the accompanying changes have created a need for additional protections for mutual fund shareholders in areas which were either unanticipated or of secondary importance in 1940.<sup>453</sup>

The Commission's recommendations were embodied in legislation designed, in SEC Chairman Cohen's words, "to give a fair shake to the more than 4

441 Securities Exchange Act of 1934 § 19(d), 15 U.S.C. § 78s(d) (1964).

442 REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES EXCHANGE COMMISSION, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt. 4, at 102-68 (1963) [hereinafter cited as SPECIAL STUDY IV].

443 *Id.* at 169-204.

million Americans who now [mid-1967] own mutual fund shares and to the uncounted millions . . . who will invest in such shares in the future."<sup>454</sup> Mr. Cohen explained the thrust of the legislation, the "result of 8 years of hard and diligent study by the Securities and Exchange Commission":<sup>455</sup>

The bill will [provide that "fair shake"] by reducing the sales loads imposed on the acquisition of fund shares where those loads are excessive and by providing a way in which unreasonably high management fees can be reduced. That is the sum and substance of the bill.<sup>456</sup>

Although the bill to which Mr. Cohen was referring, S. 1659, was not enacted during the Ninetieth Congress, similar legislation incorporating sales load and management fee provisions, as noted in the Introduction, are now pending before Congress. The substance of those bills and the effect which the enactment of either of them will have on the mutual fund industry will be discussed in the remaining segment of this Survey. Parts IV and V consider the effect which the enactment of the various measures utilized by the bills to reduce sales loads will have on the distributing system currently used to market mutual fund shares. Part VI examines in detail the existing standards governing management compensation — its potential and its deficiencies — and explores the SEC proposals which would improve that body of law.

#### IV. Regulation of Mutual Fund Distribution System

##### *A. Introduction*

Since their inception mutual funds have provided what is undoubtedly a meritorious service to the investing public.<sup>457</sup> According to leaders of the industry, the primary attributes of that service consist of making available to the public the advantages of equities investing, along with expert management and a lessening of investment risk at costs far below those otherwise available to the aspiring investor.<sup>458</sup> Many Americans, because of their desire to accumulate a separate source of wealth, are potential investors in mutual funds, since fund investing requires neither a significant capital outlay nor a knowledge of the securities

444 *Id.* at 213-33.

445 *Id.* at 235-54.

446 *Id.* at 212.

447 *Id.*

448 *Id.*

449 *Id.*

450 *Id.* at 235.

451 *Id.* at 234.

452 *Id.* at 255.

453 PUBLIC POLICY STATEMENT, Letter of Transmittal vii.

454 1967 Senate Hearings 3.

455 Statement of Senator John Sparkman, Chairman of the Senate Banking and Currency Committee, 1967 Senate Hearings 1.

456 *Id.* at 3.

457 Former Chairman of the SEC, Manuel F. Cohen, testifying before the House Subcommittee on Commerce and Finance, stated: "[N]one of our proposals are directed at mutual funds as such, their viability, continued viability, growth, and usefulness." 1967 House Hearings 706.

458 Testimony of Francis S. Williams, 1967 Senate Hearings 188.

market. The mutual funds, knowing that many citizens of modest means are more than receptive to the thought of accumulating capital, but faced with the task of ferreting out these potential investors, have developed a distribution system by which the funds approach the investors, rather than the investors, the funds.

In fact, because of the factors outlined above, it is the custom of the industry to fairly shout that mutual funds are *sold*, not bought.<sup>459</sup> Most funds seek out the investor and "sell" him on the merits of fund investing through the activities of a salesman employed by the mutual fund distribution system. Selling mutual fund shares constitutes the primary objective of fund distribution systems, though other related activities, such as servicing established accounts, are also performed by members of the distribution process.<sup>460</sup>

As indicated in Part II, the investment advisor, who forms the fund,<sup>461</sup> usually initiates the distribution chain as well.<sup>462</sup> The underwriter, usually either the fund's investment advisor or a subsidiary of the advisor,<sup>463</sup> superficially performs the traditional functions of an underwriter, *i.e.*, purchase of the shares of the issuer for resale to another buyer.<sup>464</sup> But in ordinary underwritings there exists the possibility that the underwriter will be unable to resell the shares at a profitable margin and thus will have to "unload" them at a loss, or retain them on his "shelf" until a more advantageous market for them develops.<sup>465</sup> The mutual fund underwriter, however, is not allowed to underwrite any shares that are not already the subject of a purchase order from the customer to the broker-dealer.<sup>466</sup> This fact, coupled with the corollary statutory mandate that mutual funds must stand ready to redeem their shares at net asset value,<sup>467</sup> produces an essentially risk-free transaction for the advisor or subsidiary-underwriter. The relevance of this feature will be borne out below.<sup>468</sup>

The second link in the usual form of the distribution process is the broker-dealer.<sup>469</sup> Connected to the management company-subsi- dary underwriter only

459 *E.g.*, testimony of Robert M. Gardiner, 1967 Senate Hearings 554.

460 NASD, ECONOMIC CONSEQUENCES FOR THE SECURITIES BUSINESS 35 (1967).

461 See text accompanying note 80 *supra*.

462 PUBLIC POLICY STATEMENT 201.

463 SPECIAL STUDY IV 105. See also PUBLIC POLICY STATEMENT 55. Under the provisions of section 22(d) of the Investment Company Act of 1940, a mutual fund must sell its shares to or through a principal underwriter if it wishes to sell them at a price other than the current net asset value, *i.e.*, by levying a sales load. Investment Company Act of 1940 § 22(d), 15 U.S.C. § 80a-22(d) (1964). Section 22(d) also provides that the fund may sell its shares directly to the public at the current public price described in the prospectus, but section 12(b) requires any fund acting as its own distributor to adhere to regulations prescribed by the SEC. Investment Company Act of 1940 §§ 12(b), 22(d), 15 U.S.C. §§ 80a-12(b), 22(d) (1964).

464 I. FRIEND & OTHERS, INVESTMENT BANKING AND THE NEW ISSUES MARKET 2 (1967).

465 PUBLIC POLICY STATEMENT 212-13.

466 NASD Rules of Fair Practice, art. III, § 26(f)(2) provides:

No member shall purchase the securities of any open-end investment company of which it is the underwriter . . . except for the purpose of covering purchase orders already received and no member shall purchase such securities from the underwriter other than for investment except for the purpose of covering purchase orders already received. NASD, REPRINT OF THE MANUAL ¶ 2176, at 2106 (CCH 1968) [hereinafter cited as NASD REPRINT].

467 Section 22(e) of the 1940 Act provides that the right of redemption may be postponed no longer than seven days except in isolated instances. Investment Company Act of 1940, § 22(e), 15 U.S.C. § 80a-22(e) (1964).

468 See text accompanying notes 643-58 *infra*.

469 Section 2(a)(6) of the Investment Company Act defines "broker" as "any person

by a sales agreement,<sup>470</sup> the dealer is able to obtain fund shares at net asset value. The agreement must set forth the "concession" to be received by the dealer,<sup>471</sup> and many agreements further provide that an additional percentage may be retained for sales over a stated volume.<sup>472</sup>

In the broker-dealer's employ will be the final link in the chain, the salesmen (who prefer to be called "registered representatives"<sup>473</sup>) who make direct contact with the potential investors. Ordinarily the salesmen must resort to a good deal of ingenuity in seeking out these investors, since in many instances they will not have been the target of previous securities merchandising campaigns.<sup>474</sup>

Another form the distribution process may take is the totally integrated distribution organization. Under this form, one company "combines the functions of sole underwriter for, investment adviser to, and retailer of" one open-end investment company.<sup>475</sup> Sales personnel retained by the company constitute what is termed in the trade a "captive sales force." As of 1966, funds distributed by captive sales forces held more than forty per cent of all fund assets.<sup>476</sup> This treatment of the mutual fund distribution systems will focus on non-integrated systems. However, integrated systems will be given consideration in those areas where a difference in the systems merits noting.

The independent broker-dealer is of extreme importance to the entire mutual fund distribution operation and, ordinarily, will have contracts with several different underwriters so that he can offer to the public shares of a variety of mutual funds.<sup>477</sup> The broker-dealer may be a firm that engages in general securities transactions, as for example, Bache & Co., or one that specializes in the sale of mutual fund shares. As a practical matter, it appears that members

engaged in the business of effecting transactions in securities for the accounts of others . . . ." 15 U.S.C. § 80a-2(a)(6) (1964).

Section 2(a)(11) defines "dealer" as "any person regularly engaged in the business of buying and selling securities for his own account . . ." 15 U.S.C. § 80a-2(a)(11) (1964).

While the principal difference between the two functions consists of the distributor's acting as either principal or agent, this distinction recedes into the background in the normal distribution of fund shares.

470 Under this contractual scheme, the dealer purchases as principal from the underwriter for resale to the customer. The underwriter is thereby insulated from liability for the selling practices of the broker-dealer. SPECIAL STUDY IV 107. Apparently, therefore, the qualifications of the individual broker-dealers are of little consequence to the underwriter. *Id.* at 105.

471 Rules of Fair Practice, art. III § 26(c), reprinted in NASD REPRINT ¶ 2176, at 2104.

472 1967 House Hearings 519. The sales agreement also binds the dealer to other obligations; NASD Rules of Fair Practice, article III, section 26(c) forbids any member underwriter to sell its shares to non-members except at the current public offering price, which includes the sales load. It may sell shares below the current public offering price, *i.e.*, at net asset value, only to NASD members with whom it has a sales agreement. In addition, section 26 contains other provisions relating to purchase orders (subsection (f)), conditional orders (subsection (g)), return of concession on immediate resale to the issuer (subsection (i)), and purchases as principal (subsection (j)). NASD REPRINT ¶ 2176, at 2104.

473 Upon registration as a representative, a salesman must qualify to sell securities by passing either an NASD examination or one prescribed by the SEC for non-NASD members, and, in a few instances, a state examination. Upon successful completion of the tests, the salesman's registration becomes effective. Compare NASD By-Laws, art. I, § 2(d), Schedule C, reprinted in NASD REPRINT ¶ 1102, at 1052-53 with Rule 15b8-1(ii), 17 C.F.R. § 240.15b8-1 (1968).

474 See generally SPECIAL STUDY IV 125-29 for a description of the solicitation process. Many times the salesman who runs out of "prospects" will simply have to resort to the bane of all salesmen, the "cold turkey" or "cold canvass" calls, where, the theory is that if he knocks on enough doors, he will find a promising investor. *Id.* at 127.

475 SPECIAL STUDY IV 102.

476 PUBLIC POLICY STATEMENT 207 n.28.

477 SPECIAL STUDY IV 106.

of the latter group dominate the field, for data compiled in 1962 by the *Special Study* indicates that "retailing of mutual funds is to a considerable extent a specialized business."<sup>478</sup> The *Special Study* found that sampled firms doing more than half their business in fund shares averaged nearly eighty-seven per cent of their total income in sales of mutual fund shares, while other firms derived only ten per cent of their gross income from sales of fund shares.<sup>479</sup>

The distribution process, it is contended by many, is cumbersome and uneconomic.<sup>480</sup> It is unquestionably expensive, in relation to other types of securities merchandising.<sup>481</sup> It depends for its financial existence almost exclusively on the load assessed the investor when he invests in the fund. As previously noted,<sup>482</sup> this load, averaging eight and one-half per cent, represents a percentage of the current public offering price. Of the eight and one-half per cent deducted from the investor's payment, the underwriter receives approximately two per cent.<sup>483</sup> The remaining six and one-half per cent is allocated to the broker-dealer, who splits it with the salesman responsible for the sale, retaining about three and one-fourth per cent and giving the salesman three and one-fourth per cent, though this proportion is subject to readjustment in favor of the salesman, depending upon his length of service and productivity.<sup>484</sup> The "sales load" constitutes the sole source of income from mutual fund transactions for all salesmen not in a supervisory capacity, since the broker-dealer provides no salary or draw.<sup>485</sup> The load constitutes the primary source of return from mutual fund transactions for broker-dealers as well.

However, a possible additional source of return for the broker-dealer, one that will be discussed in detail in Part VI, is the return from brokerage commissions directed to the broker-dealer on transactions in which he took no part. Known as a "customer-directed give-up," this type of transaction was formerly used to supplement the income of broker-dealers. It existed because the NYSE allowed its members to split commissions with other NYSE members<sup>486</sup> and because transactions for fund portfolios were so lucrative that firms were willing to give up a substantial portion of the commission gained on the transaction. As will appear below, the abuses connected with the give-up required the NYSE to amend its constitution so as to proscribe their use.<sup>487</sup> Consequently, give-ups are no longer allowed on transactions on the NYSE. However, the

478 *Id.*

479 SPECIAL STUDY I 33 (Table I-11).

480 The accuracy of contentions that sales loads are high constitutes one of the major disputes over the proposed amendatory legislation. Voluminous material has appeared advocating reductions in sales loads, and an equally voluminous amount has appeared rejecting that position. This debate is examined in detail at notes 662-700 *infra* and accompanying text.

481 See notes 107-09 *supra* and accompanying text.

482 See notes 100-02 *supra* and accompanying text.

483 The figures contained in this example are suggested for illustrative purposes only. Wide variations exist in the allocation of splits of the mutual fund sales load; the underwriter may receive from one to two and one-half per cent, while the dealer may receive six to seven and one-half per cent and the salesman one and one-half to four and one-half per cent. SPECIAL STUDY IV 108-09.

484 See, e.g., the commission schedule of Investors Planning Corporation, *id.* at 122.

485 *Id.* at 121.

486 NYSE CONSTITUTION art. XV.

487 See letter from R. W. Haack, President, NYSE, to Securities and Exchange Commission, August 8, 1968, [Current Volume] CCH FED. SEC. L. REP. ¶ 77,585, at 83,227, and ¶ 77,631, at 83,363.

NYSE ban on give-ups does not extend to "non-customer directed inter-dealer [broker] reciprocal business on regional exchanges . . . ." <sup>488</sup> Under this arrangement, NYSE dealers could give "their regional exchange business to regional-only members in reciprocity for NYSE business which the regional members have obtained casually in the course of their other business." <sup>489</sup> Thus, it would be possible to circumvent the ban on "give-ups" by a broker-dealer's purchase of a seat on a regional exchange and having business channelled to it by an NYSE member. However, the NYSE has made clear that it will change its view on this inter-broker reciprocity if experience indicates that it is being used not in the course of legitimate business but to avoid the give-up prohibitions. <sup>490</sup>

For the purposes of Part IV, the distribution process and allied selling practices will constitute the basis for an examination of abuses by salesmen and points of contention between the industry and the SEC over the entire process by which mutual fund shares reach the investor.

### *B. Supervision of Mutual Fund Selling Practices*

#### 1. Introduction

Though the lessons of history are learned hard, they are remembered well. The flagrant abuses throughout the securities industry which led to the Crash and the Depression of the early 1930's brought the spotlight of congressional attention squarely to bear on the industry. <sup>491</sup> Congress responded during the following decade with six pieces of legislation designed to control securities investment practices. <sup>492</sup> One of these, the Investment Company Act of 1940, was aimed at the investment company industry, including mutual funds. <sup>493</sup> In it the Congress, conscious of the highly volatile nature of that part of the securities business and having the misery of the Depression fresh in mind, adopted a scheme of regulation that went beyond the disclosure rationale it had applied in previous acts. <sup>494</sup>

Congress adopted various supervisory approaches to satisfy its estimation that the mutual fund industry required a good deal more policing than did other securities industries. Supervisory responsibility was placed on the industry itself. In addition, provision was made for SEC regulation. At the state level, super-

488 Letter of R. W. Haack to SEC Chairman Manuel F. Cohen, November 18, 1968, [Current Volume] CCH FED. SEC. L. REP. ¶ 77,631, at 83,364.

489 *Id.*

490 *Id.*

491 That history is darkest when the chapter on periodic buying of mutual fund shares is opened. Nearly one-quarter of the SEC's supplemental report on investment trusts, entitled *Companies Sponsoring Installment Investment Plans*, is devoted to a detailed examination of selling practices in that segment of the mutual fund industry prior to the 1940 Act's passage. *INSTALLMENT INVESTMENT PLANS STUDY* 143-89.

492 Securities Act of 1933, 15 U.S.C. §§ 77a to 77aa (1964); Securities Exchange Act of 1934, 15 U.S.C. §§ 78 to 78jj (1964); Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (1964); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa to 77aaaa (1964); Investment Company Act of 1940, 15 U.S.C. §§ 80a to 80a-52 (1964); Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (1964).

493 For a discussion of the general background of the 1940 Act, see text accompanying notes 347-421 *supra*.

494 See text accompanying notes 339-42 *supra*.

vision was introduced in various Blue Sky laws, whose effect on the mutual fund distribution system is not to be underestimated.

## 2. NASD Supervision

The first approach utilized by Congress, which is best referred to as "internal," consisted of authorizing any securities association registered under section 15A of the Securities Exchange Act of 1934<sup>495</sup> to prescribe for its members regulations geared to eliminate certain proscribed abuses.<sup>496</sup> Section 15A, known more popularly as the Maloney Act Amendment to the Exchange Act,<sup>497</sup> resulted from the combined efforts of representatives of the securities industry, the SEC, and members of the forerunner securities association, the Investment Bankers Conference, to forge an effective program for self-regulation.<sup>498</sup> Pursuant to the Act's terms, a newly organized association, the National Association of Securities Dealers [NASD], registered with the SEC, and was approved by it in August, 1939.<sup>499</sup> No other organization has since filed a registration with the Commission.

While at first glance it appears incongruous that Congress would have provided the industry with a convenient device to cloak itself from all outside sources of light and revelation, the provisions of the Maloney Act must be read in light of the SEC's general supervisory control over the entire industry. The Maloney Act provides that the SEC may abrogate any NASD rule if it appears to the Commission that such abrogation is "necessary or appropriate to assure fair dealing by the members of such association, to assure a fair representation of its members in the administration of its affairs or otherwise to protect investors or effectuate the purposes of this chapter."<sup>500</sup> In addition, it is readily apparent that unilateral SEC responsibility for inspection and control would have been a burden beyond the reach and budget of that agency.<sup>501</sup>

Nevertheless, the grant of self-regulation to the securities industry has not proven to be a vacuous congressional concession to mask a real grant of authority to some governmental regulatory agency. Developments subsequent to passage of the Maloney Act bear out this appraisal, particularly in regard to the mutual fund industry. For example, under one provision of the Investment Company Act of 1940, all sales literature used in connection with sales activities must be filed with the SEC for its inspection.<sup>502</sup> Increased volume in sales activities after 1940 led to a proliferation of sales literature, a sufficient proportion of which the

495 15 U.S.C. § 78o-3 (1964).

496 See 15 U.S.C. § 80a-22(a), (b) (1964).

497 83 CONG. REC. 9616 (1938).

498 For a history of this halcyon period of mutual cooperation, see NASD REPRINT ¶ 101, at 109-10.

499 *Id.* at 110.

500 15 U.S.C. § 78o-3(k)(1) (1964). The Commission may also request the NASD to alter or supplement any of its rules relating to membership policies, adoption of new rules, election of NASD officers, and affiliation of other securities associations. 15 U.S.C. § 78o-3(k)(2) (1964).

501 The SEC's budget for fiscal year 1970 is \$20,116,000. In 1940, it was \$5,300,000. Compare THE BUDGET OF THE UNITED STATES GOVERNMENT: FISCAL YEAR 1970, at 959 (1969) with THE BUDGET OF THE UNITED STATES GOVERNMENT FOR 1940, at 80 (1939).

502 15 U.S.C. § 80a-24(b) (1964).



Commission considered misleading enough to require it to issue a special set of guidelines, which are contained in the SEC's *Statement of Policy*.<sup>503</sup> Significantly, the SEC has, since 1950, delegated enforcement of the *Statement of Policy* to the NASD insofar as it pertains to NASD members.<sup>504</sup>

The Maloney Act, in providing for registration of a securities association, required that such association compile rules for its members, any violation of which was to be sanctioned by discipline, expulsion, suspension, fine, censure, or some other appropriate penalty.<sup>505</sup> In complying with that mandate, the NASD has compiled its own *Rules of Fair Practice*.<sup>506</sup> These Rules are in some respects similar to the *Statement of Policy*, but they also prescribe general forms of accepted securities practices<sup>507</sup> and delineate the manner in which certain transactions must be performed.<sup>508</sup>

"Membership in the NASD is not a legal requirement for firms engaged in the securities business."<sup>509</sup> However, it is a financial necessity for non-integrated distribution organizations. Subsection (i) of the Maloney Act provides:

The rules of a registered securities association may provide that no member thereof shall deal with any nonmember broker or dealer . . . except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such members accorded to the general public.<sup>510</sup>

While the NASD rules promulgated under subsection (i) make the provision generally significant to all members of the NASD,<sup>511</sup> it is particularly relevant to those broker-dealers whose businesses consist primarily in distribution of mutual fund shares.<sup>512</sup> If the broker-dealer were forced to obtain the shares from the underwriter at the normal public offering price — net asset value *plus* a sales load — not only would he be unable to market them at anything but a loss but he would also have paid a sales commission to some other selling organization. By and large, therefore, most broker-dealers for whom distribution of mutual fund shares constitutes a substantial source of revenue are members of the

503 15 Fed. Reg. 5468 (1950). In general, the *Statement* forbids representations as to the safety of investing in securities, stability of return, or incomplete comparisons with other investment media. *Id.* A copy of the *Statement* may also be found in NASD REPRINT ¶ 5101-223, at 5021-67.

504 See SPECIAL STUDY IV 159. The NASD has subsequently published a compilation of standards for preparing sales literature that meets the requirements of the *Statement of Policy*. NASD, WHAT YOU MUST KNOW . . . (1964).

505 15 U.S.C. § 78o-3(b)(9) (1964).

506 NASD REPRINT ¶ 2001-401, at 2011-116.

507 NASD Rules of Fair Practice, art. III, §§ 1-4, reprinted in NASD REPRINT ¶ 2151-54, at 2014-54.

508 *Id.* §§ 13-27, reprinted in NASD REPRINT ¶ 2163-77, at 2077-108.

509 SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS H.R. DOC. No. 95, 88th Cong., 1st Sess., pt. 1, at 72 (1963) [hereinafter cited as SPECIAL STUDY I].

510 15 U.S.C. § 78o-3(i) (1964).

511 NASD Rules of Fair Practice, art. III, § 25(a) provides that "[n]o member shall deal with any non-member broker or dealer except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the public." NASD REPRINT ¶ 2175, at 2098.

512 Article III, section 26(c) of the NASD Rules of Fair Practice allows an NASD underwriter to sell shares below the current public offering price only to NASD members with whom it has a sales agreement. See note 470 *supra* and accompanying text.

NASD.<sup>513</sup> As a result, the NASD has under its aegis a sizeable proportion of the securities dealers of the country.<sup>514</sup>

In theory, the enactments which the NASD is entrusted with enforcing make it a powerful body capable of exerting great influence to insure healthy securities practices. But while the NASD has not proven itself to be an entirely inept and inert organization,<sup>515</sup> neither has it proven itself entirely disinterested in the welfare of its members.<sup>516</sup>

While in principle the powers of the NASD are sweeping, in practice its outlook has been narrowed primarily to a program aimed at preventing the dissemination of sales material that does not conform to the Commission's *Statement of Policy*.<sup>517</sup> Its Investment Companies Committee reviews sales material filed with it. Since most material is filed prior to public use, a good deal of all objectionable material is eliminated by the NASD before it is used in actual sales activities.<sup>518</sup> To reach improper practices that do not involve sales material, the NASD has also developed an inspection program through which it periodically inspects its member broker-dealers.<sup>519</sup> Rule of Fair Practice 21 requires NASD members to adhere to therein prescribed rules of accounting practice and procedure.<sup>520</sup> It is compliance with these practices that the inspection program is intended to insure.

### 3. SEC Supervision

Aside from the potential conflicts of interest inherent in any scheme of self-regulation, the very complex nature of the securities industry necessitates other than mere internal supervisory forms. Congress recognized this need and provided in the 1940 Act that the SEC should exercise the dominant supervisory role in regulating the mutual fund industry.

Although members of the mutual fund industry prefer to brand fund shares as a "packaged financial program" rather than as securities,<sup>521</sup> sales of fund shares

<sup>513</sup> 1967 House Hearings 316.

<sup>514</sup> "This condition is in a very real sense the NASD's lifeline, because" the Maloney Act specifies that:

An applicant association shall not be registered as a national securities association unless it appears to the Commission that—

(1) by reason of the number of its members, the scope of their transactions, and the geographical distribution of its members such association will be able to comply with the provisions of this chapter . . . and to carry out the purposes of this section. 15 U.S.C. § 78o-3(b)(1) (1964),

<sup>515</sup> See generally SPECIAL STUDY I 116-20, 164-67 & Tables II— 2, 3.

<sup>516</sup> Cf. 1967 Senate Hearings 551-56.

<sup>517</sup> See SPECIAL STUDY IV 166-67.

<sup>518</sup> *Id.*

<sup>519</sup> *Id.*

<sup>520</sup> NASD Rules of Fair Practice, art. III, § 21(a), (b), reprinted in NASD REPRINT ¶ 2171, at 2095.

<sup>521</sup> The *Special Study* noted the following conversation between Walter Benedick, an industry official, and its own Chief Counsel:

Q. A person who has taken your course and passed the [NASD] exam is now free to go to customers and sell the securities?

A. Not securities; mutual funds.

Q. A share of a mutual fund is a share of a corporation, is it not?

A. We don't look upon mutual funds as a security. We regard it as a packaged financial program, not a security.

Q. You do sell shares of a corporation, do you not?

are subject to the applicable federal securities statutes. Of primary relevance are

the provisions of the Federal antifraud statutes,<sup>[522]</sup> the disclosure provisions of the Securities Act of 1933,<sup>[523]</sup> and Investment Company Act of 1940,<sup>[524]</sup> and the provisions of the Investment Company Act<sup>[525]</sup> requiring filing with the Commission of advertising material and sales literature . . . .<sup>526</sup>

Under all these acts, the SEC is empowered to bring its authority to bear on broker-dealer malpractices.

While the Securities Act of 1933 provides for the registration of securities, section 24(a) of the Investment Company Act of 1940 provides for registration of mutual fund shares in accordance with section 8 of the 1940 Act, in lieu of registration under the Securities Act.<sup>527</sup> Section 24 requires the registrant to list such additional information as the Commission might, by appropriate rules and regulations, require.<sup>528</sup> In addition, the 1940 Act requires registration of the fund itself if it is engaged in interstate activities.<sup>529</sup>

In numerous other provisions of the 1940 Act, the SEC is given the power to make rules and regulations to carry out the scheme of the Act.<sup>530</sup> It is also given authority to exempt an applicant from provisions of the Act.<sup>531</sup>

A. A mutual fund consists or has in its fund or portfolio the shares of a corporation.

Q. You are selling the shares of an investment company?

A. Yes.

Q. And this is generally regarded as a security?

A. From that point of view you are right, Mr. Paul. Selling shares of an investment company, and therefore a security, in a certain sense. SPECIAL STUDY IV 153.

The hesitant concession finally wrung from Mr. Benedick rings with the same tones often sounded by Cornelius Roach, Chairman of the Board of Governors of the Association of Mutual Fund Plan Sponsors, Inc.: "The mutual fund share is a security, but it is different." *The Front-End Load; Suitability Requirements and Present Status*, in CONFERENCE ON MUTUAL FUNDS 135 (S. Hodes ed. 1966).

522 Securities Act of 1933 § 17(a), 15 U.S.C. § 77q (1964); Securities Exchange Act of 1934 §§ 10(b), 15(c), 15 U.S.C. §§ 78j(b) 78o(c) (1964). See text accompanying notes 551-71 *infra*.

523 Securities Act of 1933 §§ 7, 10, 15 U.S.C. §§ 77g, 77j (1964).

524 Investment Company Act of 1940 §§ 24, 30, 15 U.S.C. §§ 80a-24, 30 (1964).

525 *Id.* § 24(b), 15 U.S.C. § 80a-24(b) (1964).

526 SPECIAL STUDY IV 156.

527 Investment Company Act of 1940 § 24(a), 15 U.S.C. § 80a-24(a) (1964).

528 *Id.* § 24(a)(2), 15 U.S.C. § 80a-24(a)(2) (1964).

529 Section 7 of the Investment Company Act of 1940 prohibits any investment company engaged in interstate commerce from carrying on operations unless registered in accordance with section 8 of the Act. 15 U.S.C. § 80a-7 (1964).

530 Most general of these provisions is section 38(a) of the 1940 Act which provides:

The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the powers conferred upon the Commission elsewhere in this subchapter, including rules and regulations defining accounting, technical, and trade terms used in this subchapter, and prescribing the form or forms in which information required in registration statements, applications, and reports to the Commission shall be set forth. For the purposes of its rules or regulations the Commission may classify persons, securities, and other matters within its jurisdiction and prescribe different requirements for different classes of persons, securities, or matters. 15 U.S.C. § 80a-37(a) (1964).

531 Section 6(c) of the Act authorizes the SEC to make exemptions from any provision of the Act:

The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation thereunder, if

Further, the SEC has authority over all broker-dealers dealing in interstate commerce and through the mails by virtue of their registration under the Exchange Act,<sup>532</sup> and exerts added control, indirectly over NASD members by virtue of the Maloney Act provisions discussed earlier, and directly over non-NASD members through a 1964 amendment to the Securities Exchange Act which will be discussed below.<sup>533</sup> These various legislative grants give the SEC a great deal of authority to use in its external policing of the industry.

#### 4. Blue-Sky Laws

State regulation of securities distribution has in the past suffered from a lack of uniformity, resources, and ability to reach interstate distribution set-ups (so-called "boiler-room" operations). Thus, although forty-nine of the fifty states have blue-sky laws<sup>534</sup>—the state equivalent of federal securities legislation—they have thus far proven "inadequate to cope with what is essentially a national problem."<sup>535</sup> While most of them adhere to a regulatory philosophy,<sup>536</sup> their practical implementation has failed to secure the goals they set out.<sup>537</sup> The most valuable function they now perform consists of restricting the entry of broker-dealers into their jurisdictions by requiring them to register and to provide information indicating their integrity and financial capacity.<sup>538</sup> For example, the state of New York, situs of a substantial portion of the country's securities transactions, requires only that the firm register and include in its registration the firm's business history for the preceding five years, any criminal record of its partners and the educational background of its partners and salesmen.<sup>539</sup>

A movement is presently under way to render state laws more effective. In 1956, the National Conference of Commissioners on Uniform State Laws approved the Uniform Securities Act, drafted by the noted securities authority, Professor Louis Loss of Harvard Law School.<sup>540</sup> The Act, thus far approved by eighteen states, Puerto Rico, and the District of Columbia,<sup>541</sup> is comparable to

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and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this subchapter. 15 U.S.C. § 80a-6(c) (1964).

- 532 Securities Exchange Act of 1934 § 15(a)(1), 15 U.S.C. § 78o(a)(1) (1964).  
 533 15 U.S.C. § 78o(b)(8) (1964). See text accompanying notes 583-86 *infra*.  
 534 Delaware has no blue-sky law. The District of Columbia has only recently been provided with one, Act of August 30, 1964, Pub. L. No. 88-503, 78 Stat. 620.  
 535 SPECIAL STUDY I 81.  
 536 See L. LOSS & E. COWETT, BLUE SKY LAW 36 (1958).  
 537 *Cf. id.* at 37.  
 538 SPECIAL STUDY I 81.  
 539 N.Y. GEN. BUS. LAW § 359(e) (McKinney 1968).  
 540 Uniform Securities Act, 9C ULA 84 (1957).  
 541 ALA. CODE tit. 53 §§ 28-50 (Supp. 1967); ALASKA STAT. §§ 45.55.010 to 45.55.170 (1962); ARK. STAT. ANN. §§ 67-1235 to 67-1262 (1966); D.C. CODE ENCYCL. ANN. §§ 2-2401 to 2-2418 (Supp. 1968); HAWAII REV. LAWS §§ 199-1 to 199-20 (1955); IND. ANN. STAT. §§ 25-854 to 25-876 (Supp. 1968); KAN. STAT. ANN. §§ 17-1252 to 17-1275 (1964); KY. REV. STAT. ANN. §§ 292.310 to 292.550, 292.991 (1963); MD. ANN. CODE art. 32A, §§ 13-44 (1967), as amended, MD. ANN. CODE art. 32A, §§ 15, 16, 18, 26, 34 (Supp. 1968); MICH. COMP. LAWS ANN. §§ 451.501 to 451.818 (1967) as amended, MICH. COMP. LAWS ANN. § 451.802 (Supp. 1969); MONT. REV. CODES ANN. §§ 15-2001 to 15-2025 (1967); NEV. REV. STAT. §§ 90.010 to 90.210 (1967); N.J. STAT. ANN. §§ 49:3-48 to 49:3-76 (Supp. 1968); OKLA. STAT. ANN. tit. 71, §§ 101-504 (1965), as amended, OKLA. STAT. ANN. tit. 71, §§ 202, 305, 326, 401 (Supp. 1968); P.R. LAWS ANN. tit. 10, §§ 851 to 895 (Supp. 1967); S.C. CODE ANN. §§ 62-1 to 62-319 (1962), as amended, S.C. CODE ANN. § 62-2 (Supp. 1968);

the federal securities legislation:<sup>542</sup> the application for the broker-dealer requires that he disclose a variety of information, including his intended plan of operation, the business history of all persons associated with him, and any record of securities injunctions, administrative proceedings and the like bearing on his ability.<sup>543</sup> The State Administrator is authorized to deny the application where it appears that the persons have engaged in "dishonest or unethical practices in the securities business"<sup>544</sup> or where it appears that they are "not qualified on the basis of such factors as training, experience, and knowledge of the securities business . . ."<sup>545</sup> To determine the applicant's abilities, provision for an examination is made; not all the states have thus far established examination programs, but the trend now is to require them.<sup>546</sup>

Despite this movement toward more effective control, the *Special Study* has noted that until more states adopt the Uniform Securities Act, "the most that can be expected from even the best of the State laws and administrations is to point the directions in which a system of national controls can profitably move."<sup>547</sup>

## 5. Conclusion

Neither the NASD nor the SEC has the fundamental responsibility for securing abuse-free selling practices. The primary supervisor, in contemplation of both the NASD and the SEC, is the employer broker-dealer itself. Under the regulatory provisions of both organizations, it is the broker-dealer who must establish within its own framework primary safeguards to control unlawful selling practices.<sup>548</sup> The interwoven effect of these various sources of broker-dealer regulation is formidable indeed.<sup>549</sup> But in light of the circumstances surrounding its birth, it does not seem improper.

### *C. Remedies for Abusive Selling Practices*

The federal and state legislation just discussed concerned the supervisory scheme established for the investment company industry. By definition, the elaborate supervision is intended to *prevent* the development of unsavory selling practices. However, judging from the frequency of reported abuses,<sup>550</sup> the antic-

UTAH CODE ANN. §§ 61-1-1 to 61-1-30 (1968); VA. CODE ANN. §§ 13.1-501 to 13.1-527 (1964), as amended, VA. CODE ANN. §§ 13.1-501, 13.1-514 (Supp. 1968); WASH. REV. CODE ANN. §§ 21.20.005 to 21.21.940 (1961), as amended, WASH. REV. STAT. ANN. §§ 21.20.005 *et seq.* (Supp. 1968); WYO. STAT. ANN. §§ 17.117.1 to 17.117.29 (1965).

542 See Commissioners' Notes to §§ 101-419, Uniform Securities Act, 9C ULA 86-149 (1957).

543 Uniform Securities Act § 202(a), 9C ULA 90-91 (1957).

544 *Id.* § 204(a)(G), 9C ULA 96 (1957).

545 *Id.* § 204(a)(I).

546 *Id.* § 204(b)(6). See SPECIAL STUDY I 132-33.

547 SPECIAL STUDY I 81.

548 NASD Rules of Fair Practice, art. III, § 27(b) states: "Final responsibility for proper supervision shall rest with the member." NASD REPRINT ¶ 2077, at 2108. The SEC's rules for regulation of non-NASD members state: "Every nonmember broker or dealer shall exercise diligent supervision over all the securities activities of all of his associated persons." 17 C.F.R. § 240.15b10-4 (1968).

549 CONFERENCE ON SECURITIES REGULATION 50-51 (R. Mundheim ed. 1965).

550 See Tables II-2, II-3, SPECIAL STUDY I 164-67.

ipated deterrent effect of supervision has not been as cogent as hoped. Where abuses have already occurred, the federal supervisory regulations give way to the remedial prescriptions contained in the securities acts. Essentially these are the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.<sup>551</sup> The effect of these provisions as they relate to specific selling abuses will now be examined.

## 1. Antifraud Provisions

### a. *Selling Below the Breakpoint*

One of the selling practices which has come to be recognized as violative of the securities statutes' antifraud provisions is the practice of persuading a mutual fund purchaser to invest an amount of money that falls just below a level at which he could receive a reduction in the sales load applicable to his purchase. From the salesman's point of view, this practice — known as "selling below the breakpoint" — combines both large dollar amount with the highest applicable sales load. For the purchaser, though the reduction in sales load from one level to the next does not represent an overwhelming display of generosity by the underwriter,<sup>552</sup> the large dollar amount involved makes the savings in sales commissions substantial.

The leading case on the subject is *Mason, Moran & Co.*<sup>553</sup> Respondent, a broker-dealer registered with the SEC since 1935, opened an account with a religious order of nuns in 1938. That account, totaling \$3 million and supplying one-sixth of the firm's annual income, was serviced for eleven years, until 1949, when the order indicated it wished to liquidate part of its portfolio to begin a building program. One of the firm's officers then persuaded the order to invest in mutual fund shares. In eleven subsequent transactions, the order invested \$254,813 in fund shares, the average transaction being approximately \$24,200. On transactions of \$25,000 or more, the order would have benefited from a reduction in the sales load. Had the order taken advantage of the breakpoint, it would have saved \$8,169.92 in commissions. On these facts, the SEC found that a "confidential relationship existed between registrant and the customer."<sup>554</sup> Though the savings in commissions were ultimately returned to the order and the delinquent officers released from the firm, the SEC revoked the firm's registration, holding that the violations did not involve

merely an error of judgment as to the appropriate markup to be charged in connection with particular transactions. They represent, in most part rather a deliberate scheme for defrauding a particularly unsophisticated customer by patterning riskless transactions so as to deprive the customer

551 See note 522 *supra* and accompanying text.

552 The typical dealer breakpoint schedule is illustrated in a table at text accompanying note 100 *supra*.

553 35 S.E.C. 84 (1953).

554 *Id.* at 89.

of established and clearly available price benefits, in order to swell registrant's profits.<sup>555</sup>

A more recent case that concerns, in part, selling below breakpoints is *Shearson, Hammill & Co.*<sup>556</sup> The salesman contended that he had informed the purchaser of the higher cost involved in buying immediately below breakpoints and that she had ordered him to proceed, in effect making a "gift to the salesman" of the additional commissions.<sup>557</sup> The SEC rejected registrant's defense outright.<sup>558</sup>

Even more recently, the SEC has held that registered representatives have, in this situation, "a responsibility, particularly where [they make] a recommendation, to be sure the customer has had adequate opportunity to study and understand the alternatives."<sup>559</sup> The SEC held that failure to do so constituted a deceptive practice within the ambit of section 10(b) of the Exchange Act and Rule 10b-5 adopted pursuant thereto.<sup>560</sup>

### b. Switching

Another device by which a salesman increases his commissions at the expense of the customer is known as "switching." The practice, as already noted,<sup>561</sup> entails advising a customer who has already invested in one fund (and consequently paid the sales load applicable to it, unless it is a "no-load" fund) to "switch" his investment to another fund. Of course, this requires payment of another sales load, in which the salesman shares. Oftentimes, there are legitimate justifications for a transfer from one fund to another,<sup>562</sup> in instances where investigations have been made, the primary reason asserted for the transfer has been poor performance of the initial fund.<sup>563</sup> This reason has rarely served as a satisfactory explanation for the transfer.<sup>564</sup>

555 *Id.* at 94.

556 SEC Securities Exchange Act Release No. 7743 (November 12, 1965), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,306, at 82,509 (1965).

557 *Id.* at 82,534.

558 *Id.*

559 Paine, Webber, Jackson & Curtis, SEC Securities Exchange Act Release No. 8501 (January 22, 1969), [Current Volume] CCH FED. SEC. L. REP. ¶ 77,651, at 83,412, 83,413.

560 *Id.* at 83,412.

561 See note 315 *supra* and accompanying text.

562 The classic example of justified switching is transferring the investment of an eighty year old widow from a growth fund to an income fund. See Hopper *Antifraud and Disclosure Requirements in Selling Investment Company Securities*, in CONFERENCE ON MUTUAL FUNDS 15, 21 (S. Hodes ed. 1966).

563 In *Shearson, Hammill & Co.*, poor performance was cited by the registrant as cause to switch an investment from the poor performer to a fund with a superior past growth performance. The SEC held that this practice violated the antifraud provisions of the Securities and Securities Exchange Acts. *Shearson, Hammill & Co.*, SEC Securities Exchange Act Release No. 7743 (November 12, 1965), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,306, at 82,509, 82,534-35.

564 *Id.* It apparently had been the belief of the registrant in *Shearson, Hammill* that a letter from the account holder to the registrant approving the switch would shield it from liability. The SEC did not pass specifically on the point, since the letter, if written, was not produced for the record. *Id.* at 82,534 n.82. However, the use of such letters as a mere pro forma ratification of the switch has not found favor with the NASD:

The [district NASD] committee noted that a member's responsibility is far greater than to accept such letters at fact [*sic*] value and that respondent did not fulfill its responsibilities in approving such transactions . . . .

The letters from the customers indicated that they were satisfied with their purchases, had initiated them, and that fines imposed [by the NASD district Com-

Accordingly, the SEC requires that all sales *literature* aimed at persuading customers who have already invested in one fund to transfer their account to another fund contain the following warning:

Switching from the securities of one investment company to another, or from one class of security of an investment company to another, involves a sales charge on each such transaction, for details of which see the prospectus. The prospective purchaser should measure these costs against the claimed advantage of the switch.<sup>565</sup>

The value of this warning is limited by the fact that the salesman usually relies on oral, rather than written, exhortations.<sup>566</sup> To that extent, however, the anti-fraud provisions mentioned earlier supplant the SEC requirement. For example, the SEC recently accepted an offer of settlement suggested by the firm of Paine, Webber, Jackson & Curtis, who consented to findings that its salesmen had willfully violated section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 by orally inducing customers to switch their investments from one fund to another without explaining the sales load involved in the switch. In the settlement, the responsible parties were temporarily suspended from selling mutual fund shares.<sup>567</sup>

### *c. Selling Ex-dividend*

A third selling practice that abuses the relationship between salesman and customer consists of the salesman's assertion that the prospective customer can reap extra benefits by buying shares of a mutual fund immediately prior to its execution of a dividend. The unsophisticated investor with whom the mutual fund salesman commonly deals will ordinarily be unaware that the price he pays for the fund shares will reflect the imminent distribution of the dividend.<sup>568</sup> "Further, the practice may result in a disadvantage to the customer because the investor must treat the dividend as ordinary income for tax purposes."<sup>569</sup>

In *Boren & Co.*<sup>570</sup> the SEC upheld an NASD finding that the dealer had violated sections 1 and 18 of the NASD Rules of Fair Practice by urging an

mittee] were, therefore, unwarranted. *We do not find that these letters exonerate the respondent from responsibility.* SPECIAL STUDY IV 165 (emphasis added).

565 *Statement of Policy* § (p), 15 Fed. Reg. 5468, 5469 (1950).

566 *See* SPECIAL STUDY IV 164.

567 Paine, Webber, Jackson & Curtis, SEC Securities Exchange Act Release No. 8501 (January 22, 1969) [Current Volume] CCH FED. SEC. L. REP. ¶ 77,651, at 83,412.

568 In a section of its Manual devoted to explanations of the sale of investment company securities, the NASD discussed the sale of fund shares *ex-dividend*:

No advantage accrues to the buyer of the shares of an investment company by reason of his purchase of such shares in anticipation of a distribution soon to be paid. The amount of such distribution is included in the price he pays for the shares and the shares decline in price on the *ex-distribution* date by the amount of the distribution.

A member who induces the sale of investment company shares by implying to a customer a rate of return that is based in whole or in part upon distributions of realized security profits or who, without full explanation and disclosure, uses any impending dividend or distribution as an inducement for the purchase of such shares may be making representations to a customer contrary to the provisions of Article III, Section 1, of the Rules of Fair Practice. NASD REPRINT ¶ 5264, at 5096.

569 Hopper, *supra* note 562, at 22.

570 40 S.E.C. 217 (1960).



investor to withdraw funds from a bank account to purchase fund shares immediately prior to execution of a fund dividend. The dealer's salesmen had indicated to the investor that although the funds would be withdrawn prior to a bank interest date, the investor would not be harmed because the fund dividends would compensate for her loss of bank earnings.<sup>571</sup> The SEC summarily dismissed this conduct as violative.

## 2. The Test of Suitability

The foregoing abuses represent those most commonly investigated under the antifraud provisions of the securities statutes or the NASD Rules. Besides the antifraud provisions, however, another criterion generally applicable to all sales of securities is the requirement contained in NASD Rule of Fair Practice section 2:

In recommending to a customer the purchase . . . of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.<sup>572</sup>

This provision stands as a warning to all member firms that their sales must pass the test of suitability, that is, the sale must be reasonably suited, other things being equal, to the investor. Although the wording of the provision ("facts, if any, disclosed by such customer") suggests that the member has no affirmative duty to elicit the nature of the purchaser's financial condition, the SEC has already held that:

The clear purpose of the Rule would be defeated if it were construed as permitting a broker or dealer to engage in a practice of recommending low price speculative securities to unknown customers . . . *without any* knowledge or *attempt to obtain* information concerning the customer's other security holdings, his financial situation, and his needs so as to be in a position to judge the suitability of the recommendation.<sup>573</sup> (Emphasis added.)

The industry has quarreled with this conclusion as "unrealistic" since it "would raise serious theoretical and practical problems,"<sup>574</sup> paramount among which would be the possibility that the salesman would become, in effect, a guarantor of suitability. This fear, based on the industry feeling that hindsight would control any judicial determination of the salesman's solicitude for his customer, appears to be groundless, since a standard of reasonableness would obtain in such investigations and meeting that standard would require neither more nor less than is required in any civil action.

The SEC has established a suitability rule for non-NASD members that is

<sup>571</sup> *Id.* at 222.

<sup>572</sup> NASD Rules of Fair Practice art. III, § 2, reprinted in NASD REPRINT ¶ 2152, at 2051.

<sup>573</sup> Gerald M. Greenberg, 40 S.E.C. 133, 137-38 (1960).

<sup>574</sup> ASSOCIATION OF MUTUAL FUND PLAN SPONSORS, INC., PRESENTATION BY THE ASSOCIATION OF MUTUAL FUND PLAN SPONSORS, INC., TO THE SECURITIES AND EXCHANGE COMMISSION RELATING TO CHAPTER XI OF THE SPECIAL STUDY OF SECURITIES MARKETS, Part IV, at 109 (1964) [hereinafter cited as PRESENTATION].

substantially similar to the NASD rule but more explicit as to the responsibility of salesmen:

Every nonmember broker or dealer and every associated person who recommends to a customer the purchase, sale or exchange of any security shall have reasonable grounds to believe that the recommendation is not unsuitable for such customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker or dealer or associated person.<sup>575</sup>

The SEC has stated that its rule

is not an attempt to second-guess the exercise of the reasonable business judgment of a broker-dealer or to make him an insurer of favorable investment performance. The recommendation must be judged in light of the information available to the broker-dealer after reasonable inquiry as to the customer's situation at the time of the recommendation and not by reference to subsequent events.<sup>576</sup>

The SEC suitability rule was not adopted under the antifraud provisions of the Securities Exchange Act; it exists as a separate criterion applicable to securities investment recommendations. However, as one authority has noted, "it takes no great prophet to foresee a closer connection between suitability and the fraud rules."<sup>577</sup> This confluence would appear to be part of a larger movement designed to fix more far-reaching responsibility on the broker-dealer in dealings with his customers.<sup>578</sup> Since the scope of that movement has yet to be finally determined, it would be premature to speculate as to the boundaries it will ultimately occupy. However, the investor safeguards that now exist or are rapidly being defined are adequate to deal with most of the historically recognized abuses.

#### *D. Salesmen and Their Selling Methods*

##### 1. Qualifications

The preceding discussion on the supervisory and regulatory devices available for control of the distribution process might lead an observer to conclude that they exist because of the numerous opportunities for the breakdown of that system. Such an observation would be well-founded indeed, as an examination of Part III would indicate.<sup>579</sup> While no segment of the securities industry has maintained itself inviolate of sales abuses, the mutual fund industry has contributed more than its share of instances of customer abuse. A part of the problem lies in the composition of the mutual fund sales force itself.

<sup>575</sup> 17 C.F.R. § 240.15b10-3 (1968).

<sup>576</sup> 32 Fed. Reg. 11,638 (1967).

<sup>577</sup> A. BROMBERG, *SECURITIES LAW: FRAUD—SEC RULE 10b-5 § 5.4*, at 100 (1968).

<sup>578</sup> See generally Cohen & Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in their Development*, 29 *LAW & CONTEMP. PROB.* 691 (1964).

<sup>579</sup> See text accompanying notes 296-328 *supra*.

Federal regulation of the character and competence of fund salesmen is accomplished in two ways: the first utilizes the internal control of the NASD, and the second employs the rules and regulations of the SEC. The Maloney Act specifies as a requirement for registration of a securities association that its members, and all persons associated with its members, must qualify for membership by conforming to such standards of training, experience, and other qualifications as the association might set.<sup>580</sup> Accordingly, the NASD has established, in article I, section 1 of its By-Laws, its membership policy: all broker-dealers authorized by the laws of any state or by the laws of the United States to conduct transactions in any branch of the investment banking or securities business are eligible for membership, so long as they have not previously been expelled from the NASD or are not the subject of an SEC order suspending or revoking their registration under the Securities Exchange Act of 1934.<sup>581</sup>

Persons associated with a member are designated as either Principals or Representatives, with a written examination prescribed for those registering under each category. Representatives must pass a two-hour, multiple-choice examination, while Principals are required to complete a three-hour, variable answer examination.<sup>582</sup>

The second means of control — the SEC's rules and regulations — applies to securities dealers and their representatives who are not members of the NASD. Prior to 1964, gaps in the regulation of the two groups existed, but this problem has been corrected by the Securities Acts Amendments of 1964<sup>583</sup> which amended section 15 of the Securities Exchange Act of 1934 by authorizing the SEC to establish standards of training, experience and other qualifications which it might determine necessary.<sup>584</sup> "This provision for comparable regulation has," in the words of one observer, "led to the formation of an organization within the SEC referred to as SECO (SEC only)."<sup>585</sup> The SECO regulations for non-member companies are similar to the regulations of NASD securities dealers and their representatives. They require all persons associated with non-member broker-dealers to pass a general securities examination designed to test knowledge of corporate and government securities, investment companies, brokers and dealers and their associated personnel, distribution of securities, and stock exchanges and over-the-counter markets.<sup>586</sup>

By and large, however, the SEC and NASD regulations have not provided insurmountable barriers to entrance into mutual fund selling by those whose qualifications are minimal. The *Special Study* considered in great detail the general qualifications of fund salesmen.<sup>587</sup> It found that of the salesmen joining large mutual fund selling groups in 1961, ninety-five per cent were inexperienced in the sale of securities (compared with forty-nine per cent in other securities

580 15 U.S.C. § 78o-3(a) (5) (1964).

581 NASD By-Laws art. 1, § 1, reprinted in NASD REPRINT ¶ 1101, at 1051.

582 *Id.* Schedule C, at 1053-54.

583 Securities Acts Amendments of 1964, 15 U.S.C. § 78o (1964).

584 *Id.* § 6, 15 U.S.C. § 78o(b) (8) (1964).

585 Wilson, *The NASD's Role in Relation to the Hiring, Training and Supervision of Mutual Fund Salesmen*, in CONFERENCE ON MUTUAL FUNDS 67, 68 (S. Hodes ed. 1966).

586 17 C.F.R. § 240.15b8-1 (1968). Salesmen must also pass any examination required by the state in which they plan to sell securities. See note 546 *supra* and accompanying text.

587 SPECIAL STUDY I 93-133.

industries).<sup>588</sup> Sales organizations find nothing objectionable in this lack of experience. As a matter of fact, they insist strenuously that the only possible source of experienced salesmen is the supply of representatives who shift periodically from one fund organization to another — the so-called “floaters” — and that they would be doing a disservice were they to rely on this type of salesman with his questionable motives.<sup>589</sup> Despite the inexperience of new recruits in securities selling, for the most part they are experienced in other types of sales activities.<sup>590</sup> Mutual fund recruiters are urged to be on the lookout for able salesmen with backgrounds in intangible sales or in sales of household durables.<sup>591</sup> Another apparently fertile ground for recruiters anxious to find sales personnel has been the armed services. According to the records of one large firm, one-third of its salesmen in 1962 were either retired or active-duty military personnel.<sup>592</sup>

As mentioned earlier, mutual fund salesmen are rarely provided with a salary or draw.<sup>593</sup> (The primary exception is the IDS complex,<sup>594</sup> the leader in the field, which will be examined below.<sup>595</sup>) The trainee-salesman, who is provided with no compensation during the training period,<sup>596</sup> must engage in some other form of work to sustain himself.<sup>597</sup> On the whole, the resultant part-time training programs do not compare favorably with those employed for the education of other types of securities representatives.<sup>598</sup>

In concise terms, mutual fund training programs have two aims: assisting the salesman in his own private preparation to take and pass the NASD examination and acquainting him with the sales methods used in the sale of fund shares.<sup>599</sup> While techniques of training vary widely in the industry, ordinarily they require little classroom work. Typically, however, these programs do include evening seminars at which the trainee presents his memorized “sales pitch” for observation by supervisory personnel and receives some instruction in the fundamentals of securities law. The *Special Study* summarized its findings regarding training programs by stating:

The overwhelming majority of mutual fund salesmen without prior experience in the securities business begin selling their merchandise to the public after completing part-time training programs consisting of a few hours a week for a period of 1 to 3 months.<sup>600</sup>

588 *Id.* at 95.

589 PRESENTATION Part IV, at 52-53.

590 SPECIAL STUDY IV 115.

591 *Id.* The connection with those fields and fund selling would apparently lie in the intangible quality of securities or the general relevance savings has to household activities.

592 *Id.*

593 See note 485 *supra* and accompanying text.

594 SPECIAL STUDY IV 116.

595 See note 860 *infra*.

596 The industry finds this an advantage — aside from the obvious economic consequences to the broker-dealer — because it attracts only those salesmen who look upon fund selling as a means of self-improvement. SPECIAL STUDY IV 116.

597 *Id.*

598 See Table II-12, SPECIAL STUDY I 172.

599 SPECIAL STUDY IV 116-17.

600 *Id.* at 121.

## 2. Markets and Methods

Once the mutual fund contractual plan salesman is qualified to sell securities, statistics show that the first sale he makes may well be to himself.<sup>601</sup> He is urged by supervisory personnel and by his training literature that since he knows the advantages of fund investing, he should show others that he himself believes in those advantages. "Proof of the pudding is in the eating," he is told.<sup>602</sup> Supposed advantages of personal ownership of investment programs are the memorabilia that might be used to show prospective purchasers that the product has the endorsement of the salesman. Additionally, some selling firms affiliated with the fund make personal investing more attractive by remitting substantially all of the sales load on the salesman's purchase.<sup>603</sup>

Since mutual fund salesmen are paid only by commissions payable on sales of fund shares, and since they cannot profit from commissions obtained by trading for customers' accounts, they must continually expand their clientele;<sup>604</sup> the only limit to that expansion is the last name in the white pages, for salesmen are urged to use every means possible to seek out potential investors. Data contained in the *Special Study* indicates that the most lucrative sources of prospects are the salesman's relatives and friends.<sup>605</sup> Thirty-five per cent of all contractual plan owners and twenty per cent of all regular account holders are introduced to mutual fund investing by salesmen who are their relatives or close friends.<sup>606</sup> It is out of fairness and friendship, the salesman is told, that he advises family and friends of the advantages of mutual fund investing. After his most fruitful sources have been panned, the salesman must turn to other streams of commerce. Often he is given directions by means of "referral" or "radiation" cards, on which are written the names (usually only two or three) of friends of the purchaser who might be interested in mutual fund investing.<sup>607</sup>

Once the salesman is presented with the opportunity to introduce a prospect to fund investing, he produces a skillfully-prepared "presentation" that combines, for the most part, well recognized techniques in salesmanship with special emphasis on the advantages of equities ownership. Generally the presentation consists of three parts: an attention-getting opening, an emphatic demonstration under the name of "financial planning" and a closing aimed at securing an investment as favorable as possible to the salesman.<sup>608</sup>

Much of this presentation is based on training material made available by publishing firms connected with dealer organizations that are interested in mutual fund distribution.<sup>609</sup> Presentations are thus fairly standardized, with most of the

601 *Id.* at 126.

602 *Id.*

603 *Id.* The sales load cannot be omitted on the salesman's purchase because section 22(d) of the 1940 Act requires that all sales to the public be made at the current public offering price. See note 463 *infra*. See generally Simpson & Hodes, *The Continuing Controversy Surrounding the Uniform Price Maintenance Provisions of the Investment Company Act of 1940*, 44 NOTRE DAME LAWYER 718 (1969).

604 SPECIAL STUDY IV 125.

605 *Id.* at 126.

606 *Id.*

607 *Id.* at 126-27.

608 See *id.* at 139.

609 *Id.* at 119. These publishing firms were formerly compensated for providing this train-

salesmen concentrating on comparisons between mutual fund investing and other potential uses of the investor's dollar. The emphasis is on "awakening" the investor to such future needs as college for the children or retirement benefits,<sup>610</sup> and persuading him that "frozen dollars" cannot provide the hedge against inflation that equities investing can. Comparisons with other investment media, such as government bonds, savings and loan shares, or simple savings accounts are frequently made.<sup>611</sup> Of course, such references by salesmen are apt to run afoul of the *Statement of Policy's* proscription of misleading statements.<sup>612</sup> While the salesman may refer to funds as hedges against inflation or compare mutual funds with other economic institutions, those comparisons must be made on an historical basis and may not be predictions as to future growth.<sup>613</sup> The *Statement* flatly prohibits guarantees of future benefits.<sup>614</sup>

Salesmen are cautioned to act with the circumspect sobriety of professionals by underselling their product. Thus, they are told to "[a]lways Sell Down" since that erases doubts in the investor's mind about the wisdom of his investment.<sup>615</sup> Yet, selling down is to a large extent compensated by a request for multiple pre-payments, at least where contractual plans are concerned. *Special Study* statistics indicated that, on an average, the prospect invested an amount equivalent to six times the required monthly investment.<sup>616</sup>

The closing is without question the most significant portion of the presentation. It is at this point that the customer either writes a check or does not. And as the *Special Study* succinctly states, "Here, where the salesman's potential commission may become a reality, is the acid test of his ethical standards."<sup>617</sup>

By and large, the typical salesman's lot has not been an extremely profitable one. The *Special Study* found that two-thirds of all mutual fund salesmen were employed only part-time<sup>618</sup> and that their average compensation was only \$1,000 annually.<sup>619</sup> Full-time personnel operate under more favorable conditions, however; NASD data indicates that 55.7 per cent of full-time salesmen earn from \$5,000 to \$20,000 per year.<sup>620</sup>

The difficulty in obtaining prospects, the small average annual earnings, and the comparatively minor commitment made to enter the field provide little incentive for the salesman to remain in the selling process. Consequently, the industry suffers from a high turnover rate, with the larger organizations hiring half their sales force every year.<sup>621</sup> This is an important consideration in evaluat-

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ing service by reciprocal brokerage business and fund-directed giveups on other brokerage transactions. *Id.* Accordingly, the mutual fund investor bore, indirectly, the cost of training the salesman who approached him about fund investing. The ramifications of customer-directed "give-ups" are discussed at note 1012 *infra* and accompanying text.

610 SPECIAL STUDY IV 131.

611 *Id.* at 132.

612 See note 503 *supra*.

613 *Statement of Policy* § (a), 15 Fed. Reg. 5468 (1950).

614 *Statement of Policy* §§ (b), (2), (c), 15 Fed. Reg. 5468 (1950).

615 SPECIAL STUDY IV 138.

616 *Id.* at 138, 191.

617 *Id.* at 138.

618 See Table II-13, SPECIAL STUDY I 173.

619 SPECIAL STUDY IV 121.

620 NASD, ECONOMIC CONSEQUENCES FOR THE SECURITIES BUSINESS 20 (1967).

621 SPECIAL STUDY I 97.

ing industry contentions that the sales load — the bread and butter of the selling groups — is necessary to maintain stable selling forces.

### E. The Sales Load

#### 1. Introduction

While there are several pieces of proposed legislation designed to affect some aspect or other of the mutual fund distribution process,<sup>622</sup> none of them purports to correct the selling abuses detailed earlier.<sup>623</sup> There is general agreement (genuine or not) among mutual fund leaders, the SEC, and the general public that the present legislation is adequate to curb or remedy these abuses.<sup>624</sup> However, there is far from unanimous thought on the larger topic of the fair amount for the mutual fund salesman's commission. Under present circumstances, salesmen are compensated in a relatively simple manner. After an investor has been persuaded of the merits of fund investing, he agrees to purchase, through one investing device or another, shares of a mutual fund. Shares are sold on the basis of an offering price (comparable to the "asked" price of over-the-counter securities), which is the net asset value of the fund, and which may vary as the market value of the underlying securities varies. Most funds also impose a sales charge, computed as a percentage of net asset value.<sup>625</sup>

The sales charge, which is the price the investor pays for having the advantages of fund investing brought to his attention and explained to him, produces the greater part of the revenue for the selling group,<sup>626</sup> since non-supervisory personnel depend for their compensation entirely on their share of the "load."<sup>627</sup>

The importance of the sales load to the distribution process is clear. Under the present method of compensating salesmen, the salesman starves unless he sells fund shares. Wearing as he does the two hats of investor advisor and breadwinner,<sup>628</sup> the potential for conflicts of interest is manifest. Insofar as that poten-

622 The various pieces of legislation relating to the sales load issue are discussed at notes 706-39 *infra* and accompanying text.

623 See notes 296-328 *supra* and accompanying text.

624 See, e.g., 1967 House Hearings 226.

625 Training material used in preparing mutual fund salesmen urges them to meet the objections to sales loads by turning them to their advantage:

You've raised a good point, Mr. Prospect. That sales charge is mighty important to you. It pays me and thousands of other salesmen to bring investors like yourself together in the ownership of this Mutual Fund so that you can afford skilled investment Management. SPECIAL STUDY IV 136.

626 Revenue from sales loads charged to investors totalled \$260 million in 1965. PUBLIC POLICY STATEMENT 201.

627 Ninety-seven per cent of all mutual fund salesmen do not receive a commission or draw. SPECIAL STUDY IV 121. The remaining three per cent act in a supervisory capacity and devote, as well, a substantial portion of their time to sales activities. In addition to commissions from their own sales, they receive "overrides" — a portion of the commission earned on other salesmen's sales — for sales by those salesmen assigned to them for supervision. *Id.* at 147.

628 The securities business seems to have a penchant for describing the various activities of its members by referring to the hats they wear. A Merrill, Lynch, Pierce, Fenner & Smith advertisement entitled "Hat Trick" explains that a Merrill, Lynch salesman wears a variety of hats and performs a variety of tasks. SPECIAL STUDY I 93-94. Evidently that wardrobe now includes one too many chapeaus, for Merrill, Lynch was recently sanctioned by the SEC for releasing prematurely information material to a security's selling price to some of its customers

tial erupts in the form of fraudulent or misleading statements, the previously mentioned judicial and statutory antifraud devices are adequate to deal with those abuses.<sup>629</sup> However, where that potential appears in the form of high-pressure selling which steers the investor into an investment that results in higher commissions for the salesman, there exists a serious question as to the adequacy of present legislation.<sup>630</sup>

In general, it is not this basic conflicts of interest problem that now constitutes the primary focus of debate concerning the distribution process; it is the SEC's contention that sales loads are too high. The industry has countered that the loads are not at all high for the type of merchandising prevalent in the mutual fund industry. The proposed amendments to the Investment Company Act adopt, in some form or other, the SEC's stance, and the lines of battle have been drawn.<sup>631</sup>

## 2. Economic Justification: The Redemption — Liquidation — Ruin Spiral

By statutory mandate,<sup>632</sup> a mutual fund is required to stand ready to redeem any security that it has issued.<sup>633</sup> Quite unanimously, and with perhaps some cause, industry leaders have theorized that the redemption privilege, which creates a standing, easily accessible investor market for the fund's own shares, invites self-immolation: when redemptions rise above sales of new shares, the fund no longer has a supply of cash to satisfy its statutory obligation of redemption,<sup>634</sup> it therefore must dispose of some of its portfolio holdings to raise the requisite cash to pay for shares tendered for redemption.<sup>635</sup> Carried far enough, investor redemptions could cause a fund to liquidate all its holdings or, in a sense, milk itself dry. To forestall the specter of a fund's redeeming itself right out

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who effected sales of the security prior to its public dissemination. Merrill, Lynch, Pierce, Fenner & Smith, Inc., SEC Securities Exchange Act Release No. 8459 (November 25, 1968), [Current Volume] CCH FED. SEC. L. REP. ¶ 77,629, at 83,347.

629 See notes 553-71 *supra* and accompanying text. A possible approach for attorneys attempting to vindicate rights of clients abused by improper selling practices is suggested in Sullivan, *Some Common Problems of Mutual Fund Shareholders*, 13 PRAC. LAW. 23 (May 1967).

630 This is particularly true of periodic investing plans, whose unique compensatory features may sway the salesman into channeling the investor's desire to purchase mutual funds into that investment media. See text accompanying notes 775-81 *infra*.

631 The proposed amendatory legislation is discussed at notes 706-39 *infra* and accompanying text.

632 Section 22(e) of the Investment Company Act provides in part:

No registered investment company shall suspend the right of redemption or postpone the date of payment or satisfaction upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of such security . . . .

15 U.S.C. § 80a-22(e) (1964).

633 *Id.* Section 22(e)(3) further provides for suspension of the redemption right in certain isolated instances, the most important of which is an SEC order to that effect for the "protection of security holders of the company." The most recent SEC order to suspend the redemption right has come in *Mates Investment Fund*, Investment Company Act Release No. 5571 (Dec. 20, 1968).

634 The industry views its emphasis on sales as a "byproduct of redeemability." One industry leader stated: "The inexorable law of this business is that when assets rise, redemptions rise proportionately so the more you succeed, the harder you have to sell, just to keep your place on the treadmill." PUBLIC POLICY STATEMENT 202.

635 See, e.g., Testimony of H. Lawrence Bogert, 1967 House Hearings 285.



of existence, the industry has concluded that sales of new shares<sup>636</sup> constitute a most effective prophylactic.

While there does exist the theoretical possibility of ruinous redemption, not much can be shown to justify it in fact.<sup>637</sup> Historically, redemptions, though occurring on a regular basis,<sup>638</sup> have never amounted to a threatening proportion of total assets. Sales of new shares in dollar amount exceeded redemptions by at least 44.9 per cent in each year from 1955 to 1965, and on the average excluded redemptions by 62.9 per cent during that period.<sup>639</sup> More significantly, however, new shares issued for reinvestment of capital gains and investment of dividend income absorbed 60.5 per cent of total redemptions in 1965.<sup>640</sup> Further, as a per cent of total assets, redemptions amounted to only 5.6 per cent in 1965.<sup>641</sup> This data readily suggests that redemptions do not represent in practice the threat they present in theory. Thus, there does not appear to be a reasonable basis for the sense of economic urgency that the industry has thus far attached to the selling of shares. Although this conclusion necessarily amounts to what some sources have candidly termed "crystal ball" gazing,<sup>642</sup> it nevertheless is suggested by past economic indicators.

One might observe that the industry's well-spoken fears for the vitality of the economy are not so altruistic as they might appear. Sales of new shares are very attractive to the industry from a number of standpoints. It will be recalled, for example, that underwriting new shares is a riskless operation.<sup>643</sup> In addition, the cost of selling new shares is borne by the purchaser, not by the selling group or the fund. Finally, sales of new shares must result in an increase of net assets, and an increase in net assets means an increase in the advisory fees of the fund advisors.<sup>644</sup> This is an important consideration in light of the tightly-knit promoter-underwriter-advisor organizations that dominate the industry. These factors, combined with historical data indicating that redemptions do not pose an overawing threat to the industry,<sup>645</sup> demand that the distribution process and its features—particularly the high sales load and the aggressiveness of fund salesmen—be treated less as an unchangeable *fait accompli* and more as a source of legitimate concern to the investing public.

### 3. The Pneumodynamic Distribution Organization

As an earlier examination of selling practices indicated, industry leaders

636 Section 24(e) of the Investment Company Act of 1940 authorizes amendment of the registration statement of an open-end investment company to provide for sales of additional shares. 15 U.S.C. § 80a-24(e) (1964).

637 PUBLIC POLICY STATEMENT 202.

638 For example, the periodic investment method of purchasing mutual fund shares allows for redemption of shares at the completion of the installment plan. The systematic maturation of these plans requires an outflow of cash. Moreover, the average holding time for mutual fund shares is thirteen years. A. D. LITTLE, INC., ECONOMIC STUDIES OF THE MUTUAL FUND INDUSTRY III-23 (1967) [hereinafter cited as LITTLE STUDY]. For both of these reasons the industry must expect to maintain a certain supply of cash to satisfy projected redemptions.

639 PUBLIC POLICY STATEMENT 203 (Table V-1).

640 *Id.*

641 *Id.*

642 Statement of Manuel Cohen, 1967 House Hearings 112.

643 See notes 465-68 *supra* and accompanying text.

644 For a treatment of advisory fees, see notes 81-93 *supra* and accompanying text.

645 See notes 633-42 *supra* and accompanying text.

have unreservedly stated that their mutual fund shares must be *sold* to the typical investor.<sup>646</sup> They are also willing to accept the corollary fact of life that salesmen must be paid for their efforts.<sup>647</sup> This is a minimal economic concession by the advisor-controlled industry, however, since the entire cost of distribution is borne by the purchaser.

The applicable load level must be stated both in the prospectus<sup>648</sup> and in the sales agreement between the underwriter and the broker-dealer distributors.<sup>649</sup> Ordinarily, since the underwriter either is the fund's advisor or is controlled by the advisor, the advisor will set the terms of the sales agreement. The SEC has suggested that the terms of such agreements, and consequently the costs of investor acquisition, have been set not to provide the most economical product for the investor but rather to provide the advisor with more revenue from his advisory fees.<sup>650</sup> This contention is sound and readily demonstrable: advisory fees are increased by increasing net assets, and it is widely known and empirically verifiable that sales of new shares constitute the major portion of increases in net assets of funds.<sup>651</sup> As the industry more than willingly admits, sales of new shares depend heavily on the efforts of sales organizations. Quite naturally, sales organizations may be expected to show more interest in soliciting sales of fund shares which compensate them more handsomely than sales of other fund shares. Thus, the SEC's position is that sales loads reflect not a consciousness of the investor's financial goal, but rather a consciousness of the necessity of maintaining the loyalty of selling groups.<sup>652</sup>

Recently compiled data lends practical support to the SEC's argument.<sup>653</sup> Adjustment of the sales load in the broker-dealer's favor can be accomplished in either or both of two ways: by increasing the sales load, *e.g.*, from seven to eight and one-half per cent of offering price, with the dealer's share taking the net increase, or by decreasing the underwriter's share of the sales load.<sup>654</sup> (Since the underwriter in most cases is considered primarily a channel for distribution and not a profit-making organization, the latter step requires no great economic sacrifice by the advisor-underwriter group.)<sup>655</sup> The recent industry statistics<sup>656</sup> indicate that both of these approaches have been taken by the various funds:

646 See text accompanying note 459 *supra*.

647 Testimony to this effect abounds in the congressional hearings on the proposed legislation. See, *e.g.*, Testimony of John R. Haire, 1967 *House Hearings* 235.

648 Section 22(d) of the 1940 Act requires the current public offering price to be stated in the prospectus. 15 U.S.C. § 80a-22(d) (1964). Therefore, if the fund wishes to sell its shares subject to a sales load, it must describe the sales load in the prospectus as part of the public offering price.

649 See notes 471-72 *supra* and accompanying text.

650 PUBLIC POLICY STATEMENT 125.

651 "[S]ales account for most of the increase in mutual fund assets since 1940." *Id.* at 202.

652 There is, of course, intense competition within the mutual fund industry among principal underwriters for different funds. It is, however, what has been described as "perverse competition" because it is cost-raising rather than cost-lowering. It is a competition for the favor and the services of fund dealers and salesmen rather than the conventional form of competition for the favor of investors. This vigorous competition for dealer interest results in powerful upward pressures on selling compensation and sales loads and because of Section 22(d), the countervailing pressures of retail price competition cannot operate. 1967 *House Hearings* 110.

653 See text accompanying note 656 *infra*.

654 *Id.*

655 See WHARTON REPORT 514-17.

656 The chart appears at PUBLIC POLICY STATEMENT 208.

*Basic sales loads and dealer concessions of 30 mutual funds, 1950 versus 1966*

	Sales load		Dealer concession		Percent increase in—	
	1950	1966	1950	1966	Sales load	Dealer concession
1. Affiliated Fund, Inc. ....	7.50	7.50	6.00	6.00	.....	.....
2. American Business Shares, Inc. ....	7.50	7.50	6.00	6.00	.....	.....
3. American Mutual Fund, Inc. ....	8.00	8.50	6.00	7.00	6.3	16.7
4. Axe-Houghton Fund B, Inc. ....	8.00	8.00	6.00	6.00	.....	.....
5. Century Shares Trust ....	7.00	8.50	4.00	6.00	21.4	50.0
6. Chemical Fund, Inc. ....	7.50	8.50	5.00	6.50	13.3	30.0
7. Colonial Growth & Energy Shares, Inc. ....	7.50	8.50	5.00	6.50	13.3	30.0
8. Commonwealth Investment Co. ....	8.00	8.50	6.00	7.00	6.3	16.7
9. Delaware Fund, Inc. ....	8.50	8.50	6.00	6.00	.....	.....
10. Dividend Shares, Inc. ....	8.67	8.67	6.00	6.00	.....	.....
11. Eaton & Howard Balanced Fund .....	6.00	7.50	4.50	6.38	25.0	41.8
12. Equity Fund, Inc. ....	3.50	3.50	2.62	.....	.....	.....
13. Fidelity Fund, Inc. ....	7.50	7.50	6.00	6.00	.....	.....
14. Financial Industrial Fund, Inc. ....	8.50	8.50	5.53	7.00	.....	26.6
15. Fundamental Investors, Inc. ....	8.75	8.75	6.00	7.00	.....	16.7
16. Group Securities, Inc. ....	8.50	8.50	6.00	6.00	.....	.....
17. Investment Co. of America ....	8.00	8.50	6.00	7.00	6.3	16.7
18. Investors Mutual, Inc. ....	7.50	8.00	.....	.....	6.7	.....
19. Keystone Custodian Funds K-1 .....	8.30	8.30	5.00	6.00	.....	20.0
20. Knickerbocker Fund .....	8.70	8.70	6.00	6.50	.....	8.3
21. Massachusetts Investors Trust .....	7.50	8.50	5.00	6.00	13.3	20.0
22. Massachusetts Life Fund .....	7.00	8.50	5.00	6.50	21.4	30.0
23. National Investors Corp. ....	7.50	7.50	5.00	6.00	.....	20.0
24. National Securities Series .....	8.50	8.50	6.00	6.00	.....	.....
25. The George Putnam Fund of Boston ....	7.00	8.50	5.00	6.25	21.4	25.0
26. Putnam Investors Fund, Inc. ....	7.50	8.50	5.00	6.25	13.3	25.0
27. Selected American Shares, Inc. ....	7.50	7.50	6.00	6.00	.....	.....
28. Television-Electronics Fund, Inc. ....	8.25	8.25	5.50	7.00	.....	27.3
29. United Income Fund .....	8.00	8.50	6.00	6.00	6.3	.....
30. Wellington Fund, Inc. ....	8.00	8.00	5.00	6.00	.....	20.0

Of course, the net effect of this self-inflating distribution mechanism is an increase in overall cost to the purchaser, who receives nothing in return for his sales load other than the salesman's appearance in his home or office. The industry strenuously insists that the investor also receives the benefit of financial management and portfolio diversification,<sup>657</sup> but this analysis seems misguided and unsound, for the investor pays one-half per cent of his net assets annually for those features when the fund pays its advisory fee.<sup>658</sup> It would not be unfair to conclude, as did the SEC in its 1966 report, that "[t]he sales load — paid at the time of purchase — is purely a payment for selling effort."<sup>659</sup>

In addition to the sales load, the purchaser, as investor, bears other costs of the distribution system. These "indirect costs" can, and formerly did, reach sizeable proportion. For example, many funds bear the cost of printing sales

657 See text accompanying note 458 *infra*.

658 See generally text accompanying notes 1023-46 *infra*.

659 PUBLIC POLICY STATEMENT 215.

material used by the salesmen in their solicitation of prospective purchasers.<sup>660</sup> Formerly, brokerage commissions gained from transactions for the fund's portfolio were also used to supplement the income of members of the distribution process.<sup>661</sup>

#### 4. Recommendations for Change — Lowering the Sales Load

##### *a. Introduction: Present Legislation*

Disturbed by numerous indications that the shareholder bears inordinate costs when investing in a mutual fund, the SEC has recommended to the Congress that it consider means of reducing sales loads.<sup>662</sup> Members of Congress responded to the SEC recommendations by introducing SEC-proposed legislation aimed at achieving that result.<sup>663</sup> The industry quickly reacted with claims that its sales loads are not unacceptable, both in view of benefits obtained and when compared to other industries.<sup>664</sup> There has ensued a war of statistically-backed claims and counterclaims which have done much to obscure the otherwise readily apparent observation that the issue over sales loads may be confined to a narrow area of public policy — whether there should or should not be competition in the sale of mutual fund shares.

The focal point of battle has been section 22(d) of the Investment Company Act, the relevant portion of which provides:

No registered investment company shall sell any redeemable security issued by it to any person except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus and, if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter or the issuer, except at a current public offering price described in the prospectus . . . .<sup>665</sup>

The intent of this section is to prevent unsavory distribution operations and to protect the net asset value of shares already held by other investors.<sup>666</sup> Achieving these objectives requires sacrificing the normal pressures of competition which act to keep prices down. On its face, section 22(d) represents an exemption from the antitrust laws. The underwriter may sell its shares at net asset value (*i.e.*, without the sales load) only to dealers. All sales to the public must be made at the offering price established in the prospectus. *No other price may be*

660 SEC, Statement No. 2, 1967 House Hearings 111.

661 See notes 486-90 and accompanying text *supra*.

662 These recommendations are discussed at note 702 *infra* and accompanying text.

663 The amendatory legislation is discussed at notes 706-39 *infra* and accompanying text.

664 The two contentions are aspects of the fundamental argument by the industry that investment risks in mutual fund purchasing are a good deal lower than those obtainable even in blue-chip securities. Accordingly, the industry argues the costs that the investor incurs must be viewed in light of costs necessary to establish comparable investment risks. See Testimony of John R. Haire, 1967 House Hearings 233-34. This contention is discussed at notes 684-88 *infra* and accompanying text.

665 15 U.S.C. § 80a-22(d) (1964). See generally Simpson & Hodes, *supra* note 603.

666 The problems of protecting net asset value before passage of the 1940 Act are discussed at notes 319-25 *supra* and accompany text.

established. Section 22(d) explicitly prohibits a dealer from lowering prices to obtain more business. He must offer the shares on the same basis as all other dealers. Section 22(d) differs radically from state fair-trade laws, because enforcement is carried out by the federal government, whereas enforcement of state fair-trade laws is left to the individual manufacturer.<sup>667</sup> In short, no price variation for the shares of a mutual fund may exist. Varying the prospectus price is subject to federal sanction.<sup>668</sup>

Since Congress recognized that it had created a vacuum in which competition over the same product could not operate, and since it also realized that such vacuums have historically placed economic burdens on the purchaser, it endeavored to insure that prices of mutual fund shares be kept as low as economically feasible. The only way in which the price of a mutual fund share can lawfully be adjusted is through adjustment of the sales load; therefore, Congress provided in section 22(b) that an association registered under the Maloney Act (*i.e.*, the NASD) could prescribe rules "in order that the price at which such security is offered or sold to the public shall not include an unconscionable or grossly excessive sales load."<sup>669</sup> As part of its Rules of Fair Practice, the NASD has enacted a policy on "spreads" (*i.e.*, broker commissions) on sales of securities.<sup>670</sup> This policy, which sets a maximum limit of five per cent on over-the-counter transactions,<sup>671</sup> does not, however, have any application to sales of mutual fund shares. Since sales loads are listed in the prospectus, individual brokers must adhere to those limits.<sup>672</sup> In effect, then, the NASD has enacted no rules to insure that sales loads are stabilized at a particular figure.

In addition to section 22(b), Congress provided in section 22(c) that the SEC should have authority to make rules binding on all underwriters and broker-dealers, irrespective of membership in the NASD, for the same end of

667 Section 22(d) is "unique." It is unlike State fair trade laws, which permit resale price maintenance but leave the initiative for establishing and enforcing the restrictions entirely with the manufacturer. Section 22(d) places the full force of the federal government behind resale price maintenance in the investment company field. If a retail dealer knowingly sells a mutual fund share for less than the price stated in the prospectus, he is guilty of a willful violation of the Investment Company Act. SEC, Statement No. 1, 1967 *House Hearings* 48.

668 Section 49 of the 1940 Act provides for a fine of not more than \$10,000 or imprisonment of not more than two years for willful violations of the Act's provisions. 15 U.S.C. § 80a-48 (1964).

669 15 U.S.C. § 80a-22(b) (1964).

670 NASD, Rules of Fair Practice, art. 111, § 4 provides:

In "over-the-counter" transactions, whether in "listed" or "unlisted" securities, if a member buys for his own account from his customer, or sells for his own account to his customer, he shall buy or sell at a price which is fair, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that he is entitled to a profit; and if he acts as agent for his customer in any such transaction, he shall not charge his customer more than a fair commission or service charge, taking into consideration all relevant circumstances including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the market therefor.

NASD REPRINT ¶ 2154, at 2054.

671 This maximum markup limit, which can be adjusted depending on the circumstances of the transaction, is commonly known as the "5% policy." *Id.* at 2055.

672 The NASD recognizes the explicit provisions of section 22(d) by noting that its "5% policy" has no applicability to sales of mutual fund shares. *Id.* at 2058.

prohibiting unconscionable sales loads.<sup>673</sup> Like the NASD, the SEC has made no regulations declaring the level at which sales loads become unconscionable. The assumption under which the SEC operates in this regard is that Congress has itself stated what an unconscionable sales load is. In section 27(a)(1), the Seventy-sixth Congress provided that loads on sales of contractual plans could not exceed nine per cent of the offering price.<sup>674</sup> Consequently, the Commission feels that "it would not be possible to establish that that standard of unconscionable or grossly excessive could be applied to the run-of-the-mill charge which approximated the figure which the Congress itself fixed in section 27."<sup>675</sup>

The accuracy of that doubt is questionable in view of the legislative history of section 27.<sup>676</sup> Although the SEC may properly feel that it should not attempt suit unless all else fails and unless it has a fairly high chance of success in doing so,<sup>677</sup> investor protection of the type the SEC now seeks would probably be closer to realization had the SEC attempted by judicial action to lower sales loads. Such an approach would have enhanced the ability of the SEC to present to members of Congress its recommendations on sales loads.

## b. Proposals for Change

### i. Analysis of the Reasons for Change

As matters now stand, it is impossible to state that competition for shares of the same fund operates in the industry.<sup>678</sup> Further, it is empirically unjustifiable to contend that mutual fund sales loads are competitive vis-a-vis each other.<sup>679</sup> In short, therefore, competition is not at work in the industry, and the SEC has resolved to install either it or an adequate substitute and to insure that sales loads are lowered to benefit the shareholder as purchaser.

Branding the SEC's argument as the "cheaper is better" philosophy,<sup>680</sup> the industry has reacted vociferously, if not always coherently. Not loathe to extol its own virtues, it has, through representatives of the NASD and the In-

673 Section 22(c) provides

(c) After one year from the effective date of this chapter, the Commission may make rules and regulations applicable to principal underwriters of, and dealers in, the redeemable securities of any registered investment company, whether or not members of any registered securities association, to the same extent, covering the same subject matter and for the accomplishment of the same ends as are prescribed in subsections (a) and (b) of this section in respect of the rules which may be made by a registered securities association governing its members; and any rules and regulations so made by the Commission, to the extent that they may be inconsistent with the rules of any such association, shall so long as they remain in force supersede the rules of the association and be binding upon its members as well as all other underwriters and dealers to whom they may be applicable. 15 U.S.C. § 80a-22(c) (1964).

674 Investment Company Act of 1940 § 27(a)(1), 15 U.S.C. § 80a-27(a)(1) (1964).

675 Testimony of Chairman Manuel F. Cohen, 1967 House Hearings 722.

676 As appears below in the discussion of contractual plans, the nine per cent provision was enacted to lower sales loads from a prevailing average level of nearly sixteen per cent. See note 803 *infra* and accompanying text. Sales loads on mutual fund shares as of 1940 approximated six per cent. 1940 Senate Hearings 801. Nevertheless, even that level was thought by at least one person — an SEC official — to be unacceptable. *Id.* at 800.

677 See note 501 *supra* and accompanying text.

678 It will be recalled that section 22(d) explicitly prohibits competition. See notes 665-68 *supra* and accompanying text.

679 The date indicated at text accompanying note 656 *supra* verifies this conclusion.

680 Testimony of H. Lawrence Bogert, 1967 House Hearings 286.

vestment Company Institute, insisted that it is highly competitive.<sup>681</sup> As proof of its position, it has adduced comparisons with other industries. Though subtle, the shift of emphasis to competition with external devices of investment conveniently obscures the fact that such comparisons are meaningless. The financial aspirations and condition of the typical mutual fund investor, the unique attributes of fund investing that attract most investors, and the existence of section 22(d) make external comparisons pointless, for the fact remains that the mutual fund industry is not internally competitive and other securities outlets are not meaningful alternatives to the fund investor.

Nevertheless, the industry has proceeded to make these external comparisons, perhaps prompted in part by the SEC's continued references to them.<sup>682</sup> The most frequent comparison is based on the means of acquisition of securities, that is, direct (via exchange) or indirect (via fund). Customarily, this has entailed detailed analyses of the costs of NYSE brokerage commissions versus the sales load charged the investor.<sup>683</sup> But the industry finds comparisons on that aspect alone to be incomplete. It argues that the *total costs* of mutual fund purchasing must be weighed against the costs of direct ownership of equities securities. The best expression of that argument comes in a study conducted by the consulting firm of Arthur D. Little, Inc. The Little firm insists that:

When comparisons are made between the costs of mutual funds and the costs in investment alternatives, they will be valid only to the extent that:

(1) the comparisons made are of full or total costs to the investor under each of the alternatives.

(2) the alternatives chosen must be in fact open to the investor; they must be real alternatives.

(3) the alternatives must be equivalent in value.<sup>684</sup>

The *Study* then notes that an important additional cost, the *investment risk*, must be added to make such comparisons complete.<sup>685</sup> Since the volatility<sup>686</sup> in mutual fund shares is extremely low, allowance must be made to equate risk of direct ownership with risk of mutual fund ownership. According to the *Little Study*, this would require allocating part of the initial direct investment to a risk-free investment device, e.g., savings account, consequently lowering the rate of return on that investment. The then comparable investment costs are to be expressed as yearly charges "spread evenly over the time the investor holds his stock or mutual funds . . . ."<sup>687</sup> From this comparison of annual investment costs, the

681 "[W]e welcome competition. We have competition and we think the more we get, the better it will be for the industry and public." 1967 *Senate Hearings* 213.

682 It must be pointed out on the industry's behalf that the SEC initiated the thus-far unending chain of statistical comparisons by charging that "sales charges bear no reasonable relationship to the cost of investing in other types of securities." PUBLIC POLICY STATEMENT 221. As will appear below, the industry was willing to prove that such a reasonable relationship does exist provided the total "cost of investing" is compared. See notes 684-88 *infra* and accompanying text.

683 See notes 107-09 and accompanying text *supra*.

684 LITTLE STUDY I-3.

685 *Id.* at II-3.

686 "Volatility is basically a linear measure relating the percentage changes over time in a particular portfolio (e.g., a mutual fund) to the percentage changes in some standard market index (e.g., the S & P index.)" *Id.*

687 *Id.*

*Little Study* concluded that "there is no way for most investors to participate directly in the ownership of listed securities and derive value equivalent to that which mutual fund ownership provides except at higher cost."<sup>688</sup>

Fairness to the industry requires that attention be given to this conclusion. Since it indicates that other investment devices are not comparable to fund ownership, it demands that the SEC's allegations that sales loads are not related to costs of other securities not be taken as an irrebuttable indictment of costs of the funds' distribution process. However, by emphasizing the advantages of fund ownership and demonstrating that many investors will find this perhaps the only attractive means of investing in securities, it does indicate that further examination of the sales load issue is warranted. Because the sales load level is not determined by competition within the industry, and since the industry is not directly affected by competition from external securities investment media, it is suggested that examination of the sales load is warranted primarily in terms of public policy — whether lack of competition is in itself justifiable.

As further proof of its competitive stature, the industry has introduced statistics bearing on the degree of fund concentration now present in the industry.<sup>689</sup> By endeavoring to show a rise in the number of mutual funds and a decrease in the proportionate size of the larger funds, the industry hopes to prove it is competitive or at least that it is becoming more so. However, this endeavor hits wide of the mark. Not only are such statistics of limited empirical value; they also bear little relevance to the question of whether sales loads themselves are competitive. To assert that the investor is presented with an opportunity to discriminate in his choice of fund on the basis of performance is not to assert that he may do so on the basis of the costs of acquisition.

Perhaps the most effective argument the industry can make is one couched in terms of public policy and addressed to the social ramifications of the proposed legislation: since the present level of sales loads is necessary to provide salesmen with incentive to sustain their selling efforts, it argues, a reduction in sales loads would not only seriously jeopardize the existence of the funds and the security of the economy but would deprive many salesmen of their right to earn a living.<sup>690</sup>

Thus the competing stances can be reduced to an issue of public policy. For those in favor of the proposed legislation, the contention is that lack of competition is inimical to the common good; the lack of competition now present in the distribution of mutual fund shares, for whatever reason it may have been instituted,<sup>691</sup> no longer is justifiable in terms of the public interest. For those who oppose the legislation, it is contended that the present lack of competition does serve the vital national interest of preventing a massive disruption of the entire securities industry; and the legislation deprives salesmen of their opportunity to make a living.

The SEC argues that the industry's contentions are baseless. To justify its

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688 *Id.* at I-4.

689 *Id.* at II-10.

690 *See 1967 House Hearings* 516. Former Chairman Cohen has called this "the most invidious of the arguments put forward." *Id.* at 702.

691 For a discussion of the background of section 22(d), see text accompanying notes 740-59 *infra*.



conclusion that fears of another economic catastrophe caused by lower salesmen's commissions are without merit, the Commission points to the history of those mutual funds which charge no sales loads for the acquisition of their shares.<sup>692</sup> The industry is understandably reluctant to make comparisons with acquisition costs of no-loads. But it is anxious to compare itself with the more established insurance industry, from which it has borrowed several of its features, not the least of which is terminology. Perhaps the most exhaustive — and most persuasive — comparison made between the funds and the insurance business exists in the *Little Study*. In a convincing mathematical demonstration, the *Study* proves that the typical sales charge on insurance premiums amounts to 7.7 per cent.<sup>693</sup> However, while the *Study's* mathematics may be unassailable, it is submitted that its logic is not. The favorable comparison it hopes to draw — that "these costs are comparable to the dealer portion of the mutual fund sales charge"<sup>694</sup> — depends on the premise that life insurance purchasing is comparable to mutual fund investing. The validity of that premise has been hotly debated. While it seems clearly invalid with respect to term insurance, there are semblances of similarity between whole-life insurance and mutual funds. However, the similarity is superficial; the purpose of the larger than necessary payments on a whole-life insurance policy is to prevent insurance costs in later years of the insured's life from becoming prohibitive.<sup>695</sup> And in terms of motive, studies have indicated that most persons purchase insurance for protection in the event of an untimely demise — not to invest.<sup>696</sup>

While the insurance analogy cannot be written off as trite, it cannot in final view be said to present a useful index for comparison of competitive rates in the mutual fund industry.<sup>697</sup> Perhaps the most conclusive summary of the estimation held by many that life insurance is not designed to compete with mutual funds is the comparatively recent entry by insurance companies themselves into the mutual fund business by way of variable annuities and mutual funds.<sup>698</sup>

It was suggested at the outset of this analysis that competition cannot exist

692 See text accompanying notes 37-59 *supra*.

693 LITTLE STUDY III-51.

694 *Id.*

695 E. HARWOOD & B. FRANCIS, LIFE INSURANCE FROM THE BUYER'S POINT OF VIEW 11-13 (1939).

696 The SEC has noted:

Life insurance, except for term insurance policies, does contain a savings element (represented by investment in debt securities), the operation of which is postponed by the front-end load. This element, however, is secondary among the reasons why people buy life insurance. Spontaneous responses to the question, "Which would you say are the major reasons for carrying life insurance?" were: support for dependents (67 percent); cleanup funds (38 percent); saving (18 percent); education (7 percent); retirement income (6 percent); borrowing (6 percent); and mortgage repayment (1 percent). When shown a card listing each of these reasons, the uses of life insurance which relate to its investment aspects were listed by larger proportions of respondents. Combining responses to spontaneous and suggested reasons, the results were: support for dependents (86 percent); cleanup funds (83 percent); retirement income (43 percent); saving (40 percent); education (40 percent); mortgage repayment (32 percent); and borrowing (30 percent). PUBLIC POLICY STATEMENT 246 n.193.

697 Moreover, regulation of insurance companies has been expressly legislated out of the domain of federal authorities by the McCarran-Ferguson Act, 15 U.S.C. § 1012 (1964).

698 See notes 946-96 *infra* and accompanying text.

— because of the positive mandate of section 22(d) — between two broker-dealers for the business of an investor when the subject of their efforts is shares in the same mutual fund.<sup>699</sup> It would seem pointless to dispute the accuracy of that conclusion. As for competition among the funds, the data introduced earlier militate against a conclusion that sales load schedules of the various funds provide meaningful alternatives to the investor.<sup>700</sup>

## ii. Options Available for Change

The non-competitive sales load structure is one the SEC has determined to be in need of substantial revision.<sup>701</sup> In its recommendations for such revision, the Commission acknowledged that options were available to the legislature. Full-scale competition could be effected by a repeal of section 22(d), so that shares could be offered to the public at any price above the net asset value of the shares, or the statutory equivalent of a price set by competition could be written into the legislation in lieu of abolition of section 22(d).<sup>702</sup> These were the major alternative avenues of action as the SEC conceived the problem. In its own recommendation it opted for the latter,<sup>703</sup> suggesting that a flat rate of five per cent be attached to sales charges,<sup>704</sup> with residual power in the Commission to adjust that load to a higher figure in cases where such action would be called for.<sup>705</sup>

Initially the SEC's proposals were accepted in toto and introduced in the first session of the ninetieth Congress by Senator John Sparkman, Chairman of

699 Economist Paul Samuelson has noted: "Perfect competition is defined by the economist as a technical term denoting the case where no farmer, businessman, or laborer has any personal influence on market price . . ." P. SAMUELSON, *ECONOMICS* 38 (6th ed. 1964).

700 See text accompanying notes 653-56 *supra*.

701 Often overlooked in the controversy over appropriate sales loads is the funds' treatment of reinvested capital gains and dividends invested by their shareholders. A large percentage of mutual fund shareholders — all contractual planholders included — invest their dividends and reinvest capital gains distributions in shares of the fund. PUBLIC POLICY STATEMENT 215.

Some funds, not a majority, impose a sales load on invested dividends. *Id.* This procedure lacks any economic justification, for no sales activity is required to achieve dividend investment. While the SEC has not expressly banned sales loads on reinvested capital gains, it has made explicit its intention to do so, should the funds impose such a load. Therefore, reinvested capital gains are not subject to loads. *Id.* at n.55.

In addition, contractual plan companies may not impose a sales load on either reinvested capital gains or invested dividends, since the total load exacted would then exceed nine percent, the statutory maximum. *Id.* at n.56. Serious consideration has therefore been given to abolition of loads on invested dividends. S. 34 includes this possibility in its treatment of sales loads. ANALYSIS OF S. 34, at 8.

702 SEC, Statement No. 2, 1967 *House Hearings* 113-14.

703 The SEC asserts among its reasons for disfavoring the abolition of section 22(d) that it would not help the smaller investor "who has never heard of the Wall Street Journal" nor would it reach the totally integrated distribution systems. 1967 *House Hearings* 60. These arguments seem unsound, for a salesman who foisted a higher sales-load fund on an investor with lesser ability to bear that load would doubtlessly be open to an action under either the antifraud or suitability provisions discussed *supra* at text accompanying notes 552-78. As for the integrated distributors, continued maintenance, by concerted action, of the price above an acceptable level would subject them to antitrust actions. Unilateral action would be limited by the sales loads charged by other funds.

704 "Sales charge" is the technical term for the ratio of amount deducted as sales commissions to the net amount invested. Thus, the actual "sales load" under such a provision would be 4.76 per cent of the gross amount invested.

705 S. 1659, 90th Cong., 1st Sess. § 12(c)(2) (1967). Section 27(b) of the 1940 Act already authorizes the SEC to relax the load ceilings on sales of contractual plans by smaller companies if it appears that they are operating at higher costs and exemption would be in the public interest. 15 U.S.C. § 80a-27(b) (1964).

the Senate Banking and Currency Committee, as S. 1659, "A Bill to amend the Investment Company Act of 1940. . . ." <sup>706</sup> However, subsequent action in the Senate on S. 1659 resulted in the passage of an amended version, S. 3724. <sup>707</sup> Since the House failed to act on S. 3724 during that term, Senator Sparkman on January 15, 1969, in the first session of the Ninety-first Congress, introduced S. 34, <sup>708</sup> whose provisions are identical to S. 3724. <sup>709</sup> As noted, however, these provisions are substantially different from the original proposals of S. 1659. <sup>710</sup>

There exists yet another piece of legislation bearing on mutual funds in general and the sales load problem in particular: Senator Thomas J. McIntyre has introduced, also in the first session of the Ninety-first Congress, S. 296, which adopts the alternate choice noted by the SEC, the complete repeal of section 22(d). <sup>711</sup>

### iii. S. 296 — Repeal of Section 22(d)

Since Senator McIntyre's proposal calls for the complete repeal of section 22(d), <sup>712</sup> the question which that proposal must confront and answer is whether a return to the practices of 1940 would occur were that section repealed. Further, since section 22(d) operates in conjunction with NASD Rule of Fair Practice 26 to eliminate the pre-Act abuses, <sup>713</sup> any answer to this question must be couched in terms of both a repeal of section 22(d) and the inapplicability, by withdrawal of fund broker-dealers and underwriters from the NASD, of section 26 of the NASD Rules of Fair Practice.

While abolition of section 22(d) may well take place, <sup>714</sup> the inapplicability of Rule 26 is a good deal less likely to occur. Since NASD members may discriminate, on the basis of price, against non-members, <sup>715</sup> withdrawal from the NASD could constitute a significant disadvantage to many mutual fund broker-dealers. However, for a relatively small percentage of NASD dealers, distribution of mutual funds constitutes nearly all of their transactions. <sup>716</sup> For them withdrawal would not work a serious hardship, provided they could persuade NASD fund underwriters to withdraw as well. <sup>717</sup>

<sup>706</sup> S. 1659, 90th Cong., 1st Sess. (1967).

<sup>707</sup> S. 3724, 90th Cong., 1st Sess. (1967). For a thorough analysis of the history of this legislation, see North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME LAWYER 677 (1969).

<sup>708</sup> S. 34, 91st Cong., 1st Sess. (1969).

<sup>709</sup> ANALYSIS OF S. 34, at V.

<sup>710</sup> Whereas S. 1659 contained the statutory maximum sales load, S. 34 contains a section that "provides that a registered securities association [the NASD] may by rule prohibit its members from offering redeemable securities at a price which includes an 'excessive' sales load . . ." *Id.* at 8.

<sup>711</sup> S. 296, 91st Cong., 1st Sess. § 12(a) (1969).

<sup>712</sup> Section 12 of S. 296 states simply: "Section 22(d) of the Investment Company Act of 1940 (15 U.S.C. 80a-22(d)) is repealed." S. 296, 91st Cong., 1st Sess. § 12(a) (1969).

<sup>713</sup> NASD, Rules of Fair Practice, art. III, § 26, reprinted in NASD REPRINT ¶ 2176, at 2104.

<sup>714</sup> Senator Sparkman has indicated that the Senate Banking and Currency Committee intends to give careful consideration to repeal of section 22(d). ANALYSIS OF S. 34, at vi.

<sup>715</sup> See text accompanying note 510 *supra*.

<sup>716</sup> In a sampling of NASD member firms, 31.9 per cent reported that mutual fund income constituted ninety to one hundred per cent of their gross income. NASD, ECONOMIC CONSEQUENCES FOR THE SECURITIES BUSINESS 12 (1967).

<sup>717</sup> NASD Rule of Fair Practice 26 prohibits member underwriters from selling shares to nonmembers except at public prices. Therefore, mutual fund underwriters would necessarily have to withdraw from the NASD also for the scheme to work.

Assuming arguendo that this development should occur, would the pre-1940 practices, specifically the taking of short and long-positions, return? Short-position taking, it will be recalled, consists of the broker-dealer's delay in placing the customer's order so as to buy at the lower of two known prices and sell the shares thus purchased to the customer at the higher price.<sup>718</sup> Rule 26(f)(1) presently controls this practice as regards NASD members.<sup>719</sup> However, even if section 26 were inapplicable, short-position taking would now be impossible. The SEC, pursuant to its grant of authority under section 22(c) of the 1940 Act, has recently adopted Rule 22c-1,<sup>720</sup> requiring all broker-dealers, irrespective of membership in the NASD, to place customer orders so that they will be priced at the asset value *next* computed after the receipt of the order. Therefore, no broker-dealer may now engage in taking short-positions.

As the SEC's 1940 report indicated, dealer accumulation of an inventory of fund shares is essential to the taking of long-positions.<sup>721</sup> NASD Rule 26(f)(2) presently prevents such an accumulation by forbidding underwriters to sell to dealers any shares not already ordered by a dealer's customer. However, assuming the inapplicability of that provision, it would appear that the dealer would be presented with an opportunity to accumulate his own inventory.

In *T. I. S. Management Corporation*,<sup>722</sup> the respondent-registrant was engaged in taking both short and long-positions, which, the SEC noted, necessarily "diminish the dollar amounts paid into the trust [fund], since, in effect, investors pay the current prices, whereas the trust receives the lowest prices, the registrant [broker-dealer] keeping the difference."<sup>723</sup> The context in which *T. I. S. Management* arose concerned a stop-order proceeding directed against respondent, principal distributor of Trusteed Industry Shares, an unincorporated investment trust of the fixed management type. For the purposes of the Securities Act of 1933, respondent was considered to be the "issuer" of the shares and was therefore required to file a registration statement in accordance with the Securities Act.<sup>724</sup> One item of the respondent's registration statement required the issuer-respondent to give a full breakdown of all the components of the sales load assessed upon acquisition of Trusteed Industry Shares. Counsel for the Commission contended that included in that requirement was a duty of the respondent to disclose, among other things, the profits made by taking both long and short-positions. The Commission agreed that the failure to disclose profits from position-taking was material and caused the registration statement to be defective.<sup>725</sup>

Although *T. I. S. Management* arose in a context distinguishable from the typical broker-dealer position-taking discussed immediately above, the SEC's 1938 determination that the term "loading charge" included profits made from position-taking is informative, for section 2(a)(34) of the 1940 Act defines "sales load" as "*the difference between the price of a security to the public and*

718 See text accompanying note 320 *supra*.

719 See text accompanying notes 400-02 *supra*.

720 See text accompanying notes 403-05 *supra*.

721 Cf. INVESTMENT TRUSTS 856-57.

722 3 S.E.C. 174 (1938).

723 *Id.* at 177.

724 Securities Act of 1933 § 2(4), 15 U.S.C. § 77b(4) (1964).

725 3 S.E.C. at 180.

that portion of the proceeds from its sale which is . . . invested or held for investment by the issuer.<sup>726</sup> (Emphasis added.) In light of the *T. I. S.* decision, that definition would appear to include position-taking as a part of the sales load.

In the event of abolition of section 22(d) and inapplicability of the NASD Rules, the apparent effect of this definition would nevertheless work to achieve an end comparable to that achieved by those sanctions. The dealer would then be selling shares to investors in direct competition with other dealers. A sales load higher than that charged by his competitors would have the effect of causing customers to purchase through other dealers in order to benefit from a lower price. Competition would therefore force the dealer to maintain profits from position-taking at a minimal level, if at all. On the other hand, if numerous dealers attempted to make profits from position-taking, theirs would be the unenviable task of convincing the Antitrust Division of the Department of Justice that this practice did not constitute industry-wide price-fixing.<sup>727</sup>

Thus, while Senator McIntyre's proposal might at first blush appear to pave the way for an untoward result,<sup>728</sup> it in reality neither contemplates nor causes such a consequence. Moreover, in repealing section 22(d) entirely, it would revoke the long-standing exemption from the antitrust laws that the industry has previously enjoyed. At a time when the SEC and the industry are at an impasse, the introduction of the Antitrust Division into the operation of the industry would indeed have unsettling effects.<sup>729</sup>

#### iv. S. 34 — Five Per Cent Maximum

S. 34, unlike Senator McIntyre's bill, does not advocate repeal of section 22(d) but amends it to empower the NASD to maintain sales loads below an "excessive" level.<sup>730</sup> This provision differs from S. 1659 in terms of applying authority, for the original bill would have set a maximum ceiling of five per cent on sales charges and would have authorized the SEC to make changes where proper.<sup>731</sup> This initial approach has been jettisoned in S. 34 in favor of the self-regulatory device of allowing the NASD to set its own rules as to sales loads.<sup>732</sup> Presumably this approach benefits from the lessons learned in the give-and-take sessions between the SEC and the NASD prior to passage of the 1940

<sup>726</sup> Investment Company Act of 1940 § 2, 15 U.S.C. § 80a-2(a)(34) (1964).

<sup>727</sup> The Attorney General is authorized by section 4 of the Sherman Act to institute proceedings to enjoin antitrust violations. 15 U.S.C. § 4 (1964).

<sup>728</sup> A possible alternative safeguard to prevent long-position taking, in the event of the inapplicability of present provisions, is Rule 22c-1, discussed *supra* at notes 403-05 and accompanying text. That Rule, adopted to prevent dilution and to eliminate results other than dilution which arise from the sale or redemption of the securities of registered investment companies and which are unfair to holders of outstanding securities of the companies, might reach this practice. Though the pertinent phrasing of the Rule—"after receipt of a tender of such security for redemption or of an order to purchase or sell such security"—does not indicate explicitly that the "tender" or "order" must be *placed by a customer*, it may be implied from the release interpreting the Rule that the Commission's Division of Corporate Regulation does think of it in those terms. See SEC staff, Investment Company Act Release No. 5569 (December 27, 1968), [Current volume] CCH FED. SEC. L. REP. ¶ 77,640, at 83,375.

<sup>729</sup> In a survey conducted among West Coast businessmen, the Antitrust Division of the Department of Justice was rated as least popular of the federal agencies, the SEC being most popular. 113 Cong. Rec. S16,386 (daily ed. Nov. 14, 1967).

<sup>730</sup> S. 34, 91st Cong., 1st Sess. § 12(a) (1969).

<sup>731</sup> See note 250 *supra*.

<sup>732</sup> If at the expiration of eighteen months, the NASD has not adopted such a rule, the

Act.<sup>733</sup> Since the NASD must first set the level and the SEC is then entitled to alter or supplement it, the scheme avoids the inflexibility of statutory implementation. Further, it avoids another problem seen by the 1940 progenitors: the fact that any sales load level once established would become the normal load charged.<sup>734</sup> Fearing that the "maximum would become the minimum," the SEC's personnel in 1940 hesitated to insert a maximum sales load prescription.<sup>735</sup> The present bill, S. 34, avoids this problem.

If enacted, S. 34 would give the NASD eighteen months to establish within its own framework a rule for sales loads.<sup>736</sup> As noted earlier, the NASD has already established a maximum of five per cent on commissions to be charged in over-the-counter transactions.<sup>737</sup> However, that policy does not apply "To the sale of securities where a prospectus or offering circular is required to be delivered and the securities are sold at the specific public offering price."<sup>738</sup> Of course, every interstate offering of a security requires the transmittal of a prospectus to accompany the transaction,<sup>739</sup> but the distinguishing feature of the offering of mutual fund shares is the requirement of section 22(d) that the "current public offering price" be maintained. The NASD's markup policy has thus far been inapplicable, simply because the dealer has to sell at the price prescribed by the underwriter-advisor in the prospectus. While S. 34 proposes to leave section 22(d) substantially unchanged, it would specifically authorize the NASD to establish a similar markup policy for the sale of mutual fund shares. Accordingly, the Five Per Cent Policy would appear to be a possible starting point for determining the proper sales load. Moreover, this figure compares favorably with the proposed statutory maximum of five per cent favored by the SEC and as originally implemented in S. 1659. Should future developments warrant, the SEC could alter or revise the markup policy to more realistically reflect changed economic circumstances.

This method of dealing with the sales load problem combines the most advantageous aspects of all the positions advanced: it allows self-regulation (always an acceptable goal in the American political context), provides flexibility, retains the previous distribution system, and insures that the interests of the mutual fund owner as first a purchaser, and then an investor, are protected.

### *c. The Options in Light of Section 22(d)*

As the Commission noted in its statement before both houses of Congress during hearings on the proposed amendments, legislators are not writing on a clean slate when they propose legislation affecting the sales load.<sup>740</sup> Section 22(d)

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SEC is empowered to make rules pursuant to its authority under section 15(b)(10) of the Securities Exchange Act, 15 U.S.C. § 78o(b)(10), for the same purpose. S. 34, 91st Cong., 1st Sess., § 12(a) (1969).

<sup>733</sup> Cf. 1940 Senate Hearings 288.

<sup>734</sup> *Id.* at 290.

<sup>735</sup> *Id.*

<sup>736</sup> See note 732 *supra*.

<sup>737</sup> See notes 671-72 *supra* and accompanying text.

<sup>738</sup> NASD REPRINT 2058.

<sup>739</sup> Securities Act of 1933 § 5(b)(2), 15 U.S.C. § 77(e)(b)(2) (1964).

<sup>740</sup> SEC, Statement No. 1, 1967 House Hearings 59.

is merely one of seven provisions of section 22 of the Investment Company Act that affect the sales load. As will be seen below, it would appear that the thrust of the entire section is exemplified in Congress's award to the NASD of power to prescribe rules

for the purpose of eliminating or reducing so far as reasonably practicable any dilution of the value of other outstanding securities of such company or any other result of such purchase, redemption, or sale which is unfair to holders of such other outstanding securities . . . .<sup>741</sup>

The SEC frequently pointed out in the 1967 congressional hearings that sales loads were not a primary source of concern in the 1940 hearings which led to the Investment Company Act.<sup>742</sup> This view is supported by the testimony of David Schenker, SEC representative, to the effect that sales loads were considered a technical item which could be left to competition.<sup>743</sup> Several other aspects of the distribution system were of more pressing concern to the 1940 legislators; these problems concerned inequities perpetrated on holders of outstanding mutual fund securities and malfeasances by persons in the distribution process. Both in turn were intimately connected with the pricing system then in effect.<sup>744</sup>

As seen in Part III, the pre-1940 pricing practices worked harm on holders of outstanding shares by diluting the value of already computed increases in net asset value.<sup>745</sup> The previous examination also indicated that a dealer could make additional profits by taking "short-positions" in the distribution of fund shares.<sup>746</sup> However, the NASD's twice-daily computation rule and recently adopted Rule 22c-1 now prevent those abuses.<sup>747</sup>

Another broker-dealer malfeasance which led to the enactment of section 22 consisted of the broker-dealer's taking "long-positions" in the sale of fund shares. A "long-position" was effected by buying shares as principal from the fund at a low price and reselling them as principal on a subsequent date at a higher price.<sup>748</sup> The difference between the dealer's purchase price and the customer's purchase price was retained by the dealer, along with his commission on the sale. Unlike the short-position, the long-position required the dealer to assume some risk; if the market turned down before the shares were resold to customers, the dealer sustained a loss. However, broker-dealer familiarity with market indices minimized that possibility.<sup>749</sup>

The effect of section 22 on this malpractice cannot be understood without considering section 26 of the NASD Rules of Fair Practice. Subsection (f) (2) of that section effectively prevents NASD members from taking long-positions by requiring that no orders may be placed unless a customer has already ordered the

741. Investment Company Act of 1940 § 22(a), 15 U.S.C. § 80a-22(a) (1964).

742. 1967 House Hearings 57.

743. Statement of David Schenker, 1940 Senate Hearings 290.

744. For a description of the two-price system used to compute the value of mutual fund shares, see text accompanying notes 318-20 *supra*.

745. See notes 319-25 *supra* and accompanying text.

746. See note 320 *supra* and accompanying text.

747. See notes 398-405 *supra* and accompanying text.

748. See notes 321-24 *supra* and accompanying text.

749. INVESTMENT TRUSTS III 853.

shares.<sup>750</sup> Subsection (j) (2) effectively stymies non-NASD members from taking long-positions by requiring them to become record owners of the shares before they can be redeemed by NASD members.<sup>751</sup> This places a good deal of risk on the nonmember, for a market downturn in the time it takes the nonmember to become record owner could be ruinous.<sup>752</sup> The net effect of these provisions is to forestall the development of what would resemble an over-the-counter market in mutual fund shares.<sup>753</sup> This effect has the desired aims of preventing the perpetration of inequities on holders of outstanding mutual fund securities and foreclosing broker-dealer malfeasances that benefited neither existing shareholders nor the mutual fund purchaser.

In sum, then, section 22 of the Investment Company Act must be read in conjunction with section 26 of the NASD Rules of Fair Practice to ascertain the general aim of Congress.<sup>754</sup> That aim, as the NASD itself put it, was "to ensure the orderly distribution of open-end investment company shares . . ."<sup>755</sup> A disorderly distribution process such as prevailed before 1940 clearly injured the investor both as purchaser and as investor. But it was a concern primarily with his status as investor that the Act manifested. The most effective manner of dealing with problems associated with that status lay in the structuring of a distribution system which eliminated the two-price system and closed off entry to independent dealers uncontrolled by NASD rules by making it uneconomical for them to deal in mutual fund shares. Section 22 and the NASD rules passed pursuant to it have largely succeeded in doing this.

Subsequent analyses have attempted to explain section 22(d) as an isolated response that dealt primarily with a so-called "bootleg market" . . . made by dealers who traded in the shares of open-end investment companies without the authority of the principal distributors for those companies."<sup>756</sup> In this market, dealers not party to a sales agreement could obtain shares for redemption by offering a higher price than net asset value, and could subsequently sell them at a lower price than that charged by members of the selling group. Since the profit on commissions was entirely theirs (*i.e.*, the sales load went to the dealer alone), the profit was still larger than that obtainable by way of dealer concession.<sup>757</sup> Theoretically, an analysis of section 22(d) based solely on the "bootleg market" could be made. However, the more persuasive analysis lies in reading section 22(d) as part of a total response—section 22 is a comprehensive attempt to eliminate unscrupulous practices by broker-dealers and unfair consequences to holders of outstanding mutual fund securities. The section structures the distributory sys-

<sup>750</sup> Rules of Fair Practice art. III, § 26 (f) (2), reprinted in NASD REPRINT ¶ 2176, at 2106.

<sup>751</sup> *Id.* § 26(j) (2), reprinted in NASD REPRINT ¶ 2176, at 2107.

<sup>752</sup> A Proposed Amendment to the Rules of Fair Practice of National Association of Securities Dealers, Inc., 9 S.E.C. 38, 44 (1941).

<sup>753</sup> *See, e.g.*, Investment Company Institute v. Camp, 274 F. Supp. 624, 629 (D.D.C. 1967); SPECIAL STUDY IV 98.

<sup>754</sup> NASD, MEMORANDUM RE: SECTION 22(d), at 5 (1958).

<sup>755</sup> *Id.* at 4.

<sup>756</sup> INVESTMENT TRUSTS III 865.

<sup>757</sup> It is significant to note that the SEC in 1939 indicated that "[s]uch operations actually had the effect of initiating a small scale price war between retailers . . . ." *Id.*



tem to make that goal attainable. It is not an attempt to place a ceiling over sales loads. Competition was selected to perform that task.<sup>758</sup>

However, it may be assumed that Congress and the SEC realized that internal competition, *i.e.*, competition for the same shares based on a difference in sales load, was effectively foreclosed by section 22(d). Assumedly, therefore, they relied on external competition between funds for the investor's dollar to stabilize sales loads at a publicly acceptable level. A previous examination of external competition with respect to sales loads has indicated that that competition has simply failed to materialize.<sup>759</sup> The reason no doubt lies in the self-inflating distribution mechanism already examined.

Proponents of the various measures now pending have concluded that section 22(d) provides protection to the mutual fund owner as investor; it does not effectively provide him with protection as a purchaser.<sup>760</sup> Rather, section 22(d) serves quite the contrary purpose: in effecting "retail (resale) price maintenance"—which is simply an exemption from the antitrust laws traveling under a flattering alias—section 22(d) effectively forestalls any competition that might redound to the purchaser's advantage. The proponents have recommended, therefore, that section 22(d) be substantially revised or entirely eliminated in order to extend to the purchaser the advantages of competition.

### F. Periodic Payment Plans

#### 1. Introduction

Mutual funds have always claimed that they provide benefits that the typical fund investor could not acquire in any other way.<sup>761</sup> Chief among these benefits is participation in equities securities with all the financial advantages such participation entails. The funds are also quick to point out that their investors receive the additional advantages of portfolio management and diversification far below the cost of comparable services to individual investors. Of course, all these beneficial aspects of mutual fund investing indicate that the funds are tailor-made for the modest means investor, whose statistical profile closely approximates the middle-class wage earner.<sup>762</sup> Since mutual fund investing is attractive to such a large potential market, the funds' desire to reach as many members of that stratum as possible is understandable.

Realizing that the investor from this class is best able to finance an investment program from current income, those familiar with the investment company industry long ago hit upon the idea of offering the "average and small investor"<sup>763</sup> the opportunity to purchase fund shares on a periodic basis. To develop such opportunities, they borrowed from many other industries, primarily the consumer goods and insurance businesses, and devised programs variously known as "con-

758 See note 743 *supra* and accompanying text.

759 See note 656 *supra* and accompanying text.

760 Cf. SEC, Statement No. 1, 1967 *House Hearings* 54.

761 See note 457 *supra* and accompanying text.

762 Compare U.S. BUREAU OF THE CENSUS, U.S. CENSUS OF POPULATION: 1960 SUBJECT REPORTS: OCCUPATION BY EARNINGS & EDUCATION 2 (1963) with WHEARTON SURVEY 273-77.

763 Roach, *A Talk*, PRESENTATION, Part II-A, at 1.

tractual plans," "installment investment plans," "periodic payment plans," "accumulation plans" and the like. The chief characteristic of these plans is systematic investing of relatively small amounts, ordinarily over a long period, usually ten years, with a general investment goal of producing a source of capital at the completion of the program.

As previously noted,<sup>764</sup> investors in such plans do not invest directly in mutual fund shares; instead their money is channeled to the funds through a separate organization, based on a "trust" indenture or similar agreement.<sup>765</sup> As evidence of his ownership, the planholder receives not shares but a "certificate of ownership." He enjoys pro rata beneficial ownership of the shares, calculated in "units" of ownership.<sup>766</sup> The shares credited to the investor's account are held by a "Custodian," which must be a qualified financial institution.<sup>767</sup>

The underlying fund shares are securities, and the offering of the trust units is also considered the offering of a security within the meaning of the Securities Act of 1933; therefore both must be registered with the SEC.<sup>768</sup> Accordingly, a prospectus for both the plan units and the underlying fund shares must also accompany solicitations by salesmen. Moreover, organizations soliciting sales of the plan must be registered in accordance with section 15 of the Exchange Act.<sup>769</sup> Prior to 1955, distribution of most plans was carried out through the captive sales force of the underwriter-sponsor. Since that date, most plans have been distributed through independent broker-dealers.<sup>770</sup>

From the investor's viewpoint, periodic investment plans represent an alternative investment vehicle to the more direct method of investing in shares of the fund itself.<sup>771</sup> For the salesman, the periodic plan constitutes an attractive segment of his customer merchandise, primarily because of the unique compensatory features of such investment plans, which will now be considered.

## 2. The Front-end Load

The plan sponsors, most of whom have banded together in their own organization, the Association of Mutual Fund Plan Sponsors, Inc. [AMFPS], claim that the features of periodic plans set their investment vehicle apart from other investment company systems (*e.g.*, mutual funds, face amount certificate companies, etc.) and make the periodic payment plan most attractive to the investor with moderate income but little investible savings.<sup>772</sup> The features they point to

<sup>764</sup> See notes 284-91 *supra* and accompanying text.

<sup>765</sup> INSTALLMENT INVESTMENT PLANS STUDY 15.

<sup>766</sup> Hence the term "unit investment trust" which describes such operations and which is defined in the Investment Company Act as one form of investment company. Investment Company Act of 1940 § 4(2), 15 U.S.C. § 80a-4(2) (1964).

<sup>767</sup> *Id.* § 26, 15 U.S.C. § 80a-26 (1964).

<sup>768</sup> All securities must have in effect a registration statement on file with the Commission before they may lawfully be introduced into interstate commerce. Securities Act of 1933 § 5, 15 U.S.C. § 77e (1964).

<sup>769</sup> 15 U.S.C. § 78o(a)(1) prohibits broker-dealers from making use of interstate commerce to market any security unless the broker-dealer is registered with the Commission.

<sup>770</sup> PUBLIC POLICY STATEMENT 224-25.

<sup>771</sup> Shares of sixty funds were available, as of 1966, through contractual plan investing. *Id.* at 225-26.

<sup>772</sup> See generally Bellemore, *The Suitability of Common Stocks for Today's Average Investor*, PRESENTATION, Part II-C, at 1.

generally include lower initial amounts of money to begin investing (ease of access), the manner in which sales loads are computed which operates to the planholder's detriment unless he completes his plan (stimulus to savings), the provision that a planholder may at any time withdraw up to ninety percent of the amount he has invested and reinvest the same amount without paying a sales load on the reinvestment (ninety per cent withdrawal rights), frequent communications to the planholders regarding their accounts and payments due (reminder notices), and the opportunity to purchase group term insurance at nominal cost to insure that the plan will be completed in the event of the investor's death (completion insurance).<sup>773</sup>

Nearly all of these features may be duplicated in one form or another by the underlying funds themselves, through a voluntary accumulation plan with term insurance.<sup>774</sup> However, the characteristic of periodic plans that sets them off from their mutual fund relatives is the atypical manner in which the investor pays the sales load. Most mutual funds levy a sales load on sales of their shares, but unlike the load structure applicable to the mutual funds themselves, the normal periodic plan commission schedule calls for the investor to pay not only the load on the units he initially buys, but also a substantial portion of the load on shares he expects to buy in the future under the plan's contemplated number of payments.

Statistics indicate that the most popular plan is the \$25-per-month-for-ten-years plan, which requires a total investment of \$3,000.<sup>775</sup> This compares with a median purchase by all fund investors, in 1966, of \$1,240.<sup>776</sup> While the plan salesman's commission percentage is the same as that of other fund salesmen, the very nature of the periodic payment plan would discourage the sale of these plans were a level load charged the purchaser. For example, if the sales load on a plan's sales was nine per cent, the statutory maximum, the salesman (assuming a level load and the \$25 per month plan with an allocation of two per cent of the sales load to the underwriter and three and one-half per cent each to the salesman and the dealer) would be entitled to the rather un princely sum of \$0.88 per month. Of course, over the length of the program, 120 months, the salesman would receive \$105 in commissions from the sale. However, the practical problems inherent in such an arrangement have caused the salesman-conscious industry to devise a more attractive system of compensation, the front-end load, which rewards the salesman more quickly and surely than does the level load. This scheme calls for the major portion of the sales loads to be paid very early. Ordinarily this is achieved by diverting up to one-half of the first year's payments to pay the sales load; usually by the fourth year sixty-four per cent of the total load has been paid, while the plan itself is less than forty per cent

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<sup>773</sup> See AMFPS Staff, *An Analysis of and Reply to Chapter XI of the Special Study*, PRESENTATION, Part IV.

<sup>774</sup> As of 1966, 220 of 242 funds listed in one industry compilation offered voluntary plans; twenty such plans were offered with completion insurance. PUBLIC POLICY STATEMENT 225, 231.

<sup>775</sup> SPECIAL STUDY IV 263 (Table XI-10).

<sup>776</sup> See PUBLIC POLICY STATEMENT 206-07.

completed.<sup>777</sup> Payments in the remaining six years are subject to loads of only four per cent. From the investor's viewpoint, this scheme does not require a total load of more than nine per cent, but it benefits him less because fewer of his assets are invested for him in the crucial early years of the plan. The sponsors state with near religious fervor that the front-end load works for the investing public's good in two ways. First, since it sets up an equitable and attractive compensatory system for salesmen, the front-end load encourages salesmen to reach and inform the vast untapped investing market of the economic advantages of periodic investing in mutual funds.<sup>778</sup> Second, the front-end load serves as a stimulus to investors to maintain the continuity of their plan. Since the planholder has in effect prepaid the sales load on payments to be made much later, he will obtain the benefits of the scheme only by completing all or substantially all of the scheduled payments.<sup>779</sup> He must therefore recoup those payments by adhering to the schedule or else he forfeits their benefit. The validity of these two arguments would seem to depend more on philosophical conceptions of the nature of man than on mere reflection of economic benefits.<sup>780</sup> Be that as it may, the front-end load is an essential part of periodic plan investing.<sup>781</sup>

### 3. Statutory Impact on Periodic Payment Plans

The provisions of the Investment Company Act of 1940 pertaining to contractual plans reveal the spirit of regulation that pervaded Congress when the Act was passed. The history of contractual plan investing, set out in one of six supplemental reports compiled by the SEC in its study of investment trusts and investment companies, indicates that congressional attention was, to say the least, richly deserved.

In assessing the causes for the development of the installment plan purchase of mutual funds, the SEC suggested in 1939 that the public had already had some two decades of experience in installment purchases of consumer goods.<sup>782</sup> Furthermore, installment purchases of securities under employee stock ownership plans contributed to public acceptance of investment purchases "on time."<sup>783</sup> Yet, most relevant of all the causes was the recognition by enterprising businessmen of the possibility that such plans could

get persons with a small amount of money into the money-making end of industry as distinguished from savings entirely; that persons who actually acquired interests in sound companies would have an opportunity to make

<sup>777</sup> For a discussion of objections to the operation of the front-end load, see notes 817-43 *infra* and accompanying text.

<sup>778</sup> *E.g.*, SPECIAL STUDY IV 136.

<sup>779</sup> *E.g.*, PRESENTATION, Part IV, at 144.

<sup>780</sup> AMFPS has not found itself unequal to this challenge. *See, e.g.*, Cook, *The Special Study Proposals Concerning Contractual Plans*, PRESENTATION, Part II-B.

<sup>781</sup> The industry further adds:

As far as is known, there is no long-term plan of any kind that people can buy, from the maternity benefits for life to funeral services for eternity, that does not involve a "front-end" load, particularly if payments are permitted to lapse. *Id.* at 28.

<sup>782</sup> INSTALLMENT INVESTMENT PLANS STUDY 4-5.

<sup>783</sup> *Id.* at 5.

some money as distinguished from pure [*sic*] saving it at a fixed rate of interest. *That is the background of the thing.*<sup>784</sup> (Emphasis added.)

That there was a large potential market for such an investment medium was beyond doubt; but the very makeup of the class of potential investors signalled problems for the "disclosure" rationale of the earlier adopted Securities Act and Securities Exchange Act. Implicit in that rationale is the concept of arm's-length bargaining, and it might be readily expected that this class of investors would lack the financial sophistication to secure the integrity of that rationale. Perhaps it was this consideration that prompted the SEC, in 1939, to note that:

Although the installment investment plan is only a small part of the entire investment company business [at the time only one-half per cent of the assets<sup>785</sup>] it is significant from the standpoint of the type of investor to which these plans are sold—individuals in the low-income brackets and the salaried and wage-earning class.<sup>786</sup>

It is suggested that this consideration is one of vital importance, and is emphasized by the comparative growth of contractual plans, which as of 1966 represented 9.1 per cent of total mutual fund assets and twenty-five per cent of shareholders.<sup>787</sup>

Installment plans mushroomed rapidly after their first appearance in 1930; by 1936, more than forty such plans were in existence.<sup>788</sup> However, pre-1940 plans, though based on a trust as are installment plans today, differed from modern plans in significant respects. Nearly all of today's installment plans utilize shares of a particular mutual fund as the underlying security, whereas only a minority of pre-1940 plans did so.<sup>789</sup> A substantial number of them selected shares of a fixed investment trust as the underlying security.<sup>790</sup> In terms of value of underlying securities, a smaller number invested directly in common stocks.<sup>791</sup> This last type, unlike the fund-based and fixed-trust-based types, required a managerial discretion to determine securities appropriate for investment by the plan; the other two types were non-discretionary, however, since the underlying security had already been established in the trust agreement. Despite this difference, several pre-1940 plans charged planowner's fees for management advice, even though it was not required.<sup>792</sup> Furthermore, in many cases, securities of the underlying fund or fixed investment trust were offered to the installment planowner only at that security's public offering price, *i.e.*, one that included a sales load.<sup>793</sup> These features constituted serious abuses; in conjunction with certain other abuses, they made the planholder's overall costs oppressive.

Charges assessed the pre-1940 planholder were numerous and expensive.

784 *Id.* at 6-7.

785 *Id.* at 13.

786 *Id.*

787 PUBLIC POLICY STATEMENT 225.

788 *Id.* at 224.

789 INSTALLMENT INVESTMENT PLANS STUDY 19.

790 *Id.*

791 *Id.* at 20.

792 *Id.* at 38.

793 *Id.* at 25.

He of course had to pay a sales load on the units he purchased. The sales load was paid through the front-end device and ordinarily was "exacted in the first six or seven months of the 10-year period of the plan."<sup>794</sup> In some plans, nearly a quarter, he had to pay a "creation fee" or "initial fee" that some sponsors established in addition to or in lieu of the sales load, depending on how the sponsor obtained other fees.<sup>795</sup>

The sales load of the pre-1940 contractual plan was doubly burdensome because the plan was an entity separate from the fund. The plan sponsor received the fund's shares at the public offering price, which included the sales load on those shares; the plan units were in turn offered to the investor subject to *another* sales load. As a consequence, the investor was bearing not one but two sales loads.<sup>796</sup>

A third charge assessed the investor was a management fee paid to the plan's own advisor. The extent of the advisory duties in non-discretionary plans were revealed in the testimony of an official of the pre-1940 era:

Q. In other words, the term "management fee" is really an erroneous term. There is no management connected with it, is there? It is simply part of the initial fee?

A. Well there is quite a lot of detail and records kept on each one of the accounts.

Q. But there still wasn't any actual management of the underlying property?

A. No.<sup>797</sup>

Another charge planholders had to bear was a withdrawal fee, levied on termination of the planholder's account, ostensibly to cover the cost of liquidation and withdrawal, but which served handily as a deterrent to liquidation.<sup>798</sup> The investor also bore the cost of the trustee's charge, analogous to the contemporary Custodian's fee, which amounted generally to two and one-half per cent of the total sum payable on the plan.<sup>799</sup> If the investor chose to buy group term insurance available to assure completion of his plan in the event of his death, he further bore the cost of the premiums. Although the premiums did not add to the sponsor's profits (because they were paid to a separate insurance company), they reduced the amount invested on the purchaser's behalf.<sup>800</sup>

Any dividends to which the investor was entitled were also subject to charges, the major ones being the primary and secondary sales loads.<sup>801</sup> Other "miscellaneous tribute" such as brokerage, taxes, expenses pertaining to the holder's fund, positions taken by the sponsor, and exchange fees increased the overall burden of the investor.<sup>802</sup> The SEC calculated that the "average total

<sup>794</sup> *Id.* at 33.

<sup>795</sup> *Id.* at 35-36. It was suggested that this fee also served to discourage those investors who lacked adequate resources to carry on the program. *Id.*

<sup>796</sup> *Id.* at 40.

<sup>797</sup> *Id.* at 38.

<sup>798</sup> *Id.* at 37.

<sup>799</sup> *Id.* at 43.

<sup>800</sup> *Id.* at 43-44.

<sup>801</sup> *Id.* at 45.

<sup>802</sup> *Id.* at 54.

load of all plans was 15.56% of the net amount to be invested if all required payments were made.<sup>803</sup> For companies that offered completion insurance, charges for loads and insurance premiums totalled 23.77 per cent.<sup>804</sup> Further, the SEC indicated that the funds with greatest sales were those whose sales loads (exclusive of insurance costs) were above the average total ranging from seventeen to twenty per cent.<sup>805</sup> Of course if the planholder made fewer than the full number of plan payments, the sales load expressed as a proportion of the net amount invested would soar to astronomical proportions.<sup>806</sup> As a practical matter, if we assumed a pre-1940 plan scheduled for \$10 monthly payments over a ten-year period, we would find that little of the "investment" would actually be invested until the second or third year.

The abuses widely prevalent in the pre-1940 sale of contractual plans led to section 27 of the Investment Company Act, which deals solely with periodic payment plans. It expressly limits contractual plan sales loads to nine per cent of the amount to be invested<sup>807</sup> (whereas sales loads on mutual fund shares are limited only by the vague "unconscionable or grossly excessive" standard<sup>808</sup>), and sales loads of periodic payment plans are defined to include the sales loads both of the plan *and* the underlying security.<sup>809</sup> To insure that the entire sales load is not exacted from the investor immediately, section 27(a)(3) requires that not more than half the payments of the first twelve months or their equivalent may be used for the sales load.<sup>810</sup> Additionally, unit investment trusts, the typical legal structure of periodic payment plan companies, may not have boards of directors.<sup>811</sup> Management fees are limited by another provision of section 27 to a standard of reasonableness to be determined by the SEC.<sup>812</sup> The effect of this provision has been to preclude the use of advisory fees by sponsors of non-discretionary plans.<sup>813</sup> The 1940 Act also reflects a concern that plans are not to be sold to persons unable to afford them, for minimum payments were set at \$10 monthly, with the minimum initial payment set at \$20.<sup>814</sup>

By and large, the pertinent provisions of the 1940 Act have succeeded in eliminating the abuses they were intended to correct. Yet there remain serious

803 *Id.* at 47.

804 *Id.*

805 *Id.* at 52-53.

806 The SEC estimated that the total loading charges for the period 1930-37 were more than thirty per cent of the net amount invested during that period. *Id.* at 61.

807 15 U.S.C. § 80a-27(a)(1) (1964).

808 As seen earlier, sections 22(b) and (c) of the 1940 Act authorize the NASD and the SEC respectively to make regulations to insure that sales loads are not set at an "unconscionable or grossly excessive" level. *Id.* §§ 80a-22(b),(c).

809 Section 2(a)(34) of the 1940 Act provides:

In the case of a periodic payment plan certificate, "sales load" includes the sales load on any investment company securities in which the payments made on such certificate are invested, as well as the sales load on the certificate itself. *Id.* § 80a-(2)(a)(34).

810 *Id.* § 80a-27(a)(3).

811 *Id.* § 80a-4(2).

812 *Id.* § 80a-27(a)(6).

813 "No advisory fee is charged by the sponsor of the contractual plan company, but such a fee is charged by the adviser to the underlying fund, and is, in effect, paid by the contractual planholder." PUBLIC POLICY STATEMENT 226.

814 Investment Company Act of 1940 § 27(a)(4), 15 U.S.C. § 80a-27(a)(4) (1964). Perhaps it is by analogy to this provision that sponsoring companies nearly unanimously require the introductory payment to be twice the normal monthly payment. As a result, the fifty per cent sales load applies to a total of thirteen, not twelve, payments. PUBLIC POLICY STATEMENT 230.

questions as to the necessity, structure, and overall efficacy of contractual plans. It apparently was not the judgment of the Seventy-sixth Congress that consideration need be given to the question whether there *should* be unit investment trusts to carry out the installment investing scheme. Its attention was focused on the question *how* such a scheme was to be carried out. Nevertheless, the 1940 congressional answer to the latter question has made very relevant a present congressional inquiry into the former as well.

There is little doubt that the "trust on a trust" system of the plan companies was a prime target of the 1940 Act. The provision that made the nine per cent sales load include both primary and secondary loads eliminated the odious features of paying a load on the certificate as well as on the underlying shares.<sup>815</sup> It is submitted that this provision has more far-reaching effects, however. Since the "trust on a trust" arrangement of the unit investment trust scheme was the backbone of installment investing, it is suggested that the economic justification for having a separate company — the unit investment trust — no longer obtains. As the SEC report noted:

In reality, a participant in the installment plan was an investor in the underlying shares of an investment trust or investment company. *The method by which the investor purchased these investment trusts or investment company shares was virtually the only change effected by the new investment payment device.*<sup>816</sup> (Emphasis added.)

When that "trust on a trust" loading device was eliminated by sections 27 and 2(a)(34), the installment investor moved one step closer to becoming in all respects an investor in the underlying security. The unit trust, has, however, remained the principal medium of installment investing.

#### 4. Objections to Front-end Loads

It is clear that the front-end load as a means of providing salesmen's commissions can never present the investor with the same advantages he would obtain were he to pay a level load.<sup>817</sup> During the first years, the contractual plan investor is deprived of dividends, capital gains, and voting rights equal to those enjoyed by the purchaser who invests directly through a voluntary plan. Yet it might be accepted for the sake of argument that the final difference between the level load and the front-end load<sup>818</sup> is a necessary fact of life resulting from the need for adequate compensation for salesmen without whom the investor would never even have known of the possibility of investing his limited means.

The fundamental objection to the front-end load is suggested by the experience investors have had in their programs.<sup>819</sup> Basically it is the contention

815 See note 796 *supra* and accompanying text.

816 INSTALLMENT INVESTMENT PLANS STUDY 4.

817 This fact is dramatically demonstrated by a comparative graph which appears at PUBLIC POLICY STATEMENT 236.

818 The ultimate difference between the two with respect to payments invested amounts to 4.46 per cent. *Id.*

819 For a discussion of the investment experience of pre-Act planholders, see INSTALLMENT INVESTMENT PLANS STUDY 185.



of the opponents of contractual plans that empirical data supports the conclusion that most planholders do not complete their scheduled payments. Failure to make all scheduled payments results in unfavorable consequences to the investor, for the sales load will never average out to be the same as a level load and may amount to a good deal higher, depending of how many fewer payments are made. The extent of these consequences to pre-1940 investors can be determined from the SEC's 1939 data, which indicated that approximately forty per cent of the plans initiated between 1930 and 1935 were lapsed by 1935.<sup>820</sup> Investors in eleven companies suffered a total loss of thirty-five per cent of their investments.<sup>821</sup>

Such outrageous figures prompted the especially stringent measures of section 27 of the Investment Company Act of 1940. To a large extent those abuses have been eliminated. Subsequent data indicates that fewer investors have since redeemed their plans at a loss.<sup>822</sup> This is well for the industry, for its contention that purchasing mutual fund shares through periodic plans benefits the average-income investor would be meaningless in the face of data which indicate that most investors would be better off had they never heard of such plans.

The fact that fewer programs result in losses today has not closed discussion of the matter, however. Still at issue is the question whether a substantial portion of periodic investors bear sales loads in excess of nine per cent by virtue of the early redemption of their plans or their failure to make all scheduled payments. As indicated above, various compilations of data relevant to investor performance would suggest that they do. It is the conclusion of the SEC that many planholders do bear much higher effective loads, ranging from twenty to fifty per cent of the total amount invested.<sup>823</sup> This conclusion has been controverted by the industry, which finds it without merit.<sup>824</sup> The extent of the impact of the front-end load has, like other aspects of the sales load problem in general, been reduced to an interpretation of several sets of statistics advanced by the interested parties.

The first grouping appeared as an appendix to *Special Study IV* entitled *Survey of Mutual Fund Investor [Wharton Survey]*, which was prepared by the Securities Research Unit of the Wharton School of Finance at the request of the *Special Study* staff.<sup>825</sup> Additional data was assembled by the *Special Study* staff which corroborated the findings of the *Wharton Survey*. The AMFPS, dissatisfied with the tenor and accuracy of this data,<sup>826</sup> in 1964 submitted to the SEC its own compilation of data relevant to the periodic investment scheme in general and the front-end load in particular.<sup>827</sup>

The *Special Study* sampled accounts opened in February, 1959, by the nine

820 *Id.* at 65.

821 *Id.*

822 See notes 840-43 *infra* and accompanying text.

823 PUBLIC POLICY STATEMENT 237, 240.

824 Letter from AMFPS to SEC dated October 11, 1963, reprinted in PRESENTATION, Part I, at 24.

825 SPECIAL STUDY IV, Appendix XI-A, at 265. This Survey should not be confused with the study of mutual funds popularly known as the *Wharton Report*, also prepared by the Securities Research Unit of the Wharton School. WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. No. 2274, 87th Cong., 2d Sess. (1962).

826 Letter from AMFPS to SEC dated October 11, 1963, reprinted in PRESENTATION, Part I, at 6.

827 PRESENTATION, Part V, Tables 1-15.

largest contractual plan companies. It found in this sampled group that 35.6 per cent of those accounts had become "inactive" in the three and one-half year period from February, 1959 to August, 1962.<sup>828</sup> In addition to the inactive accounts, two other categories were constructed: active and fully-paid.<sup>829</sup> 4.7 per cent of the contractual plans purchased in February, 1959 were prematurely completed by August 31, 1962.<sup>830</sup> The remaining 58.4 per cent were classified as "active."<sup>831</sup> Within that category, a wide range of performance was evident, indicating that not all of the holders of these accounts could be described as "systematic investors."<sup>832</sup> The median account performance demonstrated that payments had been made in "roughly three-fifths of the 42 months."<sup>833</sup> However, this figure must be viewed in light of the fact that most investors made multiple payments upon entering the plan.<sup>834</sup>

In terms of effective sales loads, the *Special Study* found that 16.8 per cent of the February, 1959 sample investors bore an effective sales load of fifty per cent.<sup>835</sup> This means that one of every six investors did not make payments beyond the first year, when reductions in the sales load would apply. Therefore only half of their payments were invested for them. Investors who had prematurely completed their payments bore an overall load of 8.5 per cent.<sup>836</sup> Those who were ahead of their payment schedules (28.1 per cent) comprised the group assessed by the *Special Study* as having a "good chance" to bear an effective sales load of 8.5 per cent.<sup>837</sup> The 50.4 per cent of the investors in the range between the two extremes bore sales loads ranging from twenty to almost fifty per cent for 6.9 per cent of the grouping, to fifteen to twenty per cent for two per cent of the grouping, while no definite assessment could be made for those remaining.<sup>838</sup>

The AMFPS, unwilling to agree with the *Special Study's* estimation that a three and one-half year period provided a statistically accurate picture, submitted a compilation of its own data in its *Presentation to the SEC Relating to Chapter XI of the Special Study of Securities Markets [Presentation]*.<sup>839</sup> Its statistics covered a "duration-of-the-plan" period for plans opened with four of its largest companies in the ten or twelve year period prior to 1963.<sup>840</sup>

The thesis of the AMFPS was that in an overall evaluation, contractual plans are profitable to their investors. The tenor of their statistics indicates that, unlike pre-1940 contractual planowners today's contractual plan investors prosper from

828 SPECIAL STUDY IV 187-88. "Inactive" was defined to include two categories of accounts: those which had been redeemed (*i.e.*, the investor had requested liquidation of the account), and those on which no payments had been made for twelve consecutive months. The former category included 14.8 per cent of inactive accounts, while the latter comprised 22.1 per cent. *Id.*

829 *Id.* at 187.

830 *Id.* at 188.

831 *Id.*

832 *Id.*

833 *Id.* at 190.

834 *Id.* In fact, eighty-seven per cent had made multiple payments, the average of which was 5.9 installments, and the median, two installments. *Id.* at 190-91.

835 *Id.* at 191.

836 *Id.* at 192.

837 *Id.*

838 *Id.*

839 See note 574 *supra*.

840 PRESENTATION, Part V, Tables 1-4.

their investments, with relatively few redemptions at a loss.<sup>841</sup> The industry's position assumes basically that an investor, even though he does not make all his scheduled payments, will, as long as he makes a reasonable portion of them, be bound to gain from his investment. The argument rests, of course, on a history of capital appreciation in our securities markets.<sup>842</sup> It rests as well on continued growth of the underlying funds through sales of new shares. Industry data does support the conclusion that fewer losses are incurred by today's planholder,<sup>843</sup> but this conclusion is open to two objections.

One is the obvious economic argument that "In a long-term rising market the contractual plan usually won't turn out as well as a voluntary purchase plan."<sup>844</sup> The more capital the investor has "at work," the larger will his long-term appreciation be. The second argument is one of policy. Its crux has been summed up by the *Special Study*:

In any event, the rationale of justifying a front-end load on the long-range success of many contractual plan purchasers appears to miss a significant point. In the securities business generally, including the mutual fund field specifically, the reasonableness of a commission rate or markup is judged in relation to the amount invested, not the ultimate success or failure of the investment. The contractual plan industry is unique in justifying its sales load by the ultimate average success of the investors involved.<sup>845</sup>

In its simplest terms, the controversy over the contractual plans is similar to that raging over sales loads, both because it is but one part of a larger problem and because it is likewise reducible to an issue of policy. This issue has two aspects, each of which has been previously examined. The first aspect concerns the oft-claimed, yet seldom verified, industry contention that salesmen are necessary to maintain a steady capital inflow to prevent fund liquidation.<sup>846</sup> The other aspect relates to salesmen as salesmen, the industry arguing that the proposed ban or severe restriction on front-end loads will deprive them of their opportunity to earn a living.<sup>847</sup> This argument has been answered by its opponents in two ways. First, there is no certainty that such a disastrous result would obtain. As proof of this, the damning statistics of the *Special Study* are more than pertinent: two-thirds of contractual plan salesmen earned less than \$1,000 per year in the

841 PRESENTATION, Part V, at 159-75. The AMFPS maintains that although the information contained therein is dated, it still supports the AMFPS position. Letter from Albro C. Fowler, Vice President-Treasurer of AMFPS, to James Webster, January 24, 1969, on file with the *Notre Dame Lawyer*.

842 See generally Bellemore, *supra* note 772.

843 PRESENTATION, Part V, Tables 1-4. Nevertheless, the losses incurred by the holders of the four plans were significant. According to the SEC's count, losses for the four plans were nine, thirty-three, three and twenty-four per cent. PUBLIC POLICY STATEMENT 243. Investors in the four plans considered by the AMFPS who failed to make payments beyond the third year constituted thirty-three per cent of United Funds', twenty-five per cent of First Investors', thirty-five per cent of Financial Industrial Fund's and forty-three per cent of Hamilton Fund's investors. Sales loads applicable to payments of thirty-six months or less ranged from fifty to twenty per cent for the last three, and sixteen to thirty-eight in the first, United Funds. See also *id.* at 240; PRESENTATION, Part V, Table 1.

844 PUBLIC POLICY STATEMENT 237.

845 SPECIAL STUDY IV 181.

846 See notes 633-45 *supra* and accompanying text.

847 See note 690 *supra* and accompanying text.

securities business;<sup>848</sup> one-third of the contractual plans sold to investors sampled by the *Wharton Survey* were sold to relatives or close friends of the salesman;<sup>849</sup> half of the contractual plan salesmen leave the business annually.<sup>850</sup> Taken together, these statistics impugn the validity of the use of the front-end load to provide sustained employment to a fairly stable selling force. Second, the pending bills' proponents question whether it is in the continued public interest to allow contractual plan salesmen to profit at the expense of their countrymen.<sup>851</sup>

There is one last piece of evidence critical to the front-end load problem — an analysis of how the voluntary payment plans have fared. Since these plans operate under a level load, they do not contain the built-in stimulus to savings claimed by the contractuales. However, where voluntary accumulation plans are sold with term insurance, the voluntary plans take on an identity similar to the contractual plans.<sup>852</sup> Premiums are deducted from the monthly scheduled payments for fund shares; if the payment is not received within one month after it falls due, the insurance lapses. Monthly reminder notices are mailed to the investor to minimize that possibility. Therefore, the investor is provided with motivation to invest systematically. Recent data indicates that a stimulus does indeed exist, for the consistency of some insured voluntary planholders has been amazingly high.<sup>853</sup>

Therefore, the front-end load is not the only means available to stimulate savings, nor is it necessarily the most effective means of doing so. It may not be justified by the fact that overall the investor does not lose anything on his investment (a strange contention indeed), and it further appears that justification on the basis of the industry's need for salesmen is untenable. All in all, it would appear that a close examination of the present status of contractual plan investing is warranted; it would seem that very little stands in the way of abolition or severe curtailment of the front-end load.

## 5. Proposals for Change

There are now pending before Congress two proposals to effectuate these results. Both are provisions contained in S. 296<sup>854</sup> and S. 34,<sup>855</sup> which have been examined earlier for their proposed enactments regarding sales loads. S. 296 presents the more stringent measures of the two: it proposes to abolish completely the front-end load by requiring that no plan may be offered if "the amount of sales load deducted from any one payment exceeds proportionately the amount

848 SPECIAL STUDY IV 121.

849 *Id.* at 339.

850 SPECIAL STUDY I 96-97.

851 The industry does not hesitate to point out that it does not receive investor complaints about high sales loads, and points to this as one more instance of popular acceptance of the sales loads now prevalent in the industry. 1967 *House Hearings* 54.

852 Group term insurance in the amount of the plan ordinarily is obtainable for a relatively small fee, comparable to the Custodian's fee in contractual plans. Upon death of the insured before all the scheduled payments are made, the term insurance completes the plan. Hence, the name "completion insurance."

853 SPECIAL STUDY IV 198.

854 S. 296, 91st Cong., 1st Sess. § 16 (1969).

855 S. 34, 91st Cong., 1st Sess. § 16 (1969).

deducted from any other payment . . . .<sup>856</sup> In the opinion of some members of Congress, this represents too harsh a step. Therefore the alternate proposal of S. 34 allows the load deducted in the first four years of the plan to remain at sixty-four per cent of the total load to be deducted.<sup>857</sup> However, it calls for a reallocation of the application of the load level so that "not more than 20 per centum of any 1 year's payment may be deducted for sales load . . . ."<sup>858</sup> This plan is reinforced by a further provision that all periodic payments in each of the first four years must be equal.<sup>859</sup>

This second proposal appears to be a compromise measure based on the experience of the IDS complex.<sup>860</sup> The standard front-end load on periodic payment plans for accumulation of shares in Investors Stock Fund, Inc., is twenty per cent for the first year, eighteen per cent for each of the next two, and seven per cent for the fourth — or sixty-three per cent of the total sales load to be deducted in the first four years.<sup>861</sup> The S. 34 measure seems designed to take advantage of the IDS experience — one that impliedly indicates that a stable selling force can be maintained at those load levels<sup>862</sup> — to bolster the congressional position that it has no intention of harming the funds themselves, or of depriving any American wage-earner of his living. This apparently reasonable position becomes extremely important in light of a recent statement by the newly-elected President of the Investment Company Institute, Robert Bogle, to the effect that the industry finds primary objection only in proposed contractual plan amendments.<sup>863</sup> Perhaps this measure comes as part of an effort to secure harmonious acceptance by the industry in order to insure the hoped-for betterment of the securities market in general. Whatever the reasons for this compromise, it seemingly represents a generous concession to the contractual plan industry.

S. 34 does not attempt to lower the maximum sales load which may presently be charged. No explanation of the reasoning behind this decision is given in the *Analysis of S. 34*; a mere announcement that no change is intended constitutes the extent of comment.<sup>864</sup> S. 296, on the other hand, proposes to abolish the

856 S. 296, 91st Cong., 1st Sess. § 16 (1969).

857 S. 34, 91st Cong., 1st Sess. § 16 (1969).

858 ANALYSIS OF S. 34, at 8.

859 S. 34, 91st Cong., 1st Sess. § 16 (1969).

860 Investors Diversified Services (IDS) is one of several fully integrated distribution organizations. See text accompanying note 475 *supra*. Organized in 1894, IDS is a face-amount certificate company that manages in addition to its own assets, those of eight other investment companies of the Investors Group: Investors Mutual Inc.; Investors Stock Fund, Inc.; Investors Selective Fund, Inc.; Investors Variable Payment Fund, Inc.; Investors Syndicate of America; Investors Accumulation Plan, Inc.; New Dimension Fund, Inc.; Progressive Fund, Inc. Assets of the group in 1967 totalled over \$7 billion, making IDS the largest company of its kind in the world. IDS, A QUICK LOOK AT A UNIQUE FINANCIAL INSTITUTION (1967). Its representatives distribute shares of these companies and also distribute insurance policies of the IDS subsidiary, Investors Syndicate Life Insurance and Annuity Company. *Id.*

861 IDS, PROSPECTUS, February 9, 1968, I.

862 IDS has approximately 4000 field representatives, whose projected average compensation for 1967 was \$7,233 from the sale of all IDS products. Statement of Robert M. Loeffler, 1967 House Hearings 464-66.

863 The Wall Street Journal, Jan. 24, 1969, at 8, col. 2.

864 ANALYSIS OF S. 34, at 9.

statutory maximum, allowing competition to determine the sales load to be charged on sales of periodic payment plans.<sup>865</sup>

While there exist these differences over the sales load, the scope of each bill's provisions relating to periodic payment plans extends to the marginal selling operations now feeding, like parasites, off the contractual plan industry.<sup>866</sup> The sponsors of the legislation quite properly feel that streamlining the contractual plan industry will not only put the installment investment scheme in proper perspective but will as well eliminate the other problems associated with contractual plan investing.

## 6. Necessity of Unit Trusts

The very fact that plan sponsors perform no management functions and merely purchase shares of underlying funds raises the question of whether they and their "trust on a trust" organizations are necessary to meet the needs of the wage-earning investor. That direct offering of such an installment package by the funds themselves is more than economically feasible can be demonstrated by reference to another form of installment purchasing made available to the investor by the funds, the so-called "voluntary plan."<sup>867</sup> Ordinarily, voluntary plans require a higher initial payment (typically about \$250) and usually require somewhat higher payments than contractual plans. Unlike contractual plans, they have no set goal or amount to be invested.<sup>868</sup> More importantly, voluntary plans do not make use of the front-end load, but rather apply the standard level load to investments made thereunder. Thus, there is no load-provided stimulus to saving; hence, the emphasis on the voluntariness of future payments. Despite these differences, the voluntary plan is sufficiently similar to show that the unit trust scheme of installment investing is largely an economic anachronism.

The continued existence of contractual plans is traceable to more than mere inertia and history, however. It is believed that the primary reason that funds have not turned to offering periodic payment plans themselves lies in section 27(a)(5) of the Investment Company Act which states that a registered investment company which is also a management company may not sell periodic payment plans if the "proceeds . . . or the securities in which such proceeds are invested are subject to management fees . . . exceeding such *reasonable amount as the Commission may prescribe*, whether such fees are payable to such company or to investment advisers thereof . . . ."<sup>869</sup> (Emphasis added.) The rel-

865 S. 296, 91st Cong., 1st Sess. § 16 (1969). Interestingly, the SEC had recommended that sales loads on contractual plans be reduced to five per cent, since "[t]here is no reason why contractual plan purchases should be especially costly to investors." PUBLIC POLICY STATEMENT 247.

866 Former Chairman Cohen succinctly stated the Commission's position regarding the compensatory system and the "umbrella" it provides to parasite operations:

It is hardly necessary or even desirable for the government to maintain a price structure under which investors — particularly small investors — subsidize an inefficient, over-sized distribution system that uses manpower lavishly and indiscriminately recruits hosts of salesmen. SEC, Statement No. 2 1967 House Hearings 112.

867 See notes 115-16 *supra* and accompanying text.

868 In many instances voluntary payment plans are sold as a means of obtaining automatic reinvestment of dividends. SPECIAL STUDY IV 201.

869 15 U.S.C. § 80a-27(a)(5) (1964).

evance of that provision lies in the standard of reasonableness which management fees of most mutual funds would be subjected to should the fund offer such plans directly. As will be seen in Part VI, funds are now subjected to a "grossly unreasonable" standard. The difference between the two is the subject of detailed analysis in Part VI and need not be repeated here. It should be sufficient to note at this point that the funds have shown a marked disinterest in having a standard of reasonableness applied to their advisory contracts. In short, it is submitted that the unit trust scheme of installment investing has been retained primarily to serve as a shield against application of the reasonableness standard to advisory fees.

It should be noted that in the event neither of the proposed bills is enacted, there exists a non-legislative approach to remedy the more egregious cases where contractual plans have been foisted upon those unable to afford them. The suitability rule<sup>870</sup> should prove a fruitful means for preventing sale of contractual plans to persons who clearly would prosper more from investment media where the front-end load is not operative and where they would therefore benefit more quickly and surely from their investments. This would be especially pertinent where comparable media, such as voluntary plans, are not explained to the investor. More aggressive use of the suitability rule would certainly seem warranted should Congress fail to provide a legislative means of dealing with the front-end load.

## V. Mutual Fund Encroachment by Related Institutional Investors

### A. Banks and the Mutual Fund Industry

#### 1. Introduction

The battles over mutual fund reform have been fought in strange arenas, for the reformers' principal adversary, the industry itself, has been none too consistent in maintaining the integrity of its battlelines. Throughout the congressional hearings on the mutual fund legislation of 1967, the industry insisted that the abolition of retail price maintenance in favor of competition would wreck the industry, the economy, and quite possibly the country.<sup>871</sup> Yet at the same time it was vehemently contending that competition already was at work in the industry.<sup>872</sup>

The strangeness of both endorsing and condemning competition in nearly the same breath was no new experience for spokesmen of the industry in 1967. A year earlier, the industry inveighed against S. 2704<sup>873</sup> which would have provided banks with channels of access to the investing public on terms substantially similar to those the industry enjoyed.<sup>874</sup> That bill, introduced by Senator Thomas

870 See notes 572-78 *supra* and accompanying text.

871 See, e.g., Statement of Robert M. Gardiner, 1967 Senate Hearings 572.

872 See, e.g., NASD Memorandum Re the Importance of the Role of Section 22(d), 1967 Senate Hearings 603.

873 S. 2704, 89th Cong., 1st Sess. (1965).

874 As will appear below, one form of collective investment trust — the managing agency account — constitutes operation of a mutual fund. See notes 897-901 *infra* and accompanying text.

J. McIntyre on October 22, 1965,<sup>875</sup> was aimed specifically at making provision for the entry of banks into what amounted in substance to operation of mutual funds.

As the bill's opponents saw the matter, the issue of allowing banking institutions to compete directly with mutual funds was divided into two questions: Should the banks be allowed *in principio* to operate investment schemes that closely parallel mutual funds? And, if they should be so allowed, which governmental agency should regulate them?<sup>876</sup> Although this approach may seem logical enough, the tactical use the industry made of it earned them no overwhelming support from the members of Congress.<sup>877</sup>

## 2. Regulation of Managing Agency Accounts

The controversy which led to the proposed legislation arose over a conflict among three federal agencies, the Comptroller of the Currency, the Federal Reserve Board and the SEC, as to which agency would have jurisdiction over the already approved "managing agency accounts."

The Comptroller of the Currency, authorized under Public Law 87-722<sup>878</sup> to assume control of certain activities of national banks, had already promulgated part 9 of title 12 of the Code of Federal Regulations [Regulation 9],<sup>879</sup> which allows a national bank to assume as one of its "fiduciary powers"<sup>880</sup> the power to act as a "managing agent" for "accounts" established with the bank.<sup>881</sup> A managing agency account functions like a mutual fund because the bank establishes a pool of assets to which members of the public are invited to contribute (minimum initial deposit of \$10,000 required<sup>882</sup>). The commingled funds deposited would then be invested in common stocks, with the depositor (investor) sharing pro rata in any increase in the value of the securities purchased.

<sup>875</sup> 111 CONG. REC. 28104-05 (1965) (remarks of Senator McIntyre).

<sup>876</sup> Testimony of Robert W. Haack, President of NASD, *Hearings on S. 2704 Before a Subcommittee of the Committee on Banking and Currency, 89th Cong., 2d Sess.*, 126-27 (1966) [hereinafter cited as *1966 Senate Hearings*].

<sup>877</sup> The industry's argument that banks should not be allowed to operate such schemes and alternately that if they should be allowed, they should be regulated by the SEC, earned them this rebuke from Chairman of the Subcommittee Senator A. Willis Robertson of Virginia:

You come before us and endorse the restricted approach of the SEC, but say "if we can knock it out, that is what we are going to do."

It seems to me that is not a very consistent position to take. With all due deference, it seems to me that it weakens your position before this committee. *1966 Senate Hearings* 129-130.

<sup>878</sup> Act of September 9, 1962, 76 Stat. 668, 12 U.S.C. § 92(a) (1964).

<sup>879</sup> 12 C.F.R. § 9.1 (1967).

<sup>880</sup> 12 U.S.C. § 24 (1964), which sets out the corporate powers of national banks, provides: "The business of dealing in securities and stock by the [bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own accounts . . . ."

<sup>881</sup> 12 C.F.R. § 9.18 (a) provides:

Where not in contravention of local law, funds held by a national bank as fiduciary may be invested collectively:

(3) In a common trust fund, maintained by the bank exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as managing agent under a managing agency agreement expressly providing that such monies are received by the bank in trust.

<sup>882</sup> *E.g.*, Brief of First National City Bank at 6, First National City Bank, SEC Release No. 4538 (March 9, 1966), reprinted in *1966 Senate Hearings* 187, 202.



This commingled managing agency account is one of three types of pooled funds that banks are authorized to handle. The other two are the common trust fund, which is comprised of assets held by a "bank in its capacity as executor, administrator, guardian or trustee,"<sup>883</sup> and collective funds, which consist of the assets of a trust qualified under section 401 of the Internal Revenue Code. The latter include trusts for employee pension, welfare, profit-sharing and bonus plans, and also plans established under the Smathers-Keogh Act (commonly called H.R. 10 plans) for retirement benefits for self-employed individuals.<sup>884</sup> The commingled account differs from the second and third types in significant respects, however; the managing agency account had not been authorized prior to 1962, whereas the other two had been authorized for some time prior thereto.<sup>885</sup> Further, the trust accounts established under the second and third methods come under the bank's aegis through rather formal channels, those associated with traditional banking functions. On the other hand, the managing agency account involves a form of active solicitation by the bank of the deposited assets. The difference has been summarized by a prominent economist: "While a bank's trust accounts hardly come to it from the skies, they do not, on the other hand, normally involve the active daily battle for business characteristic of the work of brokers and dealers."<sup>886</sup> The implication is, of course, that the managing agency trust form of the pooled or commingled investment trusts must do exactly what the mutual fund must do to obtain sales of its shares: actively solicit investors.

The striking similarity of the managing agency account to the typical mutual fund convinced the SEC that the managing agency fund was a form of investment company and therefore would be subject to SEC regulation under the Investment Company Act.<sup>887</sup> With that decision, three federal regulatory agencies became involved in regulation of banks and their managing agency accounts:

883 12 C.F.R. § 9.18 (a) (1) (1967).

884 1966 *Senate Hearings* 21. The term "collective funds" is used herein to refer specifically to this form of pooling of assets for investment. For an explanation of the operation of H.R. 10 plans and its application to a model pension plan, see Note, *Is H.R. 10, As Amended and Properly Implemented, Still "A Lion Who Merely Squeaks"?* 43 *NOTRE DAME LAWYER* 521 (1968).

885 Common trust funds were in existence prior to enactment of the Investment Company Act of 1940 and were specifically exempted from its coverage by section 3(c)(3) of the Act. 15 U.S.C. § 80a-3(c)(3) (1964). After 1955, banks were allowed by Regulation F of the Federal Reserve Board to "use the commingled fund mechanism for the investment management of assets they administer under tax-qualified employee-pension, stock-bonus, and profit-sharing plans." 1966 *Senate Hearings* 28. The H.R. 10 plans, however, were authorized only in 1962. The SEC claimed jurisdiction over them under the Securities Act, since in its judgment H.R. 10 plans constituted public offerings of a security. 1966 *Senate Hearings* 33. However, securities issued by a bank are specifically exempted from the Securities Act by section 3(a)(2) of the 1933 Act which exempts "any security issued by . . . any national bank." 15 U.S.C. § 77c(a)(2) (1964). Therefore, an additional basis for the assertion of SEC jurisdiction — a "something else" in the opinion of one official — was necessary:

That "something else" is an esoteric legal concept termed the ectoplasmic theory. According to this theory it is argued that a collective investment fund is not, in fact, an integral and organically associated function of a bank, but is instead a self-contained entity having only an incidental relationship to a bank.

Applying this doctrine the purposes of the 1933 act may be served, for the "security" is not issued by a bank but by a collective investment fund. Likewise the 1940 act jurisdiction is upheld, for although the bank is not an investment company, the "ectoplasmic fund" becomes one. 1966 *Senate Hearings* 34.

886 Statement of Eugene V. Rostow, 1966 *Senate Hearings* 80.

887 *Id.* at 33.

the Comptroller, who was specifically authorized under statute;<sup>888</sup> the Federal Reserve Board [FRB]<sup>889</sup>; and the SEC, under both the Securities Act of 1933 and the Investment Company Act of 1940.<sup>890</sup> Understandably, such a situation presented a threat of overlapping or conflicting regulations by federal agencies.

It was in this context that S. 2704 arose,<sup>891</sup> it was introduced to insure uniform regulation of such funds by delegating control over the managing agency account to the federal banking authorities (*i.e.*, the Comptroller).<sup>892</sup> However, developments just prior to consideration of the bill by the Senate Subcommittee on Financial Institutions removed a good deal of the uncertainty theretofore affecting the situation. First National City Bank of New York [FNCB], the first national banking institution to attempt establishment of a managing agency account under Regulation 9, indicated to the Comptroller that it intended to apply to the SEC for registration of its account and for exemptions from certain provisions of the 1940 Act.<sup>893</sup> This approach, implicitly recognizing the authority of each agency, met with the approval of the Comptroller.<sup>894</sup> Subsequently, on March 9, 1966, one day after the initiation of the hearings on S. 2704, the SEC released its decision, accepting the registration and granting all but one of the requested exemptions.<sup>895</sup> Since the way was cleared for a standard procedure to be followed in setting up such accounts, the possibility for conflicting regulations was eliminated and S. 2704 became unnecessary.

In its testimony in opposition to the bill, the mutual fund industry contended that the bill was both inappropriate (because it assigned control of what was obviously an investment company to the banking authorities and not to the SEC) and unnecessary in light of the accord reached between the SEC and the Comptroller.<sup>896</sup> The industry contention that FNCB's scheme is an investment company is of course correct, as a closer examination of the account reveals: investors would have to make a minimum deposit of \$10,000 to enter the fund; their ownership would then be represented by units of participation in proportion to their contribution to the fund, the holder enjoying one vote per unit.<sup>897</sup> Direction of the account was to be assumed by a committee of seven, all but one to be members of FNCB's Trust Department.<sup>898</sup> Investment of assets deposited would then be made in common stocks and securities convertible to common stocks, to be determined by the Bank which would act as investment advisor.<sup>899</sup> A fee of one-half

888 See text accompanying note 878 *supra*.

889 FRB jurisdiction did not extend to trust activities, however, and therefore is not discussed further in this analysis.

890 See note 887 *supra* and accompanying text.

891 See Statement of Senator Thomas J. McIntyre, 1966 Senate Hearings 21.

892 Section 8(a) of the proposed legislation provided in part: "The Comptroller of the Currency shall prescribe such regulations as he may deem appropriate to carry out the provisions of this Act . . ." S. 2704, 89th Cong., 1st Sess. § 8(a) (1965).

893 1966 Senate Hearings 74, 197. Application was filed on August 24, 1965. Brief of First National City Bank, *supra* note 882, at 1.

894 Statement of the Comptroller of the Currency, The Wall Street Journal, August 26, 1965, at 6, col. 2.

895 First National City Bank, SEC Investment Company Act Release No. 4538 (March 9, 1966), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,332, at 82,585.

896 Statement of Joseph E. Welch, 1966 Senate Hearings 67, 73-74.

897 Brief of First National City Bank, *supra* note 882, at 6-7, 1966 Senate Hearings 202-03.

898 *Id.*

899 *Id.* First National City Bank, SEC Release No. 4538 (March 9, 1966), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,332, at 82,591.

per cent for this investment advice would be charged each of the participants, not the fund itself.<sup>900</sup> No sales load or equivalent thereof would be charged the depositor upon initiation of his deposit.<sup>901</sup>

Despite the obvious similarities of this type of account to a mutual fund, the banking industry in its appearance in support of S. 2704 at first contended that the account was not a mutual fund.<sup>902</sup> Primary among the reasons for this belief was the fact that the account would attract a class of investor different from the typical mutual fund shareholder.<sup>903</sup> This conclusion was reached in light of the very high initial payment and the fact that the account's portfolio would be valued on a relatively infrequent basis (once monthly), thereby discouraging any but the long-term investor.

However, the FNCB decision to recognize SEC jurisdiction thereby accepted the status of its managing agency account as an investment company. That the account was to be considered an investment company was not inherently destructive of the Bank's investment scheme; but certain provisions of the Investment Company Act would have presented prohibitive obstacles to its successful fruition. These provisions concerned primarily the director requirements imposed on the account by section 10 of the 1940 Act.

Section 10(c) expressly states that no registered investment company can have a majority of its directors consisting of officers or directors of a bank.<sup>904</sup> Since FNCB had intended to utilize members of its Trust Department to serve as directors,<sup>905</sup> it therefore requested an exemption from section 10(c). The Commission, in examining the request, noted that the spirit of section 10(c) controlled its application, and reasoned that since the account sought to be registered could not have existed prior to 1963, it was not included specifically in the proscription of section 10(c).<sup>906</sup> Nor, the SEC decision continued, did the account offer numerous possibilities for conflicts of interest, *e.g.*, investing in bank loans to shore them up, since the banking institution would have to treat the account in a fiduciary context, all aspects of which would be subject to inspection by the federal banking authorities.<sup>907</sup> The Commission therefore granted the exemption.

The Bank further requested an exemption from subsection (b) (3) of section 10, which prohibits an investment company from having as a director, officer, or employee an affiliate of an investment advisor, unless a majority of its board of directors are not affiliates of the advisor.<sup>908</sup> The provision was written originally

900 Brief of First National City Bank, *supra* note 882, at 4; 1966 Senate Hearings 45.

901 Brief of First National City Bank, *supra* note 882, at 7.

902 Statement of the American Bankers Association, 1966 Senate Hearings 57: "We are not trying to be in the mutual fund business. Those are investment companies I think operating under the Investment Company Act of 1940. We are not that." *Id.*

903 *Id.* at 45-46.

904 Section 10(c) provides:

After the effective date of this subchapter no registered investment company shall have a majority of its board of directors consisting of persons who are officers or directors of any one bank . . . 15 U.S.C. § 80a-10(c) (1964).

905 See note 898 *supra* and accompanying text.

906 First National City Bank, SEC Investment Company Act Release No. 4538 (March 9, 1966), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,332, at 82,588-89.

907 *Id.* at 82,590.

908 15 U.S.C. § 80a-10(b) (3) (1964).

to prevent an investment banker from organizing an investment company to exploit the companies whose securities constituted the fund's portfolio or to serve as a dumping ground for securities the investment banker was underwriting.<sup>909</sup> Since FNCB is limited to underwriting debt securities of governmental authorities and the account proposed to invest only in common stocks, the Commission felt there was little chance for those abuses.<sup>910</sup> Accordingly, it granted the requested exemption from section 10(b)(3).

City Bank also applied for an exemption from section 10(d)(2).<sup>911</sup> Under subsection (d), a registered investment company may well have all but one of its directors as affiliates of the investment advisor provided the fund meets certain requirements.<sup>912</sup> The Bank proposed to meet all but one — the requirement of subsection (2) that the advisor be “engaged principally in the business of rendering investment supervisory services as defined in said subchapter II . . . .”<sup>913</sup> Since the Bank was to act as the advisor, it would be unable to satisfy this provision. The Commission denied this requested exemption, noting that the Bank had offered no evidence to indicate that the account could not function without the exemption.<sup>914</sup>

In sum, the FNCB account was accepted for registration substantially as proposed. But the Commission's acceptance was not unanimous. Commissioner (now Chairman) Budge, in an ominous dissent, indicated that FNCB had won a battle but not the war: “The granting of the requested exemptions is contrary to the clearly expressed policy of the Congress against bank domination of investment companies.”<sup>915</sup> This objection has relevance to the first question the mutual fund industry had raised regarding banks' entrance into mutual funds, that is, whether they should be allowed to do so at all. Industry spokesmen had intimated in their appearance before the subcommittee that upon an unfavorable disposition by the SEC they would attempt to block the banks' entry through the courts.<sup>916</sup>

### 3. Judicial Scrutiny of the Managing Agency Accounts — The *Camp* Decision

In 1967, true to its word, the Investment Company Institute, as representative of the mutual fund industry, applied to the District Court for the District of Columbia for an injunction against the Comptroller of the Currency to restrain

909 First National City Bank, SEC Investment Company Act Release No. 4538 (March 9, 1966), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,332, at 82,591.

910 *Id.*

911 *Id.*

912 Those requirements are that the company be open-ended, that it charge no sales load, that it limit fees on redemption to two per cent of net asset value, that it incur no promotional or advertising costs, that the management fee be limited to less than one per cent of net asset value, that all administrative expenses be borne by the advisor, that there be only one class of stock, and that its investment advisor be engaged principally in the business of providing investment advice. Investment Company Act of 1940 § 10(d), 15 U.S.C. § 80a-10(d) (1964).

913 *Id.* § 80a-10(d)(2) (1964).

914 Further, a bank is excluded from the definition of investment advisor by the Investment Advisers Act § 202, 15 U.S.C. § 80b-2(11) (1964).

915 First National City Bank, SEC Investment Company Act Release No. 4538 (March 9, 1966), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,332 at 82,593 (dissenting opinion).

916 Statement of Marc A. White, 1966 Senate Hearings 129.

him from authorizing national banks to operate commingled agency accounts.<sup>917</sup> It also sought a declaratory judgment adjudicating Regulation 9 to be invalid.<sup>918</sup> The case, *Investment Company Institute v. Camp*,<sup>919</sup> arose through cross motions for summary judgment, since the parties agreed that no factual issues were involved. Before proceeding to the substance of the action, the court first examined the issue of standing interposed by the Comptroller, and ruled that the "plaintiffs were the recipients by implication of congressional protection"<sup>920</sup> and therefore were entitled to sue. The court then turned to the principal question — whether the "Comptroller has the statutory authority to empower national commercial banks to create, organize and manage the commingled account."<sup>921</sup> Taking as its initial premise the statement that banks can exercise only those powers expressly conferred on them by federal statute or necessarily accruing to them by implication therefrom,<sup>922</sup> the court examined 12 U.S.C. § 92a(a), which authorized the Comptroller to take over regulation of national banks, to determine whether that statute authorized the Comptroller to sanction the commingled account. That section provides:

The Comptroller of the Currency shall be authorized and empowered to grant by special permit to national banks applying therefor, when not in contravention of State or local law, the right to act as trustee, executor, administrator, registrar of stocks and bonds, guardian of estates, assignee, receiver, committee of estates of lunatics, or in any other fiduciary capacity in which State banks, trust companies, or other corporations which come into competition with national banks are permitted to act under the laws of the State in which the national bank is located.<sup>923</sup>

The court considered the question thus presented by analysis of that statute to be "whether or not the commingled account can be considered a *fiduciary activity* as provided by the statute."<sup>924</sup> (Emphasis added.) The court found a problem in the technical relationship between the unit holder and the bank. It reasoned that since the basis of the relationship was contractual, the resultant relation was one of principal and agent, as the name of the scheme clearly implied.<sup>925</sup> After examining the fiduciary duties of an agent, the court held that they were similar to those imposed on a trustee but did not constitute a true fiduciary relationship as defined by the courts and treatise writers.<sup>926</sup> It therefore concluded that "the managing agency relationship does not fall within the traditional fiduciary powers as delineated in 12 U.S.C. § 92a(a)."<sup>927</sup>

The *Camp* court then turned to the "competitive provision" of section 92a(a). This provision authorizes national banks to operate in the same manner as other banks are allowed to operate by state laws. Since FNCB is located in the

917 *Investment Company Institute v. Camp*, 274 F. Supp. 624 (D.D.C. 1967).

918 *Id.* at 627.

919 274 F. Supp. 624 (D.D.C. 1967).

920 *Id.* at 636.

921 *Id.* at 638.

922 *Id.*

923 12 U.S.C. § 92a(a) (1964).

924 274 F. Supp. at 639.

925 *Id.*

926 *Id.* at 639-40.

927 *Id.*

state of New York, the court proceeded to examine the relevant provisions of that state's banking laws. Its search failed to produce any indications that the New York statutes permitted such operations, however, so it concluded that the commingled managing agency account is permitted neither by federal statutes nor by provisions relevant to its operation under the saving "competitive provision."<sup>928</sup>

That part of the court's analysis in *Camp* would have alone been sufficient to grant the requested injunction. However, the decision proceeded to treat the larger issue — whether national banks are positively prohibited from operating commingled accounts by the mandate of some other federal statute. The court found the controlling statute to be section 32 of the Glass-Steagall Act<sup>929</sup> which provides in substance that no officer, director, or employee of a corporation that issues securities may at the same time serve as an officer, director, or employee of a national bank. The first issue raised by analysis of the statute is, therefore, whether the units of participation issued by the account should be considered "securities." Although the Comptroller of the Currency attempted to show that the units were not securities, the court found persuasive authority that the account was indeed issuing securities, since "the test for a security is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."<sup>930</sup>

The mere fact that the account issued securities was not conclusive as to the application of section 32, however. A second question raised under section 32 is whether the issuing company is an entity separate from the national bank. This problem had already been treated by the FRB in a memorandum dealing with the relation of section 32 to the commingled account.<sup>931</sup> As the Board had noted, section 32 is applicable only if both questions are answered in the affirmative: the issuing company must be distributing securities *and* it must be legally separate from the national bank.<sup>932</sup>

Under the FRB's analysis, appropriate considerations were "the limited coverage of the statute [section 32] and its purposes in the light not only of past principles followed by the Board, but also in the light of permissible banking activity and the character of the present [FNCB] proposal."<sup>933</sup> The limited reach of section 32 was particularly significant to the Board's treatment of the question; it noted that the proposed scheme would for the purposes of the Investment Company Act certainly be considered a separate operation. However, it further noted that the applicability of one federal statute does not automatically require the application of another, particularly if the latter has a much more limited scope.<sup>934</sup> The Board therefore determined that the account could not be con-

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928 *Id.* at 641.

929 12 U.S.C. § 78 (1964).

930 274 F. Supp. at 642.

931 Memorandum of Federal Reserve Board, *Legal Considerations under Section 32 of the Banking Act of 1933 in Connection with the Proposed Commingled Investment Account of First National City Bank of New York*, 1966 Senate Hearings 581.

932 *Id.* at 583.

933 *Id.* at 584.

934 *Id.* at 585.

sidered a separate entity, and consequently the provisions of section 32 would not be violated by FNCB's operation of its investment scheme.

The *Camp* court was not impressed with this interpretation of the "prophylactic provisions of section 32."<sup>935</sup> It felt that the clear and overriding intent of Congress would be defeated if section 32 were given such a narrow interpretation. The court clearly remained unconvinced that all possibilities of incest would be barred by the FRB's interpretation. Accordingly, it held that the provisions of Regulation 9 authorizing commingled managing agency accounts were illegal, insofar as they did not comply with section 32.<sup>936</sup> At present, therefore, national banks may not operate accounts similar to the one proposed by FNCB. The *Camp* decision is now on appeal, however, so it would be premature to indicate at this point that commingled accounts will not be authorized in the future.<sup>937</sup>

#### 4. Proposed Legislation

There is a possibility that national banks may be allowed to operate agency accounts sooner than through reversal of the *Camp* decision. In both the bills now pending before the Senate (Senator Sparkman's S. 34<sup>938</sup> and Senator McIntyre's S. 296<sup>939</sup>) there are provisions which expressly state that no existing statutory provision shall be deemed to prevent the operation of a commingled managing agency account.<sup>940</sup> It has been suggested that the inclusion of such provisions serves not only the obvious purpose of clarifying the rather uncertain relation of the accounts to the Glass-Steagall Act, but brings as well the support of the powerful banking lobby squarely behind the bills.<sup>941</sup>

On the other hand, it may be expected, especially in light of a statement made by the recently elected president of the Investment Company Institute,<sup>942</sup> that industry opposition to the bills as they relate to banking schemes will not be lessened. The basis for this opposition is unclear. There is good reason to believe that the proposed banking investment plans do not represent a formidable threat to the mutual funds, since the rather large financial prerequisites to depositing in a commingled account are prohibitive to most.<sup>943</sup> However, the

935 274 F. Supp. at 647-48.

936 *Id.* at 648.

937 See INVESTMENT COMPANY INSTITUTE, 1968 ANNUAL REPORT 11.

938 S. 34, 91st Cong., 1st Sess. (1969).

939 S. 296, 91st Cong., 1st Sess. (1969).

940 Section 12(d) of S. 34 provides:

Section 22 of such Act (15 U.S.C. § 80a-22) is further amended by adding a new subsection at the end thereof as follows:

(h) no provision of law shall be deemed to prohibit—

"(1) the creation or operation of a registered investment company or a collective trust fund exempt from the definition of 'investment company' under section (3)(11) of this title, which is maintained by a bank or banks in compliance with any applicable regulations of the Comptroller of the Currency . . . ."

S. 34, 91st Cong., 1st Sess. § 12(d) (1969). Section 12(b) of S. 296 is identical. S. 296, 91st Cong., 1st Sess. § 12(b) (1969).

941 N.Y. Times, Nov. 17, 1967, at 71, col. 5.

942 See text accompanying note 863 *supra*.

943 Former Chairman Cohen noted during the 1967 House Hearings that eighty-three per cent of all mutual fund investments were below \$5,000 and ninety-three per cent were below \$10,000. 1967 House Hearings 155. This would appear to preclude use of the commingled managing agency fund for nearly all mutual fund investors.

fact that the banks charge no sales load may be taken as a further unfavorable reflection on the high distribution costs in mutual fund selling, and the funds might understandably be unwilling to have further comparisons made on that score. What is quite possibly their primary motivation is the fear that the banks may aggressively push for passage of the entire bill in order to obtain advantages of those provisions relating to banks. Such a move might well upset industry plans to effect a compromise on those aspects of the bill which relate to the industry. Its apparent willingness to reach agreement on the sales load issue<sup>944</sup> and related topics may represent a desire to achieve more favorable terms than are now contained in either of the pending bills.

At the time of this writing, banks are not allowed to organize commingled agency accounts. It is very possible that this situation will be changed in the near future, however, either by reversal of the *Camp* decision or by passage of new legislation. The consequences of such action are not immediately predictable; certainly the advantages of pooled investing would be more available to a greater number of people in a framework they might find more compatible with their financial condition. Perhaps the most far-reaching consequences, however, are those which are not directly related to the mutual fund controversy, yet are awesome in comparison. They concern the advent of a new phenomenon: the institutionalization of the securities markets. This problem is currently the subject of an intensive SEC study which hopes to determine the proper place of that movement in traditional securities practices.<sup>945</sup>

## B. Insurers and the Mutual Fund Industry

### 1. Introduction

As one recent writer speaking about another potential rival of the funds put it, "Consider the competition the *insurers* can offer existing mutual funds."<sup>946</sup> The "insurers" he refers to are the giants of the insurance business who are now striving mightily to reach the investing dollar that had previously remained the private preserve of the mutual funds. Their poaching has caused some alarm to chieftains of the fund industry.<sup>947</sup> Perhaps their alarm is warranted, for in terms of resources available to wage the war for the investor's dollar, the insurers' ability far outstrips the funds'. With 1967 year-end assets of \$177.4 billion (compared to \$47.5 billion for the funds), full-time agents numbering 200,000 (compared to approximately 30,000 full-time mutual fund salesmen), and policyholders totalling 130 million (compared to five million fund shareholders<sup>948</sup>), insurance companies would appear to hold a commanding edge in their ability to reach the public.<sup>949</sup>

However, as even leaders in the insurance business have realized, these economic figures are misleading. From 1948 to 1967, insurance companies' share

944 See text accompanying note 863 *supra*.

945 See note 141 *supra* and accompanying text.

946 Sheehan, *Life Insurance's Almighty Leap into Equities*, 78 FORTUNE, Oct. 1968, at 142, 144.

947 *Id.*

948 See note 9 *supra*.

949 Sheehan, *supra* note 946, at 143-44.



of the savings dollar has declined from forty-seven to fourteen per cent.<sup>950</sup> Though overall assets of insurance companies remain large,<sup>951</sup> the steady proportionate loss has been alarming to the insurers. The conclusion they have drawn is that the insurance companies no longer are able to reach the public as effectively as they once did.<sup>952</sup> The reason they ascribe to this inability reflects an attitudinal change not only of the investing public but of the insurance industry itself — each now believes that annual inflation is here to stay.<sup>953</sup> This represents a complete reversal of the outlook held by earlier insurance executives who regarded inflation as “nothing that a Republican Administration, with a sound fiscal policy, couldn’t cure.”<sup>954</sup> That outlook is no longer shared by the men who presently hold command at the top of the industry. The newer executives, on whom the scars of the Depression are not so deeply etched, may not regard inflation as inevitable, but they are convinced that as long as it persists, insurance companies can and should devise means of existing with it.

It is important to note that inflation is presently harming insurance companies in two ways: (1) it reduces their ability to reach the inflation-conscious investor who does not find the traditional insurance policy a suitable hedge against inflation; and (2) most industry assets are now required to be invested in non-equities securities.<sup>955</sup> While equities securities’ values rise with inflation, the fixed returns on debt securities do not. For both reasons, therefore, insurance companies have set out to get a “piece of the action.” Accordingly, they have adopted a two-pronged approach which they hope will directly improve their appeal to the investor and indirectly alleviate their problems with fixed-return investments. The two investment devices on which insurance companies have centered their efforts are development of subsidiary mutual funds and development of a type of mutual fund, the variable annuity.

## 2. Insurers’ Investment Devices

### a. *The Company-dominated Mutual Fund*

To date, the larger insurance companies have not shown a deep interest in simply acquiring the assets of an already extant fund by purchasing the fund’s investment advisor. Though there are isolated instances of such acquisitions,<sup>956</sup> the costs involved are prohibitive; moreover, certain legal consequences of an unhappy nature may attach to such transactions.<sup>957</sup> By and large, therefore, the larger companies have endeavored to set up their own mutual funds or establish variable annuities.

To be sure, some insurance companies have long been engaged in the mutual

950 *Id.* at 142.

951 Insurance company assets totaled \$177.4 billion at the end of 1967. *Id.* at 143.

952 *Id.* at 142.

953 *Id.* at 146.

954 *Id.*

955 *Id.* at 146.

956 *Id.* at 143. See also *Personal Investing*, 78 *FORTUNE*, Oct. 1968, at 207.

957 See text accompanying notes 1385-440 *infra*.

fund business.<sup>958</sup> Primarily, these are smaller companies who simply offer shares of already extant funds as either a sideline for their agents or as part of a complementary investment package.<sup>959</sup> However, the giants of the industry, Connecticut General Life, Travelers, Aetna, John Hancock, and The Prudential, have chosen to operate independently and establish their own mutual funds, shares of which are to be sold by those of their agents who qualify to sell securities. While it is no mean task to see to the qualification of this veritable army of agents,<sup>960</sup> the problems associated with that endeavor are not so pressing as the initial legal obstacles in the path of establishing insurance company-dominated mutual funds.

As the analysis in the banking institutions' section revealed, any device a non-exempt institution might set up which called for the public to entrust certain funds to the company for the purpose of "investing, reinvesting, or trading in securities"<sup>961</sup> would constitute an investment company within the meaning of the 1940 Act.<sup>962</sup> The applicability of that Act to insurance company plans was judicially questioned, however, since the Act specifically exempts insurance companies from its coverage.<sup>963</sup> The insurers contended that their investment programs should be carried on without regard to the Act's provisions.<sup>964</sup> This dispute was later settled in favor of the Act's application.<sup>965</sup> Consequently, insurance company-dominated mutual funds closely parallel the funds of the separate mutual fund industry. Ordinarily, the sponsoring insurance company contributes seed capital to comply with minimum capitalization requirements of the Investment Company Act.<sup>966</sup> The insurer also creates an investment advisor and a broker-dealer (both subsidiaries), the latter to act as underwriter. After registration with the SEC, the fund's shares may be sold by any agents of the company who have successfully completed the NASD or SEC examination and any applicable state examination.<sup>967</sup>

Thus far, performances by the various controlled funds have not "set the world on fire," yet they have been sufficiently encouraging to convince their parent companies that the future of the funds is bright.<sup>968</sup> Purely in theoretical terms, the funds established by insurance companies are competitive with already extant

958 For example, Nationwide Life Insurance Co. of Columbus has offered shares of a mutual fund since 1952. Sheehan, *supra* note 946, at 143.

959 *Id.*

960 It will be recalled that all salesmen must qualify to sell mutual fund shares by passing either the NASD examination or the SECO test administered by the SEC, and, in addition, perhaps, a state examination. See notes 580-86 *supra* and accompanying text. The insurers have chosen the NASD examination, and thus far results have been impressive. Sheehan, *supra* note 946, at 147, 180.

961 Investment Company Act of 1940 § 3(a)(1), 15 U.S.C. § 80a-3(a)(1) (1964).

962 See text accompanying notes 897-901 *supra*.

963 See text accompanying notes 992-94 *infra*. Section 3(c)(3) of the Investment Company Act exempts an "insurance company" from its coverage. 15 U.S.C. § 80a-3(c)(3) (1964).

964 This contention will be discussed below in connection with the variable annuity. See text accompanying notes 972-99 *infra*.

965 See text accompanying note 980 *infra*.

966 Section 14 of the Investment Company Act forbids the public offering of securities issued by a registered investment company unless "such company has a net worth of at least \$100,000." 15 U.S.C. § 80a-14 (1964).

967 See notes 579-86 *supra* and accompanying text.

968 Sheehan, *supra* note 946, at 147, 178.

funds. Sales loads average about 7.5 per cent,<sup>969</sup> compared to the industry average of 8.5 per cent.<sup>970</sup> While the salesman's share is smaller (2.5 per cent) than the typical split in the industry (3.25 per cent),<sup>971</sup> the funds run no risk of losing the interest of the agent, since his affiliation is secured by his ability to sell standard insurance products. Moreover, the market for the salesman's prospecting is ready-made, since the established policyholders constitute a most lucrative source of referrals.

### b. *The Variable Annuity*

The other investment device insurance companies have turned to is the variable annuity. More so than the mutual fund, the variable annuity, which was the "forerunner . . . to the life-insurance companies' full-scale foray into the mutual-fund business,"<sup>972</sup> exemplifies the technical obstacles faced by the insurance companies, whose desire to compete on more favorable terms for the investment dollar led them into these investment programs.

Though it combines features of both the fixed-annuity familiar to the insurance business and the standard mutual fund, the variable annuity differs from each in both its operation and intended market.<sup>973</sup> Typically, the variable annuity functions in two phases.<sup>974</sup> During the "pay-in" period, the investor makes payments of a fixed amount over a given number of years. Those payments are transmuted into "units" which represent a pro rata share in the underlying securities which the insurance company, acting as investment advisor, has selected. Later, during the "pay-out" period, the investor receives in cash the income from a fixed number of units per month (determined by standard actuarial principles). The actual cash amount received will vary as the value of the underlying securities varies.<sup>975</sup>

The investor may withdraw from the program at any time during the "pay-in" period. However, at the beginning of the pay-out period, the investor must choose to take a lump-sum payment equal to the value at maturity of all units he has accumulated or, if he elects not to do so, he must choose one of several alternative programs which provide for payments over a stated number of years.<sup>976</sup> These features make the variable annuity ideal, so the companies

969 *Id.* at 147.

970 *See* note 482 *supra* and accompanying text.

971 *See* note 483 *supra* and accompanying text.

972 Sheehan, *supra* note 946, at 147.

973 *See generally* Day, *A Variable Annuity is Not a "Security,"* 32 NOTRE DAME LAWYER 642 (1957).

974 The features of the variable annuity offered by the Prudential Insurance Co. have been selected as illustrative. *See* The Prudential Insurance Company of America, 41 S.E.C. 335 (1963).

975 *Id.* at 337-38.

976 This feature makes the pay-out period of the variable annuity non-redeemable. Since section 22(e) of the Investment Company Act requires that the security be redeemable, each variable annuity sponsor has had to obtain an individual exemption from the section 22(e). *See, e.g., id.* The Commission, recognizing the actuarial necessity for non-redeemability during the pay-out period of a variable annuity, has proposed to relax that requirement for all variable annuities in proposed Rule 22e-1. *See* SEC, Investment Company Act Release No. 5586 (Jan. 24, 1969) [Current Vol.] CCH FED. SEC. L. REP. ¶ 77,649, at 83,403-04.

claim, for retirement planning.<sup>977</sup> It offers the investor the opportunity to "salt away" his savings in the years he can afford to do so, and spares him the unpleasant dilemma of living on a fixed income in an inflationary economy.

Whatever its claimed benefits, the variable annuity investing scheme, like banking's commingled account, ran heavily afoul of the provisions of the Investment Company Act. The applicability of that Act to the variable annuity was at issue in the now classic case of *SEC v. Variable Annuity Life Insurance Company of America*.<sup>978</sup> Defendant [VALIC] contended that the variable annuity merely constituted a new form of insurance coverage; since insurance companies are expressly exempted from the coverage of federal securities statutes, it argued, the company should also be exempted from the 1940 Act.<sup>979</sup> The majority of the Court refused to accept this contention, however.<sup>980</sup> While Justice Douglas, speaking for three other members of the Court, stated his unwillingness to stifle the growth of the insurance business, he was constrained to note that the traditional notion of insurance—a guarantee of some return—was not present in the variable annuity. While the company guaranteed to pay the annuitant the value of his shares, there was no guarantee that the shares would have any value. This Justice Douglas called a guarantee "that has a ceiling but no floor."<sup>981</sup> Justice Brennan concurred in the result but felt compelled to express "additional reasons" for his opinion.<sup>982</sup> Accordingly, the variable annuity was held subject to the provisions of the 1940 Act.<sup>983</sup>

In his oft-cited concurring opinion, Justice Brennan fleshed out the sparse framework on which the majority opinion was laid.<sup>984</sup> Although the facts of the case were complex, he began, the issue of the case was simple: should the Securities Act of 1933 and the Investment Company Act of 1940 be applicable to the variable annuity investing scheme?<sup>985</sup> They would have manifestly been applicable had there not been specific exclusions written in the separate Acts regarding "insurance policies"<sup>986</sup> and "insurance companies."<sup>987</sup>

The question then resolved itself into a determination of whether the variable annuity fell into that "sort of investment form that Congress was then [in 1933 and 1940] willing to leave exclusively to the State Insurance Commissioners."<sup>988</sup> The Securities Act becomes applicable, Justice Brennan concluded, "where the coin of the company's obligation is not money but is rather the present condition of its portfolio."<sup>989</sup> The 1940 Act's provisions become acutely relevant, Justice Brennan further noted,

977 *The Prudential Insurance Company of America*, 41 S.E.C. 335, 339 (1963).

978 359 U.S. 65 (1959).

979 *Id.* at 67.

980 While this conclusion is not explicitly stated in the opinion written by Justice Douglas, it is readily inferable from it and has been so treated as the authoritative conclusion. *See The Prudential Insurance Co. of America v. SEC*, 326 F.2d 383 (3d Cir. 1964). *See also Case Note*, 1963 DUKE L.J. 807.

981 359 U.S. at 72.

982 *Id.* at 73.

983 *But see note 980 supra.*

984 359 U.S. at 73 (concurring opinion).

985 *Id.*

986 Securities Act of 1933, § 3(a)(8), 15 U.S.C. § 77c(a)(8) (1964).

987 Investment Company Act of 1940, § 3(c)(3), 15 U.S.C. § 80a-3(c)(3) (1964).

988 359 U.S. at 76.

989 *Id.* at 78.

to situations where the investor is committing his funds to the hands of others on an equity basis, with the view that the funds will be invested in securities and his fortunes will depend on the success of the investment.<sup>990</sup>

Recognizing that the variable annuity contract contained some features of traditional annuity contracts, he nevertheless came to the final conclusion that the predominant elements consisted of the business of an investment company and therefore decided that it was not the intent of the 1933 and 1940 statutes to exempt them.<sup>991</sup>

This conclusion was squarely backed in *The Prudential Insurance Company of America v. SEC*,<sup>992</sup> where Prudential attempted "to distinguish VALIC on the grounds that the company there involved was not, on the basis of the Court's decision, primarily or predominantly engaged in the business of writing insurance."<sup>993</sup> This argument proved unavailing, as the Third Circuit affirmed the Commission's determination that the company's variable annuity was subject to the Investment Company Act.<sup>994</sup>

Following the adjudication of the 1940 Act's applicability, insurance company sponsors of the variable annuities experienced some difficulty in adjusting their plans to the provisions of the Investment Company Act. These adjustments, which were the subject of a good deal of litigation,<sup>995</sup> have been thoroughly documented elsewhere.<sup>996</sup> At present, variable annuities are looked upon as a part of the "in-house" line of equities merchandise the registered insurance agent has in his kit to offer the policyholder who seeks a means of hedging against inflation in addition to the traditional life insurance policy which he probably will continue to purchase.<sup>997</sup>

The variable annuity competes with established funds on less favorable terms than does its half-brother, the insurance company-dominated mutual fund. All payments made during the pay-in period are subject to a sales load that varies (in the plan offered by VALIC) from eight to fifty-five per cent.<sup>998</sup> Over the thirty-year period the sales load would average out to 8.9 per cent. Furthermore, the assets held by the annuity are also subject to a .15 per cent monthly administrative fee, or 1.8 per cent annually.<sup>999</sup> This compares unfavorably with the .5 per cent charged by advisors of established mutual funds. Moreover, the

990 *Id.* at 79.

991 *Id.* at 81.

992 326 F.2d 383 (3d Cir. 1964).

993 *Id.* at 388.

994 *Id.*

995 *E.g.*, *SEC v. United Benefit Life Insurance Co.*, 359 F.2d 619 (D.C. Cir. 1966); *The Prudential Insurance Co. of America v. SEC.*, 326 F.2d 383 (3d Cir. 1964); *The Prudential Insurance Co. of America*, 41 S.E.C. 335 (1963); *The Variable Annuity Life Insurance Co.*, 39 S.E.C. 680 (1960).

996 *E.g.*, Dorsey, *The Place of "Variable Annuities" in Law and Economics*, 34 NOTRE DAME LAWYER 489 (1959); Mearns, *The Commission, the Variable Annuity, and the Inconsiderate Sovereign*, 45 VA. L. REV. 831 (1959); Comment, *The Expanding Jurisdiction of the Securities and Exchange Commission: Variable Annuities and Bank Collective Investment Funds*, 62 MICH. L. REV. 1398 (1964); Comment, *Variable Annuities and Common Trust Funds for Managing Agency Accounts*, 39 NOTRE DAME LAWYER 701 (1964); Case Note, 1963 DUKE L.J. 807.

997 Sheehan, *supra* note 946, at 147.

998 *Cf.* *SEC v. Variable Annuity Life Insurance Co. of America*, 359 U.S. 82 (1959) (concurring opinion).

999 *Id.* at 83.

long pay-in period exceeds by ten years the average holding time of a mutual fund shareholder's investment in a fund.<sup>1000</sup> This in part helps to explain the lack of rapid growth of variable annuities. In addition the variable annuity's complexities make it difficult for the typical agent to sell and the typical investor to understand. The insurance companies do not look upon these problems as insurmountable, however; they presently regard the annuity as an important part of the overall enhanced ability of the insurance company to meet the needs of the policyholder.

### 3. The Insurers as Institutional Investors

Insurance companies have not established either separate mutual funds or variable annuities solely as a means of adding to their own assets.<sup>1001</sup> Of course, the insurer does profit from the sales loads and administrative (advisory) fees charged the investor and the fund or annuity pool respectively. However, neither of these charges, taken alone or jointly, would seem sufficient to support the ambitious revamping that such projects entail. A more persuasive reason is found in the fact that the insurance giants are very anxious to make the insurance agent's entire line of merchandise more compatible with the changed needs of a new generation of investors. A desire to keep the policyholder "in the house" would seem a plausible argument capable of exerting sufficient economic pressure to overcome the burdens of transition.

By far the most forceful rationale yet advanced to explain the energetic expansion by the insurers into equities investing has been summed up by one writer in this way:

Moreover, it is widely agreed that the involvement in mutual-fund operations will logically lead life companies to take a more liberal view of common stocks as a suitable investment for their regular portfolios — the repositories of life-insurance reserves. *The implications of this development are the most intriguing of all.*<sup>1002</sup> (Emphasis added.)

The insurers hope to profit from this vicarious flirtation with the market by convincing the proper authorities that more of the insurance companies' reserves should themselves be directly invested in the market.<sup>1003</sup> Such a step would represent a gigantic stride forward. At present, insurance companies are severely limited by state regulations as to the amount of their reserves which may be invested in equities securities. A representative limitation is that imposed by the state of New York: no insurance company may invest more than fifty per cent of its surplus or five per cent of its reserves, whichever is smaller, in equities securities.<sup>1004</sup> That limitation is, however, now being evaluated in light of a proposal that would double the amount that could be invested, from five to ten

1000 The average holding period of fund shares is seventeen years. LITTLE STUDY Part II, at 7.

1001 Sheehan, *supra* note 946, at 180. See also 1967 House Hearings 251 (Tables B, C).

1002 Sheehan, *supra* note 946, at 145.

1003 *Id.*

1004 N.Y. INSUR. LAW § 81(13)(c) (McKinney Supp. 1968).

per cent of reserves, or up to one hundred per cent of surplus.<sup>1005</sup> The New York action is typical of the reconsideration being given by many states to the future regulation of insurance company investing. Moreover, there are indications that the insurers will seek a further lessening of restrictions for large-scale investments in equities would doubtless provide the insurance industry with the anti-inflationary device it needs to protect its assets.

## VI. The Mutual Fund Management Structure

### A. *Services of the Investment Advisor*

He who would explore the investment company forest may not escape a direct confrontation with an "externalized management" and its progeny. A rare breed of corporate structure indigenous to the investment company industry, an externalized management involves a contractual relationship between an investment company and a separate firm or corporation — called the "advisor" — whereby the latter undertakes, for a fee, to render certain managerial services to the former.

#### 1. Supervision of Investment Securities

The quintessence of the service is portfolio selection, supervision, and analysis, as well as arranging for execution of portfolio transactions. It is in his capacity as investment counselor and portfolio manager that the advisor theoretically earns his keep, and it is by reference to the quality of his advice that he most often chooses to justify his fees. In addition the advisor may, and usually does, furnish a variety of administrative services, sometimes charging an additional fee or fees.

In selecting and supervising the investment portfolio, the company and its advisor must operate within two basic sets of limitations. First, a recital of the fund's "fundamental policies" is required by the Investment Company Act to be in the registration statement.<sup>1006</sup> These policies, which must include the

<sup>1005</sup> Sheehan, *supra* note 946, at 145.

<sup>1006</sup> Investment Company Act of 1940 § 8(b), 15 U.S.C. § 80a-8(b) (1964) provides in part:

(b) Every registered investment company shall file with the Commission, within such reasonable time after registration as the Commission shall fix by rules and regulations, an original and such copies of a registration statement, in such form and containing such of the following information and documents as the Commission shall by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors:

(1) a recital of the policy of the registrant in respect of each of the following types of activities, such recital consisting in each case of a statement whether the registrant reserves freedom of action to engage in activities of such type, and if such freedom of action is reserved, a statement briefly indicating, insofar as is practicable, the extent to which the registrant intends to engage therein: (A) the classification and subclassifications, as defined in sections 80a-4 and 80a-5 of this title, within which the registrant proposes to operate; (B) borrowing money; (C) the issuance of senior securities; (D) engaging in the business of underwriting securities issued by other persons; (E) concentrating investments in a particular industry or group of industries; (F) the purchase and sale of real estate and commodities, or either of them; (G) making loans to other

essential elements of the investment company's financial framework, may not be altered without shareholder authorization.<sup>1007</sup> The second set of limitations is contained in the company's prospectus, which may set out in greater detail the investment guidelines that give the fund its unique character.<sup>1008</sup> Thus there is typically a statement of the fund's investment objectives: current income, capital appreciation, or some combination of the two. Also typical is a broad statement of the investment policy envisioned to attain these goals: whether the fund will concentrate in high or low risk securities; common stocks, preferred stocks, or bonds; specialized or widely diversified industries, special situations, etc. Within the ambit of these limitations, however, there is wide latitude for managerial discretion in selection and liquidation of portfolio securities. To assist him in his prognostications of market trends or the prospects of a single issue, the advisor may have at his disposal the sagacity and augury of the fund's "advisory board." The 1940 Act makes provision for such an arrangement and defines the "advisory board" as a panel separate from the board of directors and separate from management or executive personnel "which . . . has advisory functions as to investments but has no power to determine that any security . . . shall be purchased or sold . . ." <sup>1009</sup>

In addition to the advice of an advisory board and management's own research through the common media of business, financial, and governmental publications, many fund managers rely heavily on impressions of specific companies derived from field visits. Thus the advisory function may entail considerable firsthand investigation of portfolio companies or companies whose securities are being considered for acquisition. The *Wharton Report* found that twenty-eight per cent of the advisors reporting on this matter stated that they visited all or virtually all portfolio companies annually; another twenty-five per cent declared they made such visits "frequently"; while only twelve per cent said that they do not make such visits at all.<sup>1010</sup> The *Wharton Report* also found a significant

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persons; and (H) portfolio turn-over (including a statement showing the aggregate dollar amount of purchases and sales of portfolio securities, other than Government securities, in each of the last three full fiscal years preceding the filing of such registration statement);

(2) a recital of the policy of the registrant in respect of matters, not enumerated in paragraph (1) of this subsection, which the registrant deems matters of fundamental policy and elects to treat as such. . . .

See *Green v. Brown*, 398 F.2d 1006 (2d Cir. 1968), *rev'g* 276 F. Supp. 753 (S.D.N.Y. 1967). See also notes 347-52 *supra* and accompanying text.

1007 Investment Company Act of 1940 § 13, 15 U.S.C. § 80a-13 (1964).

1008 Any transgression of limits contained in the prospectus is, of course, actionable. Securities Act of 1933 § 12, 15 U.S.C. § 771 (1964). See also *Lutz v. Boas*, 39 Del. Ch. 585, —, 171 A.2d 381, 393 (1961); *Managed Funds, Inc.*, 39 S.E.C. 313 (1959), *rev'd sub nom. Brouk v. Managed Funds, Inc.*, 286 F.2d 901 (8th Cir. 1961), *vacated as moot per curiam*, 369 U.S. 424 (1962) (see note 1288 *infra*).

1009 Investment Company Act of 1940 § 2(a)(1), 15 U.S.C. § 80a-2(a)(1) (1964).

The composition of the advisory board is regulated by the Act. *Id.* § 10(g), 15 U.S.C. § 80a-10(g) (1964). It must contain the same minimum percentage of non-affiliated members as required for the board of directors under section 10 of the Act.

1010 WHARTON REPORT 423-24.

According to one medium-sized company, "The information sought is along the following lines:

"1. Earnings outlook for the current quarter, half year, year, and subsequent year or years, if possible.

"2. Prospects regarding dividend retention, increase, decrease, stock dividends, or stock splits.



correlation between visitation policy and the size of the fund under management. Not surprisingly, the more pecunious managers of the larger funds are the more frequent visitors, while managers of smaller funds are often unable to indulge in the luxury of the "martini method" of securities evaluation.<sup>1011</sup>

The advisor may also receive investment advice and information (sometimes superior or more timely than that otherwise obtainable) from researchers and investment analysts affiliated with brokerage firms. In return for his information (and for his efforts in selling the investment company's shares), the broker is generally compensated through disposable brokerage: reciprocal business or (formerly) give-ups.<sup>1012</sup> A well-publicized illustration of this "timely" information

"3. The likelihood of any new financing, and, if so, what type.

"4. The possibilities of major plant increases, additions, or new plant construction.

"5. Possibilities regarding corporate acquisitions, mergers, etc.

"6. Inquiries as to the development of any important new products.

"7. The approximate amount of money expended for research and advertising.

"8. The likelihood of any major management changes." *Id.* at 424 n.30.

The practical impact of the advisor-portfolio company relationship is apparent from the following exchange:

[Mr. Keith] Perhaps the case in point would be that of Motorola . . . where it is my understanding that speaking to a group of investment analysts for mutual funds, a corporate official announced what [*sic*] there was a drop in corporate earnings and that afternoon the boys went back from their lunch and decided with each other to take this perishable opportunity that they had and the price of Motorola dropped I believe about 36 points very quickly. . . .

. . .

Mr. LORIE. You are essentially correct. 1967 *House Hearings* 420.

1011 WHARTON REPORT 423-24.

1012 Reciprocal business, grossly oversimplified, is the practice of executing investment company portfolio transactions through the broker to be rewarded. Where a large number of brokers in several securities markets are involved, the technique is obviously cumbersome and unsatisfactory. Hence, the give-up.

The customer-directed give-up is not much more sophisticated than reciprocal business. A large portfolio transaction is placed with a favorite broker on condition that he "give-up" a portion of his brokerage commission to other brokers selected by the customer. Because of the large size of investment company brokerage transactions and the inflexible commission rate minima on the exchanges, a broker may be quite willing to give up over half his commission to other brokers who had no part in the execution. If the receiving broker or firm is not a member of the same exchange, he may receive compensation in the form of a "service give-up" — theoretically sales promotional or training materials, but actually a monthly check. The receiving broker may also be rewarded by means of a nefarious device known as "interpositioning," whereby a broker-dealer is inserted between the fund and the primary executing broker in order to generate a mark-up for the inserted broker.

The give-up provides a crude form of volume discount, and when used to benefit the fund by opening channels of information, pricing services, etc., represents some accommodation to the fixed commission anomaly. The give-up, however, is also used to additionally compensate broker-dealers for their efforts in *selling* the fund's shares. To the fund shareholders, who ultimately bear the cost of brokerage, the give-up may thus represent no savings at all, but rather a *waste* of disposable brokerage. In fact, through the mechanism of the exchange anti-rebate rules, minimum fee structure, reciprocal business, and give-ups, existing fund shareholders were effectively subsidizing the underwriting function, which is presumably supported by the sales load. The conflict of interest problem here is apparent. Since his fee is based on fund net assets, the advisor stands much to gain by encouraging and rewarding the sale of fund shares. Hence it is in the advisor's interest to maximize give-ups and reciprocal business by "churning" a fund's portfolio and by trading on an exchange even when a third market is available and more economical in a given security. Moreover, the advisor may own or be affiliated with his own brokerage firm, thus recapturing give-ups and brokerage, occasionally reducing his management fee accordingly but often retaining the disposable brokerage at the expense of the fund. In the colorful terms of Abe Pomerantz:

[E]ven in those instances where the brokerage is ostensibly farmed out to third-party brokers, the insiders have their hands on the commission by way . . . of reciprocals and giveups and other ways of commandeering the commission to serve the interest of the underwriter or the advisor . . . 1967 *Senate Hearings* 690.

Give-ups have been abolished on the New York Stock Exchange, and a nominal volume

phenomenon centers on the escapades of Merrill Lynch, Pierce, Fenner & Smith, Inc., and some of its high rolling friends.<sup>1013</sup> Merrill Lynch, which received large brokerage commissions and give-ups from several mutual fund managers, notably Investors Management Company, Inc., Van Strum & Towne, Inc., The Dreyfus Corporation, and one closed-end company, Madison Fund, Inc., was the prospective managing underwriter for a \$75 million convertible subordinated debenture issue by Douglas Aircraft Company. On June 7, 1966, Douglas had issued a news release showing its first five months' earnings to be about eighty-five cents per share. In the course of its investigation of Douglas, however, Mer-

discount assimilated into the commission rate structure. See Letters of R. Haack to Manuel Cohen and exchange members, Nov. 19, 1968 and Nov. 22, 1968, [Current Volume] CCH FED. SEC. L. REP. ¶ 77,631; letter from Robert Haack to Manuel F. Cohen, Aug. 8, 1968, [Current Volume] CCH FED. SEC. L. REP. ¶ 77,585. The president of the NYSE, in understandable apprehension of reforms to come, has admonished members not to subvert the abolition by resorting to institutional inter-broker give-ups and reciprocity. Letter of R. Haack to exchange members, Nov. 22, 1968, [Current Volume] CCH FED. SEC. L. REP. ¶ 77,631, at 83,364-65. Clearly the only satisfactory solution would be elimination of minimum commission rates altogether.

See SEC Exchange Act Release No. 8324 (May 28, 1968), [Current Volume] CCH FED. SEC. L. REP. ¶ 77,557 (SEC order for public hearing to inquire into minimum commission rate structure, including letter from Chairman Cohen of the SEC to R. Haack, President of NYSE); SEC Exchange Act Release No. 8328 (June 5, 1968), [Current Volume] CCH FED. SEC. L. REP. ¶ 77,563 (procedures for hearings on minimum rate structure); New York Stock Exchange Special Membership Bulletin, June 7, 1968, [Current Volume] CCH FED. SEC. L. REP. ¶ 77,564 (exchange counsel looking for legal justification for minimum commission rates informs members that pressure is on from SEC and discusses generally position of NYSE); NASD Press Release, July 18, 1968, [Current Volume] CCH FED. SEC. L. REP. ¶ 77,576 (NASD capitulates); Statement of R. Haack before the SEC, Aug. 19, 1968, [Current Volume] CCH FED. SEC. L. REP. ¶ 77,590 (president of NYSE defends minimum commission rates); Statement of R. Saul before the SEC, Aug. 26, 1968, [Current Volume] CCH FED. SEC. L. REP. ¶ 77,591 (president of American Stock Exchange predicts disaster if minimum commission abolished); Letter from Robert Haack to Manuel F. Cohen, Aug. 8, 1968, [Current Volume] CCH FED. SEC. L. REP. ¶ 77,585 (NYSE adopts policy of appeasement, volunteers nominal volume discount and discontinuance of customer-directed give-ups); Letters from Manuel F. Cohen and Irving M. Pollack to R. Haack, Aug. 30, 1968 and September 4, 1968, [Current Volume] CCH FED. SEC. L. REP. ¶ 77,599 (accepting NYSE concessions as interim measure and admonishing as to necessity of enforcement); New York Stock Exchange Member Firm Educational Circular No. 242, Aug. 30, 1968, [Current Volume] CCH FED. SEC. L. REP. ¶ 77,600 (NYSE clarifies ban on give-ups, including service give-ups); Statement of R. Walbert before SEC, Sept. 17, 1968 [Current Volume] CCH FED. SEC. L. REP. ¶ 77,605 (NASD foresees cataclysm if minimum commissions abolished); Letters of R. Haack to Manuel Cohen and exchange members, Nov. 19, 1968 and Nov. 22, 1968, [Current Volume] CCH FED. SEC. L. REP. ¶ 77,631 (NYSE abolishes give-ups by constitutional amendment, hoping, by the concession, to assuage the SEC; NYSE warns members not to circumvent new rules lest attention be centered again on commission rates). See generally WHARTON REPORT 527-39, 473-75; SPECIAL STUDY IV 213-35; PUBLIC POLICY STATEMENT 162-88; OFFICIAL PROCEEDINGS, THE FIRST ANNUAL INSTITUTIONAL INVESTOR CONFERENCE 233-45 (1968); Note, *Use of Brokerage Commissions to Promote Mutual Fund Sales: Time to Give Up the "Give Up"*, 68 COLUM. L. REV. 334 (1968); 1967 DUKE L.J. 1059.

The trigger for the statements and correspondence was the SEC's proposed rule 10b-10, designed to assure that give-ups on investment company transactions benefit the shareholders rather than the managers. SEC Securities Exchange Act Release No. 8239 (Jan. 26, 1968), [Current Volume] CCH FED. SEC. L. REP. ¶ 77,523. The Department of Justice immediately took its cue and argued forcefully that the forces of competition should, as far as possible, be permitted to operate in the area of brokerage commissions. UNITED STATES DEPARTMENT OF JUSTICE, COMMENTS OF THE UNITED STATES DEPARTMENT OF JUSTICE BEFORE THE SEC (April 1, 1968). Recently the Department of Justice has expanded and more vigorously pressed its views, urging in a very able and thorough memorandum that the SEC act to eliminate minimum commission rates except where necessary. The specter of the Antitrust Division is not masked. UNITED STATES DEPARTMENT OF JUSTICE, MEMORANDUM OF THE UNITED STATES DEPARTMENT OF JUSTICE ON THE FIXED MINIMUM COMMISSION RATE STRUCTURE (Jan. 17, 1969).

<sup>1013</sup> Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC Securities Exchange Act Release No. 8459 (Nov. 25, 1968), [Current Volume] CCH FED. SEC. L. REP. ¶ 77,629.

rill Lynch had obtained certain non-public information from management: (1) Douglas was about to report earnings for the first six months of far less than eighty-five cents; (2) Douglas now anticipated little or no profit for the entire 1966 fiscal year; and (3) Douglas had substantially reduced its earnings estimates for fiscal 1967.<sup>1014</sup> Before this inside information became public, it was quietly and confidentially passed along to the investment company managers and certain other select clients of Merrill Lynch, who not so discreetly proceeded to dump 190,000 shares of Douglas common on the market.<sup>1015</sup> On June 22, 1966, Douglas common had opened at 90½; it closed the following day at 78¾. After Douglas had issued a press release showing six months' earnings of only twelve cents per share, the price immediately plummeted further to 69, declining to 61¾ by the end of that week.<sup>1016</sup> To aggravate matters, Merrill Lynch was executing purchases in Douglas for its non-favored customers at the same time that it was disclosing the inside information and executing sales for the elite.<sup>1017</sup> Not one to deny that a Merrill Lynch man "is called on to wear a variety of hats,"<sup>1018</sup> the august firm was obviously caught wearing one too many. Merrill Lynch's experience will no doubt serve as a warning to other investment houses tempted to simultaneously play the twin roles of confidant and tipster.

## 2. Administrative Services

In addition to investment counselling, the advisor may furnish a number of administrative and clerical services,<sup>1019</sup> including the preparation, printing,

1014 Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC Administrative Proceedings File No. 3-1680 (Aug. 26, 1968), [Current Volume] CCH FED. SEC. L. REP. ¶ 77,596, at 83,273-74 (allegations of Division of Trading and Markets).

1015 *Id.*

1016 Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC Securities Exchange Act Release No. 8459 (Nov. 25, 1968), [Current Volume] CCH FED. SEC. L. REP. ¶ 77,629, at 83,349 n.7.

1017 *Id.* at 83,349.

1018 SPECIAL STUDY I 93.

1019 Indeed, some advisory corporations provide nothing but administrative services, actually subcontracting for investment advice elsewhere.

For example, First Investors Management Co., under a management contract with First Investors Fund for Growth, Inc., receives a management fee of .75 per cent on the first \$300 million of the fund's average net assets, .625 per cent on the next \$200 million, and .5 per cent on the excess. FIRST INVESTORS FUND FOR GROWTH, INC., PROSPECTUS, June 19, 1968, at 5. Actual investment advice, however, is provided pursuant to a subcontract with Naess & Thomas calling for a relatively low fee of 1/12 per cent on the first \$100 million in assets, 1/15 per cent on the excess. *Id.* First Investors Management also serves First Investors Fund, Inc., under a contract calling for a generous management fee of one per cent on the first \$5 million, and .5 per cent on the excess of the fund's assets. FIRST INVESTORS FUND, INC., PROSPECTUS, April 26, 1968, revised June 19, 1968, at 6. Again, actual investment advice is furnished by Naess & Thomas for a fee of 1/12 per cent on the first \$100 million, 1/15 per cent on the excess. *Id.* at 6-7. (Net assets of Fund for Growth stood at \$23.9 million as of December 31, 1968, while net assets of Fund stood at \$39.9 million. INVESTMENT COMPANIES 1968 (L. Wessmann ed., Supp. Dec. 31, 1968).)

Similarly, Security Equity Fund, Inc. and Security Investment Fund each operate under management contracts with Security Management Co. calling for a fee of .5 per cent of net assets annually. Management subcontracts the actual investment advisory function to Fred Alger & Co., which is compensated at a rate of 1/8 per cent of net assets. SECURITY EQUITY FUND, INC., PROSPECTUS, Jan. 29, 1969, at 5; SECURITY INVESTMENT FUND, PROSPECTUS, Mar. 28, 1968, amended Dec. 27, 1968, at 5. Fred Alger, the subadvisor, claims that he "runs the fund," which, if true, makes the advisory corporation a legal sham which merely siphons off the excess profits. *See 1967 House Hearings* 505-06.

The One Hundred Fund, Inc. and the One Hundred and One Fund, Inc. are managed by The Hundred Management Corporation, which, in turn, has farmed out the advisory task

and distribution of prospectuses, shareholder reports, and proxy materials; the convocation of director and shareholder meetings; the issuance, transfer, and cancellation of shares; and the distribution to shareholders of income and capital gains dividends. The advisor may also make arrangements for brokerage services, custodial care of the fund's portfolio securities, and receipt of various communications from portfolio companies. Where an investment company recomputes net assets and adjusts bid and ask prices frequently — as mutual funds do — the advisor may provide this service as well.<sup>1020</sup> Even the investment company's office space is generally furnished by the advisor.<sup>1021</sup> As the SEC properly points out, the continuous offering and redemption of mutual fund shares makes several of these items especially important elements of the advisor's service.<sup>1022</sup>

### B. Management Fee Structure

#### 1. Advisory Fees

While most funds continue to pay an advisory fee calculated as a fixed percentage of the fund's net assets, there appears to be a small but rapidly accelerating movement towards a "performance" based computation, which makes at least a portion of the advisor's compensation contingent upon some measure

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to First Trust Corporation. In the case of One Hundred Fund, management receives a fee of 3/8 per cent of average net assets plus a performance bonus. Twenty per cent of management's compensation is paid over to First Trust. *THE ONE HUNDRED FUND, INC., PROSPECTUS*, Jan. 2, 1969, at 8-9. The management fee for One Hundred and One is .7 per cent, and again First Trust is allocated twenty per cent. *THE ONE HUNDRED AND ONE FUND, INC., PROSPECTUS*, Jan. 9, 1969, at 7-8.

Perhaps the most striking example is to be found in the management of Aberdeen Fund. Aberdeen is technically under the auspices of Aberdeen Management Corporation [AMC], formerly controlled by a brewery. *MOODY'S 1968 BANK & FINANCE MANUAL 1065*. The management contract calls for compensation to AMC of the traditional .5 per cent, *ABERDEEN FUND, PROSPECTUS*, May 2, 1968, revised Oct. 15, 1968, at 2, although AMC subcontracts the actual advisory function to Steadman Securities Corporation [SSC] for a .1 per cent fee. *Id.* at 3. In 1968, control of AMC was sold to SSG for an undisclosed amount of cash, *MOODY'S BANK & FINANCE (CURRENT) 1885 (May 3, 1968)*, so that SSC presently owns 50 per cent of AMC's stock, including all of AMC's voting securities. *ABERDEEN FUND, PROSPECTUS*, May 2, 1968, revised Oct. 15, 1968, at 4. This creates the somewhat anomalous situation in which the "subadvisor" owns and controls the "principal advisor," dramatically illustrating the fact that the principal advisor here is nothing more than a corporate facade. (SSC affiliates dominate AMC's complement of officers and directors. *Id.* at 5.) Under these circumstances, the principal advisor serves no function other than to provide a source of income and prospective capital gains to its minority shareholders.

One of the "unaffiliated" directors on the board of a fund which was the object of an advisor-subadvisor arrangement was once confronted with the suggestion that the middleman served no useful function but merely increased the fund's cost of management by capturing for himself a portion of the advisory fee. The director replied that he was "not at all [a] suspicious soul," that the thought had "never occurred" to him, and that the realization that the advisor was surplusage came as "a terrible shock and disillusionment." 114 *CONG. REC. S9496* (daily ed. July 26, 1968). Even with the matter brought to his attention, that director remarked, "I have to be awfully careful that I don't question people's motives." *Id.*

None of these arrangements seem to have resulted in pronounced economy, as the average expense ratio for the mentioned funds is .86 per cent. *NUVEEN CORP., MUTUAL FUNDS PANORAMA* (1968). If a mutual fund is sometimes thought of as a mere "shell" through which an established counselling firm may offer its services, then in these cases it is the management company which is the corporate "shell" through which promoters and executives are able to capitalize on a fund's growth. The utility of this arrangement to anyone save a small group of management stockholders is obscure.

1020 *PUBLIC POLICY STATEMENT* 86-87, 91.

1021 *Id.* at 46; *WHARTON REPORT* 476-77, 476 n.35.

1022 *PUBLIC POLICY STATEMENT* 86.

of the quality of his advice. Perhaps the industry has become so enamoured of the glamorous go-go that it has developed a performance fixation, or perhaps management simply feels that it can more easily justify its handsome fees when these are related to performance; but whatever the reason, it appears that the performance fee is becoming an increasingly popular device.<sup>1023</sup> In 1960, the *Wharton Report* found that only five funds paid advisory fees based on a percentage of income, and only one fund related its management fee to a market index of performance.<sup>1024</sup> Today there are at least forty-three funds with management fees in some way dependent upon performance.<sup>1025</sup> Of these, thirty-four fee provisions are related to some market index, while nine are based solely on some measure of the fund's performance itself, without reference to the performance of any index. Of the thirty-four related to an index, the most popular index is the Dow Jones Industrial Average (thirty stocks) which is used in fourteen cases. Other indices in use include Standard and Poor's 500 Stock Composite Index (thirteen funds); the New York Stock Exchange Composite Index (all stocks listed on the Exchange) (four funds); the highest of Dow Jones Industrial, Standard and Poor's 500, and the NYSE Composite (two funds); and the National Quotation Bureau Over-the-Counter Industrial Average (thirty-five stocks) (one fund). Significantly, no fund determines its fees by relating its performance to an index of funds.

In thirty-three of the thirty-four cases using some market index, the contract calls for a basic advisory fee calculated in the traditional manner as a percentage of net assets. Fully twenty-one of these "base" rates, before the addition of any performance bonus, are one-half per cent or higher. Not only are the base rates generous at the outset, but they also fail to reflect in any manner the economies of size — only eight of the base rates employ any form of sliding scale, however modest.<sup>1026</sup> The performance fees related to an index are lopsided in another respect, namely, that while all thirty-four afford the managers additional compensation for outperforming the index, only eighteen impose any penalty for underperformance. Furthermore, only seven of these require a penalty for underperformance which is commensurate with the bonus for outperforming the index.<sup>1027</sup> The upper limits of compensation under the index-related formulae are similarly weighted to the advisor's advantage. Three contracts have no ceiling at all on the advisor's compensation while the rest authorize ceilings as high as six per cent of net assets.

Legislation introduced in the Ninety-first Congress would require that any

1023 However, this type of compensation is not an entirely new innovation. Of 105 investment companies with management contracts during the period 1927-35, seventeen provided compensation to the manager based on a percentage of earnings, with the percentage ranging as high as twenty-five per cent. INVESTMENT TRUSTS III 1922 & n.245.

Cf. *DeRenzis v. Levy*, 37 U.S.L.W. 2560 (S.D.N.Y. Mar. 19, 1969).

1024 WHARTON REPORT 480.

1025 See Appendix A *infra*.

1026 Certainly one of the most astonishing comments voiced on this subject is that of Allan Conwill: "If the fund measures up to that objective [*i.e.*, performs well], I do not think it is mandatory to take advantage of the economies of size." Statement of Allan F. Conwill, *University of Pennsylvania Law School Conference on Mutual Funds*, 115 U. PA. L. REV. 659, 764 (1967).

1027 As Mr. Pomerantz has commented, "I would think, if you are going to have a system of rewards, the connotation is that the system, to use a harsh word, have punishments, or the opposite of rewards, whatever it is — demerits." *Id.* at 767.

performance fee include penalties proportionate to possible bonuses,<sup>1028</sup> thus proscribing the arrangements of many companies listed in Appendix A. A one year period for adjustment would be allowed.<sup>1029</sup>

As noted, some funds calculate their management fee on a performance basis which is independent of any market index and independent of the performance results of other funds. Appendix A shows that this type of fee generally depends on net realized capital gains of the fund, and is employed by eight funds. (A ninth fund bases its fee on dividend income alone.) There are, however, basic deficiencies in this method of determining performance fees. The most obvious, of course, is that a manager may simply ride the tide of a rising market, and even though he performs well below the market averages, he will still receive bonus compensation. Conversely, even the best manager in a rapidly declining market, in spite of the fact that he may have upheld the value of the fund's shares far more effectively than managers of other funds, may be penalized or receive no additional compensation if not able to show positive gains.

As already indicated, a performance fee could be based on an index of other funds having similar investment objectives,<sup>1030</sup> although none of the funds represented in Appendix A do so. The principal difficulties with this approach are that advisors who outperformed the market might be penalized if other advisors excelled, while a fund could do poorly but its advisor be rewarded with a bonus if other managers did even worse.<sup>1031</sup> The former consideration would

1028 S. 34, 91st Cong., 1st Sess. § 25 (1969); S. 296, 91st Cong., 1st Sess. § 25 (1969). In the course of amending sections 203(b) and 205 of the Investment Advisers Act, 15 U.S.C. §§ 80b-3(b), 80b-5 (1964), to eliminate an exemption granted to advisors whose only clients are investment companies, bills in the Ninetieth Congress would have outlawed performance fees based on a share of capital gains or capital appreciation of the fund. S. 1659, 90th Cong., 1st Sess. §§ 25, 26 (1967); H.R. 9510, 90th Cong., 1st Sess. §§ 25, 26 (1967); H.R. 9511, 90th Cong., 1st Sess. §§ 25, 26 (1967). The change was first introduced in 1968, S. 3724, 90th Cong., 2d Sess. § 25 (1968), with the blessing of the Commission. 1967 *House Hearings* 79.

1029 S. 34, 91st Cong., 1st Sess. § 29 (1969); S. 296, 91st Cong., 1st Sess. § 29 (1969).

1030 This index would relate the performance of one manager to that of many funds. Something of the same philosophy — although not, strictly speaking, involving a performance fee — can be seen in arrangements which relate the performance of several managers to a single fund. The cornerstone of both systems is competition between managers. The most recent annual report of the SEC informs us that two registrant funds propose to employ multiple advisors. For the fund which is already offering shares to the public, the assets are allocated by a "principal manager" to several independent portfolio managers so that each of the independents manages a portion of the fund's entire portfolio. "New money received from the continuous offering of the fund's shares," we are told, "will be allocated, on the basis of respective investment performances, among those portfolio managers who have outperformed the Dow-Jones Industrial Average during the preceding four quarters." 34 SEC ANN. REP. 130 (1968). (It appears that the fund which the SEC spoke of is Competitive Capital Fund, Inc., which uses five independent portfolio managers. COMPETITIVE CAPITAL FUND, INC., PROSPECTUS, Nov. 1, 1968, at 3-4.) Although the fees paid to the independent managers are relatively modest, the total cost of this aggressive arrangement is likely to be high due to the overriding fee paid to the "principal manager." 34 SEC ANN. REP. 130 (1968).

The pension plans of Illinois Bell Telephone, Eastman Kodak Co., and General Motors afford other examples of competing multiple managers. See FORTUNE, Nov. 1967, at 145.

1031 Another difficulty is the near impossibility of classifying funds to achieve uniformity within each class as to size, investment objective, trading and concentration policy, etc. See, e.g., FUNDSCOPE, February 1969, at 54.

Professor Herman notes that:

The variation in performance by time periods and by type of fund is so complicated that I would think this would really present immense difficulties. You could have very drastic fluctuations in compensation that, really, I don't think would be based on anything very sound. Statement of Dr. Edward S. Herman, *University of Pennsylvania Law School Conference on Mutual Funds*, *supra* note 1026, at 765.

make this method intolerable to advisors, while the latter is contrary to the interests of fund shareholders. Some illustrations are appropriate.

Of seventy aggressive-growth [go-go] funds in 1968, fifty-five outperformed the Dow-Jones Industrial Average. Nevertheless, forty-two of the seventy failed to outperform the average for the group. If bonus fees were based on outperforming the group average, it is apparent that twenty-seven managers who did better than the market generally but not better than the average would be penalized or receive no additional compensation.<sup>1032</sup> Whether advisors would accede to such an arrangement is at least problematical. An even more egregious example can be cited. Examining eleven growth funds specializing in insurance securities, we find that during 1968 every fund in the group outperformed the Dow-Jones Industrial Average. Nevertheless, seven of the eleven performed below the group average and would be ineligible for the contingent bonus because of the exceptional performance of a few.<sup>1033</sup>

On the other side of the question, the performance fee based on an index of funds may produce a curious result in that management could receive additional compensation though performing more poorly than a random portfolio. For example, in 1962 the adjusted net asset value of sixty-six growth funds declined an average of 18.3 per cent.<sup>1034</sup> In that same year, Standard and Poor's 500 Stock Index declined only 11.8 per cent unadjusted.<sup>1035</sup> Thus, although fifty-eight of the funds performed well below even the unadjusted index, thirty-six outperformed the group average and would have been eligible for bonus compensation.<sup>1036</sup>

As noted, most performance fees are based on a general market index,<sup>1037</sup> the most popular of which is the Dow-Jones Industrial Average.<sup>1038</sup> This is at least partly explainable by the composition of the hypothetical portfolio which determines the index. The thirty stocks in the average, numbering among their complement such issues as International Nickel, Standard Oil of New Jersey, General Motors, and American Telephone & Telegraph,<sup>1039</sup> have properly been called "the bluest of the blue chips."<sup>1040</sup> Standard & Poor's 500 [S&P], on the other hand, is a far more broadly based index, embracing 425 industrials, fifty utilities, and twenty-five rails, while the New York Stock Exchange Composite

1032 FUNDSCOPE, *supra* note 1031, at 46.

1033 *Id.*

1034 INVESTMENT COMPANIES 1968, at 114, 116 (L. Wessmann ed. 1968).

1035 *Id.* at 411.

1036 *Id.* at 114, 116.

1037 See Appendix A *infra*. Cf. Statement of James J. Lorie, 1967 House Hearings 411-21.

1038 See Appendix A *infra*. Since Dow-Jones is a simple arithmetic average of prices, [t]he influence of each issue upon the average is thus proportional to the magnitude of its price per share. As an illustration, in June, 1937, Standard Oil of New Jersey was selling at 65, Allied Chemical at 215. In the Dow-Jones averages the former received a weight of less than one-third the latter. Yet the market value of the common stock of the former was \$1,680 millions and of the latter \$476 millions. COWLES COMMISSION FOR RESEARCH IN ECONOMICS, COMMON-STOCK INDEXES 35 (1939).

1039 Other stocks in the average are Eastman Kodak; Chrysler; Sears, Roebuck; Procter & Gamble; Texaco; General Foods; International Harvester; United Aircraft; Anaconda; du Pont; Westinghouse Electric; Swift & Co.; Goodyear Tire; F. W. Woolworth; Owens-Illinois; American Tobacco; Standard Oil of California; General Electric; Johns-Manville; Aluminum Co.; American Can; International Paper; Allied Chemical; Union Carbide; Bethlehem Steel; U.S. Steel. INVESTMENT COMPANIES 1968, at 53 (L. Wessmann ed. 1968).

1040 Statement of Paul Samuelson, 1967 Senate Hearings 369.

Index [NYSECI] is the most plebeian of all, averaging all stocks on the exchange. During 1966, not exactly a banner year for common stocks, S&P declined 13.1 per cent, NYSECI declined 12.6 per cent, while Dow-Jones plummeted fully 18.9 per cent. The following year saw a 20.1 per cent gain in S&P, a 23.1 per cent gain in the NYSECI, but only a 15.2 per cent increase in Dow-Jones.<sup>1041</sup> This discrepancy continued through 1968 with S&P exhibiting an increase of 7.7 per cent and the NYSECI 9.4 per cent, while Dow-Jones was up only 4.3 per cent.<sup>1042</sup> It would seem, then, that the Dow-Jones Industrial Average has become the poorest "performer" among the major indices,<sup>1043</sup> making it correspondingly more attractive to managers whose compensation depends on outperforming the index by the maximum margin.

Regardless of the index used, any performance fee based on a market average has the inherent infirmity of disregarding risk. As Professor Wallich observed, when comparing fund performance with an index or an average of other funds,

proper measurement requires that risk be taken into account. Different funds deliberately seek different degrees of risk. They are thus not comparable in terms of their capital gains and current income alone.

Risk is usually measured by the variability of a portfolio, i.e. by the dispersion or range of its rate of return, taking capital gains and current income together. When risk is so measured, it turns out that indeed the mutual funds that accept higher risk have on average a higher rate of return. But it is also shown that an average of randomly selected portfolios will usually have a higher rate of return for a given risk, or a lower risk for a given rate of return, than mutual funds.<sup>1044</sup>

Even Mr. Jaretzki, long an industry champion, recognizes the risk factor when he states that the performance fee is "a rather dangerous method of compensation. I think it encourages speculation."<sup>1045</sup>

Under these circumstances, it is apparent that the advisors, in general, have the benefit of a very one-sided agreement. The facts support this observation. As Appendix B indicates, three performance fee funds had assets in excess of \$100 million at June 30, 1968. Managers of these funds garnered fees amounting to .63 per cent, .73 per cent, and 1.24 per cent of the funds' assets. This is certainly handsome booty.

Beginning with a comparatively high base fee, accepting the benefits of superior performance while assuming little or no risk of loss from inferior performance, and seldom if ever sharing the economies of scale to any degree, these

1041 INVESTMENT COMPANIES 1968, at 411 (L. Wessmann ed. 1968).

1042 N.Y. Times, Jan. 1, 1969, at 31, col. 8.

1043 Professor Samuelson refers to Dow-Jones as a "tired" index, far less valid as a market indicator than the newer, more comprehensive indices. 1967 Senate Hearings 370. The professor also points out that fund managers, once embarrassed by their inability to outperform Dow-Jones, vociferously protested any comparisons between the funds and the index. *Id.* at 369. Now that outperforming the blue chips is as simple as selecting a random portfolio, however, these same men are anxious to compare their performance records with the Dow-Jones Industrials. *Id.* at 371.

1044 1967 House Hearings 583; 1967 Senate Hearings 1061 (statement of Henry C. Wallich).

1045 Statement of Alfred Jaretzki, University of Pennsylvania Law School Conference on Mutual Funds, *supra* note 1026, at 765. See also 1967 Senate Hearings 368.



performance fees are, in the main, fine examples of the "heads I win, tails you lose" arrangements roundly condemned in 1940.<sup>1046</sup>

## 2. Operating Expenses Defrayed by Advisory Fee

Of course, the investment advisor is paid a fee primarily for the expertise he provides in the supervision of the fund's portfolio, but the same advisory fee may cover a potpourri of administrative services as well. However, the *Wharton Report* underscored the "considerable variation in industry practice as regards the allocation of administrative duties and expenses."<sup>1047</sup> Administrative services most often furnished by the advisor and fully or partially defrayed by the basic advisory fee include salaries and compensation of fund officers, office space for the fund, clerical and bookkeeping services, and determination of bid and ask prices. Services least often covered by the basic fee include custodial accommodations, stock transfer and dividend disbursement, audits, and reports to shareholders. The following table<sup>1048</sup> lists the administrative expenses covered by the advisory fees paid by a sample of one hundred funds. With minor variations in sequence, the data is in accord with the findings of the *Wharton Report*.<sup>1049</sup>

*Nonadvisory expenses covered by the advisory fees of 100 mutual funds<sup>a</sup>*

Expense <sup>b</sup>	Number of funds		
	Expense fully covered	Expense partially covered	Expense not covered
1. Salaries and compensation of officers	88	1	11
2. Occupancy and office rental	85	2	13
3. Clerical and bookkeeping	81	4	15
4. Determination of offering and redemption prices	71	1	28
5. Accounting services	65	1	34
6. Stationery, supplies, and printing	54	8	38
7. Registration and filing fees	40	4	56
8. Salaries and compensation of directors <sup>c</sup>	32	0	68
9. Legal fees	25	4	71
10. Reports to shareholders	25	2	73
11. Auditing services	16	2	82
12. Stock transfer and dividend disbursing fee	10	2	88
13. Custodian fee	4	2	94

<sup>a</sup> Selected, after eliminating funds with the same adviser, from externally managed mutual funds that filed annual reports with the Commission prior to Jan. 1, 1966, on form N-1R adopted on Jan. 25, 1965. See Investment Company Act Release No. 4151 (Jan. 25, 1965).

<sup>b</sup> Excludes expenses which were not covered by the basic advisory fee.

<sup>c</sup> Includes only directors who are unaffiliated with the adviser or principal underwriter.

1046 See S. REP. NO. 1775, 76th Cong., 3d Sess. 22 (1940).

1047 *WHARTON REPORT* 476. The *Report* further notes that "the act of 1940 does not require a precise statement of services to be rendered in exchange for the precisely defined compensation, and in a number of cases the contractual obligations of the adviser are vague." *Id.* at 476 n.33. See *Acampora v. Birkland*, 220 F. Supp. 527, 541-42, 544-47 (D. Colo. 1963).

It should be observed that pending legislation would require the management contract to describe precisely and *separately* the amounts to be paid for advisory services and for all other services. S. 34, 91st Cong., 1st Sess. § 8(a) (1969); S. 296, 91st Cong., 1st Sess. § 8(a) (1969).

1048 PUBLIC POLICY STATEMENT 91.

1049 *WHARTON REPORT* 477.

It should be observed that the expenses least often covered by the basic fee are among the most substantial non-advisory cost incurred by a fund. Specifically, only twelve advisors, in an SEC study of one hundred funds, bore any part of the cost for transfer and disbursing, and only six paid for custodianship of fund securities — services almost invariably furnished by a commercial bank or trust company. In 1964, the cost of these services among the twenty largest externally managed funds ranged from \$101,936 for Chemical Fund, Inc., to \$828,154 for Wellington Fund, Inc.<sup>1050</sup> This amounted to approximately 7.5 per cent of Chemical's total expenses and 13.4 per cent of Wellington's.<sup>1051</sup>

For some funds, especially in the larger complexes, the services rendered for the advisory fee may be more comprehensive. The IDS advisory contract, for example, requires that the advisor assume all normal operating expenses of certain of the funds in the complex.<sup>1052</sup> The funds in the Waddell & Reed, Inc., United Funds group have a similar arrangement, while the composite MAT fee<sup>1053</sup> paid by Insurance Securities, Inc., also covers all normal operating expenses of the funds.<sup>1054</sup>

Where all normal fund operating expenses are not covered by the basic advisory fee, two devices are common: the first is an "administrative fee," and the second (often combined with the first) is a "contractual limitation."

### 3. Operating Expenses Defrayed by Administrative Fee

The administrative fee is a separate charge levied against the fund by the advisor (or, in some cases, by the trustee or principal underwriter), and like the basic advisory fee it is usually based on a percentage of average net assets.<sup>1055</sup> This fee, not surprisingly, is intended to compensate the recipient for administrative services furnished to the fund,<sup>1056</sup> and may take several forms.

The first form, intended to cover all normal fund administrative expenses, is illustrated by the "recurring fee" charged to the Keystone Custodian Funds. The ten funds are organized as trusts with Keystone Custodian Funds, Inc., named as trustee.<sup>1057</sup> For investment advice, the trustee receives an annual fee of one-half per cent on the first \$150 million of combined net assets and a scaled-down percentage on the balance. The "recurring fee" is also computed on the

1050 PUBLIC POLICY STATEMENT 91-92, 91 n.34.

1051 See INVESTMENT COMPANIES 1968, at 163, 276 (L. Wessmann ed. 1968).

1052 MOODY'S 1968 BANK & FINANCE MANUAL 1091-96; 1967 Senate Hearings 756; 1967 House Hearings 467.

1053 MAT is an acronym for "management, administrative, and trusteeship" fee. PUBLIC POLICY STATEMENT 89. See *id.* at 89 n.26.

1054 *Id.* at 92.

1055 *Id.*

1056 To some of the directors who are asked to review and approve an administrative fee, this may come as a surprise. A director of a fund which pays such a charge was asked whether the purpose of the fee had ever been explained to him. He replied that he could not recall. 114 CONG. REC. 9496 (daily ed. July 26, 1968). When another director of the same fund was queried as to why he thought the charge should be levied, he answered "I don't know." "Q. Have you ever raised any questions about it? A. No. Q. Have you known that it was unusual? A. [N]o. Q. You have no idea of what the continuing fee is used for? A. No." *Id.*

1057 The trustee is not an investment advisor within the technical meaning of the Act. Investment Company Act of 1940 § 2(a)(19)(A), 15 U.S.C. § 80(a)-2(a)(19)(A) (1964). See note 1239 *infra*.

basis of combined assets, but at a rate of one-quarter per cent on the first \$500 million and a sliding scale thereafter.<sup>1058</sup> The individual trusts bear the cost of the fee pro rata.

A second type of administrative fee arrangement, covering only a portion of fund expenses, is illustrated by the trust agreement of the National Securities Series. The funds are registered as a single investment company trusted by the Bank of New York and issuing seven series of shares. Under the trust indenture, the Bank of New York provides custodial, dividend disbursing, and transfer services, for which it receives a fee of one-quarter per cent of the first \$60 million in assets.<sup>1059</sup> On assets in excess of \$60 million a progressively lower percentage applies.<sup>1060</sup> The company also pays a separate advisory fee to its investment advisor and sponsor, National Securities & Research Corporation.<sup>1061</sup> While the administrative fee in this case covers only those services specifically enumerated in the trust agreement, these are the fund's principal administrative burdens.<sup>1062</sup>

Axe-Houghton Funds A and B each pay a traditional advisory fee to their investment advisor, E. W. Axe & Co. In addition, both funds pay an administrative fee to the principal underwriter, Axe Securities Corporation, at a rate of .2 per cent on the first \$50 million in assets and thereafter on a sliding scale.<sup>1063</sup> While this case demonstrates the administrative fee paid to a separate underwriter, it should be observed that the fee does not cover the most important elements of expense — custodial fees, stock transfer fees, and dividend disbursing expenses.<sup>1064</sup>

#### 4. Contractual Limitations

The second device used to defray administrative expenses excluded from the basic advisory fee is the contractual limitation. This is nothing more sophisticated than a provision in the advisory contract calling for the advisor to absorb the fund's operating expenses to the extent that these exceed a specified limit.

In its simplest form, the device is well exemplified by Equity Fund, Inc. The fund pays an advisory fee to its investment advisor, Pacific Northwest Management & Research Company, at a rate of one-half per cent on its first \$250 million in assets and on a sliding scale thereafter. If, however, aggregate expenses of the fund exceed one per cent of the fund's average net assets, the advisor must absorb the excess.<sup>1065</sup>

The contractual limitation device may be coupled with the administrative fee quite simply. The Axe-Houghton Stock Fund, Inc. does precisely this. The Stock Fund pays its investment advisor, E. W. Axe & Co., the traditional

1058 INVESTMENT COMPANIES 1968, at 221 (L. Wessmann ed. 1968).

1059 NATIONAL SECURITIES SERIES, PROSPECTUS, July 29, 1968, amended Jan. 13, 1969, at 13-14.

1060 *Id.* at 14.

1061 The fee is computed at one-half per cent on the first \$410 million, and .375 per cent on the excess net assets annually. *Id.* at 12.

1062 See text accompanying note 1050 *supra*.

1063 INVESTMENT COMPANIES 1968, at 148 (L. Wessmann ed. 1968).

1064 These are borne independently by the fund and paid to the custodian and transfer agent, First National City Bank of New York. *Id.*

1065 MOODY'S 1968 BANK & FINANCE MANUAL 1114. Cf. WHEARTON REPORT 478.

one-half per cent advisory fee, and also pays a .2 per cent administrative fee to its principal underwriter. The administrative fee, however, does not cover fees of the custodian and transfer agent — Fiduciary Trust Company of New York and The Corporation Trust Company, respectively. At this point the contractual limitation may become effective so that if the fund's total expenses exceed one per cent of net assets, the difference is reimbursed to the fund by the advisor.<sup>1066</sup> The contractual limitation may also be combined with a performance fee arrangement, as in the case of Republic Technology Fund, Inc., Oppenheimer Fund, Inc., Ivest Fund, Inc., Fletcher Fund, Inc., Enterprise Fund, Inc., and several others.<sup>1067</sup>

### C. Analysis of Management Fees

#### 1. The Economies of Scale

Only an investment advisor with his back to the wall would be disposed to dispute the substantial economies of scale which inhere in the fund management process. The *Wharton Report*, through a meticulous analysis of operating ratios among corporate-form advisors, demonstrated clearly that operating ratios decline steadily as total assets under management increase. Moreover, where the advisor's business is confined to investment company management, the decline is even more rapid, as is apparent from the table<sup>1068</sup> below.

*Operating ratios of corporate investment advisers, by size of total assets managed, 1960-61*  
[In per cent]

Total assets managed (in millions)	Operating ratios <sup>a</sup> for advisers having —	
	Investment company clients only	Investment company and other clients
\$1 and under \$10	135.5	161.5
\$10 and under \$50	81.5	88.5
\$50 and under \$150	68.3	90.9
\$150 and under \$300	59.0	87.0
\$300 and under \$600	36.7	83.4
\$600 and over	48.8	71.2

<sup>a</sup> Total operating expenses as a per cent of total income.

The findings of the *Wharton Report* in this regard should not have surprised many. During the 1940 Senate hearings on S. 3580, Merrill Griswold, then Chairman of the Board of Massachusetts Investors Trust, uttered what has become classic idiom:

It is now almost axiomatic in the trust business that operating costs decline proportionately as the size of a trust increases. The experience of

1066 INVESTMENT COMPANIES 1968, at 148 (L. Wessmann ed. 1968).

1067 See Appendix A *infra*.

1068 WHEARTON REPORT 503.

shareholders of Massachusetts Investors Trust clearly proves this. With assets of \$13,000,000 in 1932, operating costs were \$11.02 per \$1,000 of net assets. By 1939, when the trust had grown to \$121,000,000, operating costs per \$1,000 of assets had been reduced to \$4.41, a decrease of 60 per cent from the 1932 figure.

This advantage of size from the shareholder's standpoint is also clearly evident from a study we have made of 22 representative open-end companies with assets ranging from about \$2,000,000 to about \$50,000,000.

[W]hether a company is a one-million-dollar company, a ten-million-dollar company, or a hundred-million-dollar company, it has to maintain an office, pay rent, pay for long distance telephone calls, retain experts, clerks, stenographers, all the numerous expenses that go with it; and those expenses do not go up proportionately. We maintain what we consider to be a very good research department. We have a number of men who receive good salaries, and a large staff. If our trust were half as large, if we were to do the same kind of an investment job, we could not fire one single one of those people.

It is our belief that further growth in the assets of Massachusetts Investors Trust would bring about still further reduction in proportionate costs of operation, with resulting benefit to all shareholders.<sup>1069</sup>

History has confirmed Mr. Griswold's predictions in every particular. From the figures cited in his testimony, MIT's expense ratio for 1932 was about 1.1 per cent; by 1939 that had declined to .44 per cent. In 1957, MIT's total net assets had increased to over \$976 million while its expense ratio had been more than halved again, to .21 per cent.<sup>1070</sup> As of June 30, 1968, MIT had over \$2.3 billion in assets, with a further reduction in expense ratio to .19 per cent.<sup>1071</sup> It should be noted that this is an expense ratio, and hence accounts for more than simply the cost of portfolio management.

In its *Public Policy Statement*,<sup>1072</sup> in its statement before the Senate Committee,<sup>1073</sup> and again before the House Subcommittee,<sup>1074</sup> the SEC cited the record of The Dreyfus Corporation to dramatically underscore the economies of scale inherent in the fund advisory business:

The Dreyfus Corp. is investment adviser to The Dreyfus Fund, which grew from net assets of \$171 million at year end 1960 to \$1.1 billion at September 30, 1965.<sup>[1075]</sup> The advisory fees received by The Dreyfus Corp. almost tripled, increasing from about \$1.2 million in 1961 to \$3.4 million in 1964. During the same period operating expenses allocable to the advisory fees rose at a much slower rate. Those expenses increased from \$469,000 in 1961 to \$846,000 in 1964. Thus, the operating ratio of The Dreyfus Corp. declined from 39 percent in 1961 to 25 percent in 1964. For the first 9 months of 1965, its operating ratio declined further to 21 percent.<sup>1076</sup>

1069 Testimony of Merrill Griswold 1940 Senate Hearings 498.

1070 INVESTMENT COMPANIES 1968, at 229 (L. Wessmann ed. 1968).

1071 NUVEEN CORP., MUTUAL FUNDS PANORAMA (1968).

1072 PUBLIC POLICY STATEMENT 95-96.

1073 1967 Senate Hearings 132 (without naming the company).

1074 1967 House Hearings 35 (without naming the company).

1075 \$2.4 billion at June 30, 1968. NUVEEN CORP., MUTUAL FUNDS PANORAMA (1968).

1076 PUBLIC POLICY STATEMENT 95-96.

The Commission admits that such pronounced examples are not necessarily typical, but counters that the available data on other advisors clearly indicates "significant" economies of scale.<sup>1077</sup>

There is one fund complex which provides us with laboratory conditions for determining the actual cost of fund management. This complex, commonly known as the "Broad Street Group," consists of six corporations:

- (1) Tri-Continental Corporation, a closed-end investment company;<sup>1078</sup>
- (2) Broad Street Investing Corporation, an open-end investment company;<sup>1079</sup>
- (3) National Investors Corporation, an open-end investment company;<sup>1080</sup>
- (4) Whitehall Fund, Inc., an open-end investment company;<sup>1081</sup>
- (5) Union Service Distributor, Inc., which acts as wholesale distributor of the three open-end funds;<sup>1082</sup> and
- (6) Union Service Corporation, which acts as investment advisor to all the investment companies in the complex, and which provides investment research, economic analysis and supervision of portfolio acquisitions and liquidations.<sup>1083</sup>

Union Service Corporation [Union] is jointly owned by the four investment companies in the complex. Union's function is to provide investment management as well as certain administrative services, including accounting, bookkeeping and budgetary services, office space, and preparation of shareholder reports and proxy materials.<sup>1084</sup> Each investment company pays separately for its own officers' and executives' salaries, stock transfer, custodial, dividend and capital gains disbursing, legal and auditing services, taxes, the cost of printing and mailing shareholder communications, and holding of shareholder meetings.<sup>1085</sup> Since the most substantial of these are the costs least often covered by the advisory fee for other funds, the services provided by Union are comparable to those typically furnished by an external investment advisor under the basic advisory fee.<sup>1086</sup>

1077 *Id.* at 96.

1078 Tri-Continental Corporation merged in 1967 with Tri-Continental Financial Corporation, formerly its wholly owned subsidiary, which, in turn, was whole owner of its own subsidiary, Broad Street Sales Corporation. Since the merger, of course, Broad Street Sales Corporation is a wholly owned subsidiary of Tri-Continental Corporation. Compare 1967 *House Hearings* 686 with MOODY'S 1968 BANK & FINANCE MANUAL 1037.

1079 A common stock fund, Broad Street Investing's objective is income with growth. BROAD STREET INVESTING CORPORATION, 1968 ANNUAL REPORT 4 (page proof ed. 1969).

1080 Also a common stock fund, National Investors strives for long term growth. NATIONAL INVESTORS CORPORATION, 1968 ANNUAL REPORT 4 (page proof ed. 1969).

1081 Whitehall is a balanced fund. WHITEHALL FUND, INC., 1968 ANNUAL REPORT 4 (page proof ed. 1969).

1082 Union Service replaced Broad Street Sales Corporation as distributor on November 30, 1968. *Id.* at 17.

1083 Union Data Service Center, Inc., a wholly owned subsidiary of Union Service Corporation, was organized to provide data processing and all functions formerly performed for the funds by agent banks, except custodianship. Like Union Service, Union Data operates at cost. *Id.* at 6, 18.

1084 *Id.* at 18.

1085 *Id.* at 15; BROAD STREET INVESTING CORPORATION, 1968 ANNUAL REPORT 19 (page proof ed. 1969); NATIONAL INVESTORS CORPORATION, 1968 ANNUAL REPORT 19 (page proof ed. 1969); TRI-CONTINENTAL CORPORATION, 1968 ANNUAL REPORT 27 (1969).

1086 See text accompanying note 1049 *supra*.

The unique feature of this arrangement, however, is that Union provides these services *at cost*.<sup>1087</sup> Each fund simply pays Union a sum which represents its pro rata share of Union's total expenses. Thus we have an excellently controlled situation in which to segregate the actual cost of the management function.<sup>1088</sup>

*Expenses of Broad Street Group*<sup>1089</sup>

Year	Average Net Assets (Thousands)	Management Expense <sup>a</sup> (Thousands)	Management Expense Ratio <sup>b</sup> (%)	Total Expense (Thousands)	Expense Ratio (%)
1968	1,837,971	1,877	.10	3,503	.19
1967	1,596,016	1,620	.10	3,064	.19
1966	1,460,807	1,602	.11	2,564	.17
1965	1,411,438	1,543	.11	2,358	.17
1964	1,254,184	1,432	.11	2,263	.18
1963	1,085,623	1,378	.13	2,261	.21
1962	1,029,330	1,302	.13	2,092	.20
1961	939,492	1,208	.13	1,948	.21
1960	770,980	1,182	.15	1,856	.24
1959	681,008			1,633	.24
1958	552,144			1,497	.27
1957	474,047			1,415	.30
1956	451,979			1,207	.27
1955	388,590			1,085	.28
1954	301,144			997	.33
1953	253,357			912	.38

<sup>a</sup> Equals total expenses of Union for year indicated.

<sup>b</sup> Management expense as per cent of average net assets.

1087 Since Union furnishes its services at cost, it is not an investment advisor within the language of the Act. Investment Company Act of 1940 § 2(a)(19)(B)(iii), 15 U.S.C. § 80a-2(a)(19)(B)(iii) (1964).

1088 Although Union operates on a non-profit basis, its executives, managers, and staff members certainly do not. Union employs 120 people to operate the four investment companies. TRI-CONTINENTAL CORPORATION, 1968 ANNUAL REPORT 34 (1969).

1089 Sources: 1967 House Hearings 686; MOODY'S 1968 BANK & FINANCE MANUAL 1038, 1040-42; TRI-CONTINENTAL CORPORATION, 1968 ANNUAL REPORT 26-27 (1969); BROAD STREET INVESTING CORPORATION, 1968 ANNUAL REPORT 19-20 (page proof ed. 1969); WHITEHALL FUND, INC., 1968 ANNUAL REPORT 15-16 (page proof ed. 1969); NATIONAL INVESTORS CORPORATION, 1968 ANNUAL REPORT 19-20 (page proof ed. 1969); NATIONAL INVESTORS CORPORATION, PROSPECTUS, May 1, 1968, at 3.

EXHIBIT I

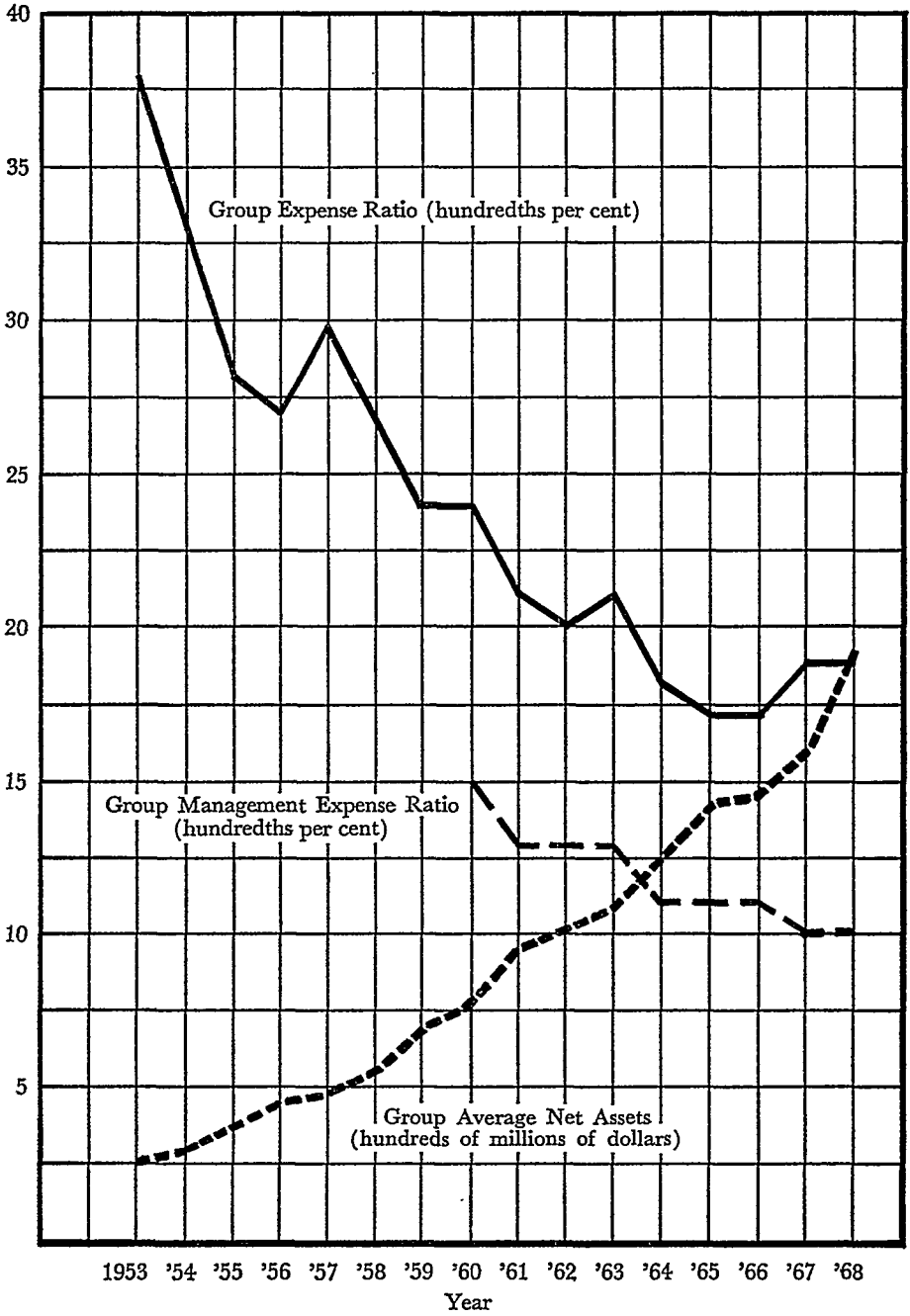




Exhibit I graphically displays the trends recognizable in the data of the above table. While average net assets of the funds increased by 151 per cent between 1960 and 1968, the total dollar cost of management furnished by Union increased only fifty-nine per cent. The relative stability of management cost combines with soaring net assets to produce a direct index of the economies of scale. On the graph and table this is illustrated by the declining "management expense ratio."

## 2. Effect of Economies of Scale on Management Fee Rate

The example of the Broad Street Group indicates the actual cost involved in furnishing typical advisory services in a fully operational complex. It is interesting to compare these figures with advisory fees paid by other funds. To provide a basis for comparison, Appendix B is constructed to show an "advisory fee rate" expressed as a per cent for eighty-seven externally managed funds with assets over \$100 million. The "advisory fee rate" is the ratio of advisory fees paid to average net assets for the fiscal year, and is thus directly comparable to the "management expense ratio" used in the analysis of the Broad Street Group. The advisory fee rate has the virtue of reducing sometimes complex formulae for the computation of individual fees to a simple percentage of net assets.<sup>1090</sup>

Since the Broad Street group embraces a relatively large pool of assets under common management, we should begin the comparison by examining the largest funds in Appendix B. Among the twenty largest externally managed<sup>1091</sup> funds, advisory fee rates range from a high of .63 per cent to a low of .23 per cent. This range has a mean of .43 per cent, a median of .40 per cent, and an average of .40 per cent. Contrasting these with the .10 per cent management expense ratio of the Broad Street Group, we note that the externally managed funds spend nearly four times as much for management. Continuing the comparison, the entire range of fee rates shown in Appendix B has a mean of .47 per cent, a median of .50 per cent, and an average of .47 per cent. This type of comparison leads one to suspect that the economies of scale among externally managed funds and fund complexes have not inured to the benefit of anyone save the advisor.

The definitive study of this phenomenon is still the *Wharton Report*. That report showed that in 1960, nearly eighty per cent of advisory fees charged to mutual funds were computed on a flat rate basis, making no allowance for the size of assets under management. At the same time, investment advisors applied a fee rate scaled by asset size or directly negotiated to over seventy-five per cent of their non-fund clients.<sup>1092</sup> Furthermore, the *Wharton Report* was not able to justify the differences in fee rates charged to fund and non-fund clients on the basis of the advisor's cost. Despite vociferous objection from the industry that

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1090 For this reason it is called, in the *Wharton Report*, the "effective fee rate." For more detailed description of *Wharton's* method of computation, see *WHARTON REPORT* 484.

1091 This excludes Massachusetts Investors Trust, Massachusetts Investors Growth Stock Fund, Inc., and National Investors Corporation, which are internally managed funds not listed in Appendix B.

1092 *WHARTON REPORT* 480-81.

it is more expensive for an advisor to handle a large fund account than to service a non-fund account,<sup>1093</sup> the *Report* concluded from the facts that the opposite is true:

[F]or each size class of investment advisers (classified by size of total assets managed) the total operating expense ratios are sharply higher in those cases where income is received from both investment company and noninvestment company clients, than in cases where the adviser is managing investment company assets only. . . . [W]ithin each of these asset size classes the total operating expense ratios increase fairly consistently with increases in the percentage of the total advisory income received from noninvestment company clients.<sup>1094</sup>

This pronounced tendency of operating ratios to correlate positively with an advisor's concentration in non-fund business points up the fact that fund management is, comparatively at least, a most lucrative enterprise. Recognizing that a definite absence of arm's length bargaining could be implied from these findings,<sup>1095</sup> the report was at pains to meticulously test and retest its conclusion that fee rates charged to the funds were not responsive to increased asset size.<sup>1096</sup>

It was still true at the time of the *Wharton Report* that "[t]he effective fee rates charged open-end companies tended to cluster heavily about the traditional rate of .5 per cent per annum of average net assets,"<sup>1097</sup> a condition generally unchanged from that prevalent in 1940.<sup>1098</sup> The advisory fee rates shown in Appendix B bear witness to this monumental inertia, for the median of those rates is still .50 per cent, or nearly five times the management expense ratio of the Broad Street Group.

### 3. Industry Defense of Fee Structure

Investment advisors indefatigably insist that theirs is a fiercely competitive profession. When compelled to defend his fee an advisor may display a Pavlovian reflex, the word *competition* spewing from his lips:

Mr. ALGER. We [advisors] view it [the fund share] as a product which we are just trying to —

Mr. KEITH. Yes.

Mr. ALGER. I mean that is the way we view it.

Mr. KEITH. The SEC does not think this is healthy.

Mr. ALGER. Well, there is such tremendous competition. How can something be unhealthy which is so tremendously competitive? . . .

I mean you can only describe it in competitive terms. . . .

1093 *See Id.* at 492.

1094 *Id.* at 495.

1095 *Id.* at 481 n.39.

1096 *Id.* at 484-91.

1097 *Id.* at 28.

1098 "The usual fee is one-half of 1 percent annually of the asset value of the fund." Testimony of Mahlon E. Traylor, 1940 *Senate Hearings* 453. *See also* INVESTMENT TRUSTS III 1922 (prior to 1935).

... I mean no one is making an awful lot of money. . . .

... I mean management companies really are not very profitable. That is the fact of it.<sup>1099</sup>

These contentions do not merely invite inquiry, they fairly implore investigation. From the standpoint of practical economics, strong competition among advisors for a fund's advisory contract is highly unlikely. This is partly due to the extreme dependence of a fund on its present advisor-underwriter. As we have already seen, the advisor generally supplies most, if not all, of the fund's officers and usually pays their salaries as well. He may control the fund's underwriting mechanism, without which it would cease to grow. He likewise provides the fund's clerical staff, bookkeeping personnel, and accounting services. In most cases the fund depends on its advisor for its very office space.<sup>1100</sup> The dependence of the fund on its advisor is so complete, and its control by the advisor so nearly absolute, that the *Wharton Report* was disposed to characterize the difference between them as "strictly legal."<sup>1101</sup> This reliance leaves little room for arm's length negotiation of the advisory contract, since the fund is not in an economic position to strike out on its own in search of a new advisor.<sup>1102</sup> Given the completely captive client, and the knowledge that other funds are securely locked in their own advisors' desk drawers, there is little incentive for an advisor to

1099 Testimony of Fred M. Alger, 1967 *House Hearings* 506-07.

1100 The court in *Acampora v. Birkland*, 220 F. Supp. 527 (D. Colo. 1963) observed: The closeness of the relationship between Fund and Management is to be especially noted. Fund grew up under Management's sponsorship. Through the years they have shared office facilities and have oftentimes shared employees as well as officers, directors and managers. *Id.* at 534.

Other courts have recognized and remarked upon the closeness of this relationship and the position of extreme dependence occupied by the fund:

The links between Mutual [a fund] and IDS [its advisor] are very close. Mutual was actually organized by IDS as evidenced by the following statement at page 20 of the prospectus: "Investors organized and is principal underwriter and investment manager of Investors Mutual, Inc." The two companies share the same principal office in Minneapolis, Minnesota. The entire business of Mutual is conducted exclusively by IDS. There is a considerable interlock between their directors and officers (prospectus, pp. 18-19). The prospectus (front cover and p. 2) describes Mutual as being "affiliated" with IDS. With respect to the sale or distribution of the stock of Mutual, "its shares have been distributed exclusively by" IDS, pursuant to distribution agreements between the two companies. Applications for shares of Mutual are solicited by representatives of IDS and are submitted to Mutual in Minneapolis for acceptance or rejection (*ibid.*). *Ackert v. Ausman*, 29 Misc. 2d 962, 964, 218 N.Y.S.2d 822, 824 (Sup. Ct. 1961), *aff'd mem.*, 20 App. Div. 850, 247 N.Y.S.2d 999 (1964).

1101 *WHARTON REPORT* 463.

1102 A theme very often repeated in the 1967 *Senate Hearings* and 1967 *House Hearings* is that any refusal to accept the management contract as dictated by the incumbent advisor would be disastrous for the fund. Thus, the unaffiliated directors and the shareholders, even assuming that some are so inclined, are left to steer between a Scylla and Charybdis if they are dissatisfied with the management's terms. They may choose an onerous contract on the one hand or corporate chaos on the other, for to reject a proposed contract is to eviscerate the fund. There is no middle course. It is submitted that the law should not countenance such an inequitable and completely unchecked stranglehold. *See, e.g.*, statement of Donald E. Schwartz, 1967 *House Hearings* 818-19:

Shareholders of a fund are asked, by means of a proxy statement to approve of the appointment of an advisor at a specified fee or to disapprove. They are left with no alternatives in between. They cannot renegotiate the fee imposed by the advisor. The mutual fund shareholder is not in the same position as a shareholder in other corporations in this matter. Elsewhere, he may feel free to reject a submitted transaction without fear of disrupting the corporation. If the mutual fund shareholders

narrow his profit margin in order to attract other investment company clients and even less incentive for him to lower the price to his captive fund.

That advisors do not, in fact, seek to lure other funds is conceded by the industry. If directly confronted and unable to avoid the issue, the advisor's tendency is to simply equivocate on the content of the word *competition*. For example, the following dialogue took place:

Mr. MOSS. . . .

Do they [fund directors] cover offers from other managers?

Mr. LOEFFLER. They have had no occasion to do [so], sir.

. . . .

Mr. MOSS. Can you cite me any instance in any fund where that has happened?

Mr. LOEFFLER. . . . Generally speaking, sir, it does not happen, and I do not mean to contend, and would not suggest, that the unaffiliated directors of the funds . . . should sit down and say, "We can get a better deal from another management company . . . . Therefore, we shift over here."

Mr. MOSS. They do not really know, do they, because they do not invite any competing offers —

Mr. LOEFFLER. It is all published, sir.

Mr. MOSS (continuing). Or proposals?

Mr. LOEFFLER. This information is all published.

Mr. MOSS. Do they entertain any proposals?

Do you go out and submit proposals to other funds?

Mr. LOEFFLER. To other funds?

Mr. MOSS. To undertake management activities for them?

Mr. LOEFFLER. No, sir.

Mr. MOSS. You do not.

Mr. LOEFFLER. We have never considered this.

Mr. MOSS. Do you know of anyone else who does?

In other words, we are going to use terms here. I think if we are going to talk about competition, let's bring it down to —

Mr. LOEFFLER. That would be one form of competition and I am not contending that that form —

Mr. MOSS. I am using it more or less in the orthodox sense. Do you actually compete in that market for that particular account? . . .

Now it is in a different sense that you use the word "competition" here, is it not?

Mr. LOEFFLER. It is a different form of competition . . . yes, sir.<sup>1103</sup>

The competition to which the industry refers is a rivalry for investor favor, and the focus is on sales. "What we compete for essentially is the investor dollar of the customer, the ultimate customer."<sup>1104</sup> This approach views the investment company as a mere legal technicality — a set of finely drafted papers to be placed in an advisor's desk drawer for safekeeping — the only function of which is to provide a mechanism whereby the advisor may market a product: the

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reject an investment advisory contract, the fund is left with no management at all. Most important, of course, in an uncontested election, it is common knowledge that he who controls the proxy machinery can obtain the approval of anything he seeks; at least, there is no record of any experience to the contrary. That important legal consequences as to the meaning of the vote should flow from this exercise is the sheerest of legal casuistry.

1103 1967 House Hearings 479-80.

1104 *Id.* at 480.

“mutual fund share.” On this view, management profit is considered an element of the ultimate price of the product — a cost borne directly and individually by the consumer. Since there are myriad funds among which the purchaser may choose, so the argument goes, management compensation is effectively regulated by the economic forces of the marketplace.

#### 4. Validity of Industry Position

The validity of the industry's contention, overlooking for the moment the legal infirmity of the theory upon which it is based, depends first on the consumer's awareness of management costs. Generally, it might be expected that prospectus disclosure of the management fee would be sufficient to allow the competitive pressures of the marketplace to operate, thus leading to management compensation limited by economic forces. There are several reasons why this mechanism does not effectively function in the sale of investment company shares.

First, the unique distribution system described in Part IV, whereby shares are aggressively marketed by commissioned salesmen, couples with the relatively unsophisticated characteristics of the typical purchaser of this investment medium to effectively minimize the investor's awareness of management cost. Professor Herman explained the salesman's de-emphasis of management costs this way: “The salesman could hardly stress differences in management fee rate (under 1%) without raising questions about differences in the much higher sales charge (8% or more).”<sup>1105</sup>

Among the internally managed funds and those externally managed complexes with extraordinarily low management costs, however, there is some effort to apprise the investor of fee rates. Among the funds in the Broad Street Group, for example, Tri-Continental, Broad Street Investing, and National Investors are careful to explain in their prospectuses<sup>1106</sup> and annual reports<sup>1107</sup> the management economies they realize through Union Service Corporation, and these funds invite cost comparisons with other investment companies. Giving due credit to these funds,<sup>1108</sup> which occupy an atypical niche, does not seriously detract from the validity of the general rule that there is seldom any concerted effort to draw attention to the management fee.

Secondly, for the few shareholders who are even cognizant of the advisory fee, the charge is likely to seem relatively inconsequential when compared to the sales load. Assuming a sales load of eight per cent and a flat management fee rate of one-half per cent, the costs on a \$5,000 investment are respectively \$400

1105 Statement of Edward S. Herman, 1967 *Senate Hearings* 729; 1967 *House Hearings* 814.

1106 *E.g.*, NATIONAL INVESTORS CORPORATION, PROSPECTUS, May 1, 1968, at 3.

1107 *E.g.*, BROAD STREET INVESTING CORPORATION, 1968 ANNUAL REPORT 10 (page proof ed. 1969).

1108 The credit can be overemphasized. It is probably still true that in spite of their willingness to spotlight management economies, the internally managed funds and those with otherwise low expense ratios do not succeed in actually alerting their investors to differences in operational costs. The *Special Study* found that seventy to eighty per cent of fund investors were totally ignorant of the expenses of their fund, and that investors in funds with extraordinarily low expense ratios were equally oblivious of the facts. SPECIAL STUDY IV 344.

and \$23 in the first year.<sup>1109</sup> The investor is, quite naturally, more concerned with the \$400 load which he bears immediately and directly than with the \$23 management cost which he bears only indirectly as an expense of the entire fund. The \$23 is probably seldom noticed, for it is only reflected as a reduced dividend or a depletion in capital at the end of the year. The relatively minor initial impact of the advisory fee on the individual shareholder tends to dilute further the argument that competition for investor favor has significant impact on fee rates.

Thirdly, the formulae used to determine the advisory fee may be so complex as to discourage investigation by the fund's investors. Such formulae may embrace breakpoints, recapture of brokerage, expense ratio limitations, some form of performance adjustments, administrative fees, or any imaginable combination of these. In addition, the services furnished by the advisor in consideration of his fee will vary widely from fund to fund, making comparisons the more difficult for an investor.

The industry itself recognizes this problem, and in a letter from NASD it is stated:

We recognize the statutory mandate and the practical need for the full and accurate disclosure that is presently published in the prospectus of each investment company. Viewed objectively, however, that disclosure is, in many instances, couched in such technical terminology as to obscure for the average reader the important differences between funds and some of the factors that he should consider in making his investment decision. In many cases, no doubt, the prospectus is so formidable as not to encourage the interest and attention of the customer.<sup>1110</sup>

## 5. Statutory Regulation

### a. Introduction

The lack of competition and arm's-length bargaining in the negotiation of an advisory contract is attributable to more than simple practical considerations. There lies at the root of the problem a fundamental legal deficiency, and this is our main concern.

The *Wharton Report* emphasized a fact which every advisor knows — that there is a minimum size of assets which must be under management if the advisor is to make a profit.<sup>1111</sup> Thus a fledgling fund may be a money loser for some time before it reaches a profitable size. If the fund-advisor relationship is unstable for some reason, the advisor will have less expectation of recouping his initial losses, and hence less incentive to organize and promote a fund. Since the fund, as it grows beyond critical size, may well become a very profitable client, the advisor has a vested interest in insuring maximum possible stability in the

<sup>1109</sup> The management cost is calculated at one-half per cent of \$4,600, the amount actually invested after deduction of the sales load. The example makes no allowance for appreciation of the investment company's portfolio, nor does it adjust for reinvested distributions, factors which would revise the management cost slightly upward.

<sup>1110</sup> Letter from R. M. Gardiner to Hastings Keith, Nov. 7, 1967, reprinted in *1967 House Hearings* 378.

<sup>1111</sup> *WHARTON REPORT* 503.

relationship. This he is able to do by installing himself and his affiliates on the fund's board of directors and by dubbing himself and his friends officers of the fund.

There are limits, however, on the closeness of this affiliation (alternatively called "business incest"<sup>1112</sup>), and those limits are directly imposed by the Investment Company Act. S. 3580 would have mandated that no more than a *minority*<sup>1113</sup> of an investment company's board of directors or advisory board could be composed of the company's managers, investment advisors, brokers, underwriters, or their affiliates.<sup>1114</sup> H.R. 10065, the bill which ultimately became law,<sup>1115</sup> however, reflected an obvious compromise with the industry,<sup>1116</sup> since it permitted the advisor, his affiliates, and the fund's managers to occupy a majority (up to sixty per cent) of the seats on the company's advisory board and board of directors.<sup>1117</sup>

This situation, in which the advisor or members of the management organization staff a fund and sit on its board of directors, generates a very obvious conflict of interest in the fixing of management compensation. On the one hand, there is a personal interest in the advisor and his associates to maximize the profits of the advisor, while on the other hand there is a fiduciary duty owing to the shareholders of the fund to obtain management services on the most favorable terms. Moreover, in some instances the conflict may escalate beyond self-interest to embrace conflicting fiduciary duties owed to two sets of public shareholders. This would be the case where the advisor is a publicly owned corporation<sup>1118</sup> and there is an interlock between the fund's board of directors

1112 Note, *The Mutual Fund and Its Management Company: An Analysis of Business Incest*, 71 YALE L.J. 137 (1961); Statement of Abraham Pomerantz, *University of Pennsylvania Law School Conference on Mutual Funds*, *supra* note 1026: "[O]f all dualities and of all conflicts on this scene, nothing—but nothing—approaches the open end mutual fund [sic] for incestuous relationships." *Id.* at 739.

1113 S. 3580, 76th Cong., 3d Sess. § 10(a) (1940). The bill would also have prohibited majority interlocks between an investment company and any other company, including another investment company. Thus, an advisor with more than one fund would have been prohibited from using the same men on more than one board to satisfy the unaffiliated director requirement. *Id.* For a discussion of the reasons for S. 3580's failure to become law, see North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME LAWYER 677 (1969).

1114 The original definition of "affiliated person," S. 3580, 76th Cong., 3d Sess. § 45(18) (1940), is similar to that presently contained in the Act. See note 1141 *infra*.

1115 86 CONG. REC. 9819 (1940) (passed House); 86 CONG. REC. 10071 (1940) (passed Senate); 86 CONG. REC. 10949 (1940) (signed by the President, Aug. 22, 1940).

1116 The compromise took place off the record. Initially Mr. Schenker noted that the interlock provision of S. 3580 was itself the product of a compromise:

There is nothing here that prevents a minority interlock; and I thought after we discussed this with the industry we had made a very substantial concession, because Senator, we feel, as many people in the industry feel, that even to have one interlocking director creates problems. 1940 Senate Hearings 879 (speaking of broker

interlock).

The industry, however, was not yet appeased; and Arthur Bunker, speaking on behalf of a committee of investment companies, advocated that a sixty per cent interlock be permitted. 1940 Senate Hearings 1055. Bunker's demand was made on Friday, April 26, as the last testimony preceding an adjournment of the hearings. During the hiatus the industry and the SEC negotiated on many facets of the legislation, ultimately arriving at an armistice. 1940 Senate Hearings 1105-07 (testimony of Robert Healy). Schenker made the formal announcement of the SEC's concession, which gave Bunker and his allies their sixty per cent. 1940 Senate Hearings 1113.

1117 H.R. REP. NO. 2639, 76th Cong., 3d Sess. 14 (1940).

1118 Of principal corporate-form advisors, the stock of Anchor Corporation is held by 2,924 shareholders; Channing Financial Corporation by 2,614; The Dreyfus Corporation by

and the advisor's. Clearly, the common directors in this situation are under pressure to serve two masters<sup>1119</sup> with irreconcilable interests.

The Investment Company Act attempts to deal with this problem in a crude sort of way — by defining certain functions of the unaffiliated directors. Section 15(c) of the Act requires that a majority of the directors who are not parties to the contract or affiliates of any party to the contract must initially approve the terms of the agreement and must further approve any renewal unless ratification is supplied by a majority vote of the fund's shareholders.<sup>1120</sup> Whether this provision is adequate to protect shareholders against over-reaching by the advisor and whether the injection of unaffiliated directors has actually produced an arm's-length bargaining element in contract negotiations is the fundamental question.

### b. Investment Advisor Control of Fund

As previously noted, the advisor usually organizes and promotes the investment company in the first instance.<sup>1121</sup> The *Wharton Report* observed that, "[t]ypically, a charter to do business is obtained, officers and directors are selected, and an investment advisory or management contract is entered into by the promoter-management group, before any securities are sold."<sup>1122</sup> Or, if the reader prefers the somewhat more colorful language of Mr. Pomerantz:

Now, this is about the birds and the bees of the American corporate scene . . . .

The fund is conceived by a bunch of people whom we call advisers or

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6,554 (Dec. 31, 1966); Insurance & Securities Inc. by 11,000 (June 30, 1965); Investors Diversified Services, Inc. by 12,796 (including Alleghany Corporation); Keystone Custodian Funds, Inc. by 2,138; National Securities & Research Corporation by 2,984; Supervised Investors Services, Inc. by 886 (Dec. 11, 1967); Vance, Sanders & Co. by 4,500; Waddell & Reed, Inc. by 2,678; Wellington Management Co. by 3,400. MOODY'S 1968 BANK & FINANCE MANUAL 876, 917, 951, 1013, 1057, 1067, 1085, 1102, 1117, 1120, 1135 (stockholders as of Dec. 31, 1967, except as indicated).

While these figures hardly reveal the advisors to be corporate leviathans, neither are they exclusively closely held. Some, at least, represent a substantial public participation.

Legally, of course, it does not matter how widely the advisory corporation's shares are diffused. The advisor's directors owe the same fiduciary duties to the stockholders in the closely held corporation that they owe to stockholders in the publicly owned corporation. The difference is only pertinent to the public policy involved, for in the one case a public interest is opposed to the interest of a small group and more nearly approaches direct self-dealing, while in the other case the interests of two public groups are at odds. Hence, whatever difference there may be reposes only in the conscience of the common director, not in the law.

<sup>1119</sup> "No man can serve two masters; for either he will hate the one and love the other, or else he will stand by the one and despise the other." *Matthew* 6:24.

This statement was apparently too temperate for Justice Brandeis, who wrote:

The practice of interlocking directorates is the root of many evils. It offends laws human and divine. . . . Applied to corporations which deal with each other, it tends to disloyalty and to violation of the fundamental law . . . . [I]t tends to inefficiency; for it removes incentive and destroys soundness of judgment. It is undemocratic . . . substituting the pull of privilege for the push of manhood. L. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* 51 (1914).

<sup>1120</sup> Investment Company Act of 1940 § 15(c), 15 U.S.C. § 80a-15(c) (1964).

<sup>1121</sup> See text accompanying note 80, *supra*. "As a business enterprise the typical fund is unique from the moment of its inception, the circumstances of its formation to some extent foreshadowing its essential character and its difference from other types of companies." Lobell, *The Mutual Fund: A Structural Analysis*, 47 VA. L. REV. 181, 184 (1961). We would dispute the word *essential*.

<sup>1122</sup> WHARTON REPORT 66.



managers. . . . This group gives birth to the fund. The fund is manned by the advisers. If I may carry on this figure of speech, the umbilical cord is never cut after birth, as would be true in ordinary biological life.<sup>1123</sup>

Thus the advisor has virtually absolute control of the investment company's initial management. Moreover, one of the principal prerequisites of management is control of the corporate proxy mechanism, and by this means the advisor and his bedfellows are invariably able to retain their stranglehold on the fund, obtaining at will pro forma shareholder ratification of management contracts and election of hand-picked directors.<sup>1124</sup>

The effectiveness of management's control of the proxy is well illustrated by the *Wharton Report's* analysis of 107 mutual fund elections in 1958:

Having occupied the strategic positions within the organization at its inception, the management group is able to preserve its control over the investment company as an almost automatic consequence of management control over the proxy machinery. Personal attendance of shareholders at annual meetings of open-end companies has been unusually small, and shareholder voting at annual elections has been almost invariably carried out by means of proxies turned over to the management proxy committee.<sup>1125</sup>

*Percentage of voted shares voted by the management proxy committee, for 107 companies, by size of open-end company assets, 1957*  
[Dollar amounts in millions]

Percentage of shares voted	Open-end company assets								Total	
	1 and under 10		10 and under 50		50 and under 300		300 and over		Number of companies	Percent of companies
	Number of companies	Percent of companies	Number of companies	Percent of companies	Number of companies	Percent of companies	Number of companies	Percent of companies		
99 to 100	30	75.0	24	85.7	32	100.0	6	85.7	92	86.0
90 to 98.9	8	20.0	4	14.3	0	0	0	0	12	11.2
80 to 89.9	2	5.0	0	0	0	0	0	0	2	1.9
70 to 79.9	0	0	0	0	0	0	1	14.3	1	.9
Below 70	0	0	0	0	0	0	0	0	0	0
Total	40	100.0	28	100.0	32	100.0	7	100.0	107	100.0

As may be seen in the above table,<sup>1126</sup> management's proxy committee voted ninety per cent or more of all votes at the meeting in 97.2 per cent of all cases. In no case did the proxy committee control less than seventy-five per cent of the votes. Thus, we are told on eminent authority, "[l]egally, the proxy is an agent for the shareholder . . . . Factually, he is a dummy for the management, and is expected to do as he is told."<sup>1127</sup> The effectiveness of the proxy extends

1123 Statement of Abraham Pomerantz, *University of Pennsylvania Law School Conference on Mutual Funds*, *supra* note 1026, at 739.

1124 Even Mr. Jaretzki concedes that "the power to submit proposals to stockholders is the power to determine the issue submitted." Jaretzki, *Duties and Responsibilities of Directors of Mutual Funds*, 29 LAW & CONTEMP. PROB. 777, 792 (1964).

1125 WHARTON REPORT 68.

1126 *Id.* at 69.

1127 A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 245 (1933).

beyond the election of directors to embrace approval of management and underwriting contracts, an exercise in empty form with disproportionate legal consequences. Thus the advisor is able to control shareholder approval of his own dictated terms with such unfailing regularity that stockholder disapproval of an advisory agreement "has never happened."<sup>1128</sup>

The strength of management's control by proxy is dependent, of course, on shareholder acquiescence. As we have seen, fund shares are usually widely distributed among a myriad of small, relatively unsophisticated investors. Arguably, this factor combines with the redeemability of fund securities to further explain the shareholders' supine posture.<sup>1129</sup> It is, however, doubtful whether redeemability can be used to explain any extraordinary passivity on the part of fund shareholders, for similar mechanisms are found at work in other contexts. The redeemability factor is obviously inapplicable to the closed-end companies, whose shares must be traded on the market, yet there is no evidence that management control of closed-ends is any less tenacious than management control in the mutual funds. Moreover, stock of a closed-end as well as stock of an ordinary corporation is usually freely marketable, at least when listed on an exchange; and this outlet for minority shareholder dissatisfaction may be quite as effective as the redemption feature in the open-end case.<sup>1130</sup> Further, for the mutual fund shareholder to redeem and then reinvest in the shares of another fund under different management will typically involve a second sales load as well as realized capital gains<sup>1131</sup> — considerations which tend to impeach the redemption rationale as an explanation of stockholder passivity.

Whatever the reason, rarely must additional chairs be brought into the advisor's office in order to hold a meeting of thousands of shareholders.<sup>1132</sup> Naturally this permits perpetuation of the advisor-affiliated board, which in turn results in a striking family resemblance between officers and executives of the

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1128 1967 *House Hearings* 678. A theme which is repeated ad nauseam by wooden soldiers of the status quo and which is integrally bound up with the "shell theory" of mutual funds, *see* notes 1248-58 *infra* and accompanying text, maintains that the purchaser of a fund share is consciously purchasing the services of a particular management group. "The consumer in purchasing his shares in a mutual fund is purchasing its management—by name. To mention but a few of the best known, he is purchasing Fidelity, or *Wellington*, or Tsai . . ." 114 CONG. REC. S9409 (daily ed. July 25, 1968) (remarks of Senator Bennett) (emphasis added). Thus, we are expected to believe, shareholder ratification of management contracts ought to be "routine," for the fee is disclosed to the investor and "he is aware" of it when he makes his initial purchase and when asked to specifically approve the contract which provides it. *Id.* There is no such awareness. *See* note 1108 *supra*. Moreover, "technical terminology" of the prospectus is not, as implied by the NASD, the only villain. *See* text accompanying note 1110, *supra*. Certainly the name of a fund's advisor is not couched in "technical terminology," and in spite of the fact that Senator Bennett and others assume that a fund shareholder purchases stock in the belief that he is buying the advisor "by name," the court in *Taussig v. Wellington Fund, Inc.* was "surprised when two of defendants' expert witnesses, particularly knowledgeable in the investment company field, could not name Wellington Fund's investment adviser. *No greater knowledge can be imputed to the investing public.*" *Taussig v. Wellington Fund, Inc.*, 187 F. Supp. 179, 214 (D. Del. 1960) (emphasis added).

1129 WHARTON REPORT 64.

1130 In the case of an exceptionally large shareholding this may not be universally true. While a large block of fund shares may be easily redeemed, a shallow market may prohibit a profitable execution of a sizable transaction in the stock of a non-fund corporation. To this extent, the holder of a large block of stock in a non-fund corporation may have more incentive to participate actively when dissatisfied with management, for his alternative may be to depress a limited market, if, indeed, he can find a market at all.

1131 *Cf. Saminsky v. Abbott*, 40 Del. Ch. 528, —, 185 A.2d 765, 771-72 (Ch. 1961).

1132 WHARTON REPORT at 64 n.57.

fund on the one hand, and the advisor's consociates on the other. In the great majority of cases, affiliates of the advisor compose a majority of the fund's official and executive personnel.<sup>1133</sup> In the classic, if somewhat euphemistic, understatement of Mr. Jaretzki:

As the officers and personnel of the fund are normally persons from within the advisory organization, it follows that the investment adviser in such cases will be making recommendations to persons from its own organization acting also as officers or directors of the fund.<sup>1134</sup>

### c. Role of Unaffiliated Directors

This concentration of control in the incumbent, advisor-oriented management has important consequences in our consideration of the technically "unaffiliated" directors. As Judge Moore observed in *Brown v. Bullock*,<sup>1135</sup> "Directors are usually selected by and known to management; they are not self-appointed strangers."<sup>1136</sup> That they are not. In fact, the unaffiliated directors, nominated<sup>1137</sup> and elected through the proxy machinery by the incumbents, are "frequently" relatives, close personal friends, or business associates of the affiliates.<sup>1138</sup> Thus the affiliated directors are able to satisfy the requirements of the Investment Company Act by arranging for a friendly board whose "unaffiliated" members are independent only in a very artificial sense.<sup>1139</sup>

1133 *Id.* at 67-68.

1134 Jaretzki, *supra* note 1124, at 780-81.

1135 294 F.2d 415 (2d Cir. 1961).

1136 *Id.* at 424. Unaffiliated directors have testified that they were selected for board positions on such grounds as a wife's college association with the investment advisor, or personal acquaintance through an introduction by the director's father-in-law. 114 CONG. REC. S9494 (daily ed. July 26, 1968). One director gave the following narration of his appointment:

(The investment advisor) called me. (He) is a cousin of mine, and I have known him, of course, for a few years and he called me and told me that they were organizing a fund which was to invest in some special situations to be a growth fund for those who were particularly interested in capital advancement rather than income, and wanted to know if I would help them out by being on the Board.

And I told (the advisor) that I didn't know the first thing about the funds or really investments at all, that I didn't see what I could contribute to the Board.

And he said, well, I could be of some help to them because I had just the general background that they wanted to get a varied Board put together and I could be of some help to them.

I said, "What you really want to do is use my name."

And he said, "Well, if you want to put it that way, I suppose that is it." *Id.* at

S9494-95.

Another director was asked what he thought he could contribute to the board, since he conceded a complete ignorance of securities markets. He replied that he certainly could not add any investment acumen, but he "could at least give [the advisor] a friendly director . . . ." *Id.* at 9495.

1137 "[T]he board nominates the board, so they would be in effect continuously self-appointing." Testimony of Robert Loeffler, 1967 House Hearings 486.

The fact of nomination has been considered by the courts where there is a question of domination or control. *Cf. Guth v. Loft, Inc.*, 23 Del. Ch. 255, 274, 5 A.2d 503, 512 (Sup. Ct. 1939).

1138 WHARTON REPORT 465. This element may properly bear on the issue of control, which is one way to establish "affiliation." *Cf. George Washington Memorial Park Ass'n v. Memorial Dev. Co.*, 139 N.J. Eq. 280, 283-84, 51 A.2d 221, 223 (Ch. 1947); *Chicago Corp.*, 28 S.E.C. 463, 465-69 (1948).

1139 WHARTON REPORT 465-66. At least the industry may claim that it gave some warning that this would occur. When it was proposed in 1940 to require a certain percentage of

Two concepts, central to any discussion of the role of the unaffiliated directors, are contained in the Investment Company Act's definitions of "affiliated person" and "control." A person is "affiliated" with another person<sup>1140</sup> if:

(A) he owns, controls, or holds with power to vote, five per cent or more of the voting securities of the other person;

(B) five per cent or more of his outstanding voting securities are so controlled by the other person;

(C) he directly or indirectly controls, is controlled by, or is under common control with the other person;

(D) he is an officer, director, partner, or employee of the other person;

(E) he is an investment advisor or member of the advisory board of the other person (when the other person is an investment company with a board of directors); and

(F) he is the depositor of the other person and the other person is an investment company which does not have a board of directors.<sup>1141</sup>

On its face this definition seems simple enough, but there does appear to be one problem. The difficulty centers around clause (E) and involves the question whether this clause is to be read as exclusive or non-exclusive.

If clause (E) is read as non-exclusive, so that persons other than the investment advisor may be considered affiliates of an investment company, the requirements of section 15(c)(1) of the Act will be impossible to satisfy.<sup>1142</sup>

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unaffiliated directors, one company responded to the effect that the industry would simply pack its boards with stooges:

We believe restrictions on outside affiliations would, in most cases, result at best in the election of some directors who would be more or less uninformed and subservient to the others, in whom the effective control of the management would lie . . . . Letter from Francis Amory and E. R. Kittredge to Robert Wagner, May 2, 1940, reprinted in *1940 Senate Hearings* 1096-97.

1140 "Person" is defined to include either a natural person or any form of business association. Investment Company Act of 1940 § 2(a)(27), 15 U.S.C. § 80a-2(a)(27) (1964).

1141 Investment Company Act of 1940 § 2(a)(3), 15 U.S.C. § 80a-2(a)(3) (1964) provides:

"Affiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

1142 Investment Company Act of 1940 § 15(c), 15 U.S.C. § 80a-15(c) (1964) provides:

In addition to the requirements of subsection (a) and (b) of this section it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, except a written agreement which was in effect prior to March 15, 1940, whereby a person undertakes regularly to serve or act as investment adviser or of principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved (1) by a majority of the directors who are not parties to such contract or agreement or affiliated persons of any such party, or (2) by the vote of a majority of the outstanding voting securities of such company.

If an advisory contract is involved, neither affiliates of the advisor nor affiliates of the

This is so because section 2(a)(3)(D) will then dictate that every director of the investment company is an affiliated person of the investment company and hence ineligible to approve contracts in accordance with section 15(c).

If, on the other hand, clause (E) is given an exclusive reading, then the investment advisor and only the investment advisor<sup>1143</sup> may be considered an affiliated person of the investment company.<sup>1144</sup> Clearly, this is not possible without emasculating the rest of section 2(a)(3). There is no case which considers director affiliation for purposes of section 15(c) and which directly holds a person, not an advisor, ineligible to approve a contract by reason of his affiliation with the investment company. Nevertheless, it is abundantly clear that a person other than an advisor may be an affiliate of the investment company for purposes of other sections of the Act. For example, an insurance company was held to be affiliated with an investment company on the ground that the investment company owned 5.09 per cent of the insurance company's outstanding voting securities.<sup>1145</sup>

It would appear, then, that a non-exclusive reading of clause (E) would be impossible to reconcile with section 15(c), while an exclusive reading of clause (E) would seriously impair the operation of other sections of the Act, especially section 17. The judicial solution to this problem has been to ignore it.<sup>1146</sup> The non-exclusive rendering is accepted for all purposes except where section 15(c) is drawn into the question. When that happens, a director's affiliation with the investment company under section 2(a)(3)(D) is disregarded as inapplicable and his vote is counted unless he is affiliated with the investment advisor (or, in the case of an underwriting contract, the principal underwriter).<sup>1147</sup>

Another situation which demands a non-exclusive reading of clause (E)

investment company should be classified as eligible to approve the contract under the literal terms of this section.

1143 This disregards members of any advisory board.

1144 On this reading of clause (E), directors of an advisory corporation are not necessarily affiliates of the investment company even though they may also sit on the investment company's board. This is so because these men do not fall within the definition of "investment adviser" contained in section 2(a)(9) of the Act. Nevertheless, as affiliates of the advisor, which they are by reason of section 2(a)(3)(D), they are still ineligible to approve contracts pursuant to section 15(c).

1145 Aetna Life Ins. Co., SEC Investment Company Act Release No. 4082 (Nov. 19, 1964), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,159, at 82,204. See also Securities Corp. Gen., 15 S.E.C. 714 (1944).

1146 Though the judiciary has not resolved the matter, it will not persist if the fund reform bills are passed. Legislation pending in the present Congress will remedy what appears to have been imperfect draftsmanship. While the proposed bills retain unchanged the definition of "affiliated person," they rephrase section 15(c) to speak in terms of an expanded concept, "interested person." S. 34, 91st Cong., 1st Sess. § 8(c) (1969); S. 296, 91st Cong., 1st Sess. § 8(c) (1969). The definition of "interested person" includes all cases of affiliation under the existing section 2(a)(3) except that a specific exclusion is made so that directors of an investment company may not, ipso facto, be considered "interested persons." S. 34, 91st Cong., 1st Sess. § 2(3) (1969); S. 296, 91st Cong., 1st Sess. § 2(3) (1969).

1147 "Section 15 (c) of the Act provides that the investment adviser's contract . . . must be approved annually by a majority of the board of directors of the investment company who are not affiliated with the investment adviser." Institutional Investors Mut. Fund, Inc., 35 S.E.C. 72, 76 (1953). In *Acampora v. Birkland*, 220 F. Supp. 527 (D. Colo. 1963), a director-officer of an investment company was permitted to cast an "unaffiliated" vote for purposes of section 15(c). The court said that he, Bromfield, "was not an affiliated person within the meaning of Section 2(a)(3)(D)," thus apparently giving clause (E) an exclusive reading. The vote was counted "[s]ince Bromfield was . . . non-affiliated" with the advisor. *Id.* at 544.

involves the concept of "control,"<sup>1148</sup> for only if clause (E) is non-exclusive would it be possible to find a person affiliated with an investment company by reason of clause (C). Just such a finding was reached by the SEC in *Equity Fund Incorporated*.<sup>1149</sup> In that case, two investment companies, neither of which owned any stock of the other, had "substantially the same officers and directors, same investment adviser and principal underwriter," and were therefore held to be "under common control."<sup>1150</sup> This, of course, made each an affiliate of the other.<sup>1151</sup>

For our purposes, the pertinent question of control will require a determination whether a particular director may be counted as unaffiliated with the investment advisor or underwriter in order to satisfy sections 10 and 15(c) of the Act.<sup>1152</sup> Section 2(a)(3)(C) declares that a person is affiliated with another if he directly or indirectly controls, is controlled by, or is under common control with the other person. Thus a director may be considered an affiliate of the fund's advisor or underwriter if his relationship to the advisor is such that "control" can be established.<sup>1153</sup> The clear intent of this provision is to assure that the unaffiliated directors are more than mere pawns of the men whose contracts they review and approve.

Establishing control of a natural person under the Act, however, is no mean accomplishment. The major impediments result from certain presumptions incorporated in the Act's definition of control:

Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company shall be presumed to control such company. Any person who does not so own more than 25 per centum of the voting securities of any company shall be presumed not to control such company. *A natural person shall be presumed not to be a controlled person within the meaning of this subchapter.* Any such presumption may be rebutted by evidence, but except as hereinafter provided, shall continue until a determination to the contrary made by the Commission by order either on its own motion or on application by an interested person.<sup>1154</sup> (Emphasis added.)

The presumption against control of a natural person weighed heavily in the opinion of the court in *Acampora v. Birkland*.<sup>1155</sup> The case involved a determination of the status of several directors whom the plaintiff considered to be under the control of a fund's advisor-underwriter [Management] and hence affiliated with Management. The directors in question had various relationships with Management, including stock interest in Management, interests

1148 "Control" is defined in Investment Company Act of 1940 § 2(a)(9), 15 U.S.C. § 80a-2(a)(9) (1964).

1149 15 S.E.C. 288 (1944).

1150 *Id.* at 288-89.

1151 *Id.* at 289.

1152 See text accompanying notes 378-86 *supra*. Cf. *Acampora v. Birkland*, 220 F. Supp. 527, 544 (D. Colo. 1963).

1153 *Acampora* emphasizes that "a factual relationship whereby there is actual control" will be sufficient to establish affiliation. *Acampora v. Birkland*, 220 F. Supp. 527, 542 (D. Colo. 1963). "[T]he term 'control' . . . means the act or fact of control . . ." *Id.* at 543.

1154 Investment Company Act of 1940 § 2(a)(9), 15 U.S.C. § 80a-2(a)(9) (1964).

1155 220 F. Supp. 527 (D. Colo. 1963).

in businesses which contracted with both Management and the fund, interests in a brokerage firm which received give-ups or other brokerage commissions generated by Management's supervision of the fund's portfolio, and a general friendliness with Management's president.<sup>1156</sup> In refusing to hold these men affiliates of Management, the court cited a leading case wherein the Commission commented that "[t]he burden of overturning the presumption against control of a natural person is not one that will be lightly assumed or easily carried to success."<sup>1157</sup>

*Acampora* is significant in the level of proof it demands to rebut the presumption. Though the plaintiff had shown many of the board members to have benefited financially from their confraternity with Management, the court required "actual domination and operation. Mere influence," it said, "would fall short of this level of proof."<sup>1158</sup> Moreover, the court demanded causative evidence—evidence which would prove that the director-Management relationship actually *resulted* in directorial decisions that were not considered independently.<sup>1159</sup> If *Acampora* stands as the law on the question of control of natural persons, the Act's definition of "control" has been severely crippled.

*Acampora* was not a factually strong case on the issue of control. The director with a stock interest in Management held only .4 per cent of Management's securities, and by the time of suit had divested himself of half of it. On the other hand, his personal stake in the fund was quite large, amounting to \$130,000. The director who received give-ups and insurance business had a similarly attenuated interest in Management. The brokerage in question totaled only \$3,000 over a five-year period, while insurance commissions ranged from \$2,000 to \$4,000 annually. This director also had a personal stake in the fund, as did his family and his company's profit-sharing plan. The third director was associated with sundry brokerage houses which received fees on fund transactions, but the fees were not exceptionally high and the testimony was undisputed that brokerage had been allocated to his firms for good business reasons. There was little or no evidence tending to impugn the independence of the remaining directors.<sup>1160</sup>

Despite its weakness on the facts, *Acampora* has set precedent. When the

1156 *Id.* at 536-37, 543.

1157 Fundamental Investors, Inc., 41 S.E.C. 285, 294 (1962).

1158 *Acampora v. Birkland*, 220 F. Supp. 527, 543 (D. Colo. 1963).

1159 *Id.* See also *Coran v. Thorpe*, 42 Del. Ch. 67, —, 203 A.2d 620, 623 (Ch. 1964).

Whether the exercise of actual influence is necessary under the Act is doubtful. By analogy to the situation in which control of a corporation is involved, it would seem that "causative evidence" should not be required. In the corporate situation it is settled that "[a] controlling influence need not be actually exercised; the latent power to exercise it is sufficient under the Act." Investors Mut., Inc., SEC Investment Company Act Release No. 4595 (May 11, 1966), [1964-66 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,348, at 82,635 (footnotes omitted). The SEC has agreed in *Transit Inv. Corp.*, 23 S.E.C. 415 (1946).

The question at issue is whether, in the light of the circumstances discussed above, Horan has "the power to exercise a controlling influence over the management or policies" . . . . Clearly the "power to exercise a controlling influence" means something less than actual control . . . and includes the latent power to exercise a controlling influence as well as the active exercise of such power. *Id.* at 420 (footnotes omitted). See also *M. A. Hanna Co.*, 10 S.E.C. 581, 589 (1941).

1160 *Acampora v. Birkland*, 220 F. Supp. 527, 536-37 (D. Colo. 1963).

Delaware Chancery Court was presented with a similar, if somewhat stronger, case, *Coran v. Thorpe*,<sup>1161</sup> the issue was resolved on authority of *Acampora*. In *Coran*, plaintiff charged that certain directors of a fund were affiliates of the fund's advisor and underwriter, thus rendering composition of the board unlawful under section 10 of the Act. To show affiliation, he relied on section 2(a)(3)(C) of the Act and attempted to prove that these men were controlled by the advisor-underwriter.<sup>1162</sup> The alleged control in this case took the form of pecuniary benefits accruing to the challenged directors through their several connections with certain brokerage houses and research corporations which had formerly served as advisors or sub-advisors, or presently served as brokers.<sup>1163</sup>

The court considered the presumption of non-control of a natural person and declared that the factual issue of control turned upon "an individual's state of mind."<sup>1164</sup> The burden of rebutting the presumption is not sustained, according to the holding in *Coran*, if only a strong economic relationship is shown.<sup>1165</sup> The case, then, fairly sanctions a personal financial interest on the part of the unaffiliated directors, for if "control" is impotent to cover the situation, there will be no "affiliation" within the meaning of the Act. To this extent, the Act has seriously diluted common-law principles of conflicting interests.

The statutory presumption of non-control was also considered in *Rome v. Archer*,<sup>1166</sup> but the court in that case apparently felt that it might not be free to decide the factual question prior to a determination by the SEC in an adminis-

1161 42 Del. Ch. 67, 203 A.2d 620 (Ch. 1964).

1162 It appears, however, that the fund, Atomic, Physics and Science Fund, Inc., contracted from 1952 to 1956 with the NYSE firm of Auchincloss, Parker & Redpath for advisory and management services. During this time, the fund also paid Nuclear Development Corporation of America a .16 per cent fee for technical advice.

From July 1, 1956 to April 1, 1959, the fund contracted with Atomic Development Management Corporation for management services and also contracted with the Auchincloss firm for investment advice. Technical advice, still being furnished by Nuclear Development Corporation of America, was paid for jointly by these two companies. Subsequent to April 1, 1959, Atomic Development Management Corporation acted as manager and advisor, subcontracting for technical advice from Nuclear Development Corporation of America until October 1962. Ultimately the fund's underwriter, which had begun as a partnership and was later incorporated, merged with Atomic Development Management Corporation in 1960.

The directors in question included a partner in the Auchincloss firm, one Sullivan, who presumably shared in the profits of that firm. Auchincloss had received "very substantial" advisory fees during its tenure as the fund's advisor, and at all times received "substantial brokerage commissions on the purchase and sale of Fund's portfolio securities." *Id.* at —, 203 A.2d at 622. A second director, Buxton, "was a salaried employee of Auchincloss and Sullivan's subordinate." *Id.* Hence these two were affiliates of the advisor during the years prior to 1959 by reason of section 2(a)(3)(D) of the Act.

A third director, Fleming, was a partner in a brokerage firm which did business with the fund. No further connection is evident between Fleming and the advisor-underwriter.

A fourth director, Menke, was an officer and principal shareholder of Nuclear Development Corporation of America, which had furnished technical advice. Depending on the nature of the advice his company had furnished (see Investment Company Act of 1940 § 2(a)(19), 15 U.S.C. § 80a-2(a)(19) (1964)), he too might have been an affiliate of the fund's advisor prior to 1962.

The fifth director, Merritt, was an employee of a subcontractor of Nuclear Development Corporation of America. His employer, Longyear Company, provided technical advice which was passed along to the fund's primary advisor. *Id.* at —, 203 A.2d at 621-22.

1163 *Id.* at —, 203 A.2d at 622.

1164 *Id.* at —, 203 A.2d at 623.

1165 *Id.*

1166 41 Del. Ch. 404, 197 A.2d 49 (Sup. Ct. 1964).



trative proceeding.<sup>1167</sup> This, of course, is entirely incorrect.<sup>1168</sup>

Part of the difficulty with section 2(a)(9) is attributable to the fact that it is not geared to control of natural persons. The first paragraph of the section seems to contemplate nothing beyond control of a business organization. The presumptions in the second paragraph relating to ownership of voting securities supply valuable criteria in determining the issue of control of a business association,<sup>1169</sup> but the presumption with respect to a natural person, on the other hand, appears to have been inserted into the section as the result of a legislative compromise<sup>1170</sup> and presents "more difficult problems of concept and proof."<sup>1171</sup>

The net result of the presumption against control of a natural person and the generally toothless definition of affiliated persons has been to permit some rather closely associated people to sit as unaffiliated directors.<sup>1172</sup> One distinguished attorney remarked that he had, in two instances, encountered "unaffiliated" directors who were sons of the advisor's principal stockholder.<sup>1173</sup> Mr. Pomerantz is fond of relating his experiences with unaffiliated directors:

I have had fourteen investment company cases and fourteen sets of depositions and/or cross-examinations of the independent directors, and in not one single case did any unaffiliated director ever respond "Yes" to this type of question: When your fund grew from \$100 million to \$600 million, did you ever give any thought to making a comparison between your half of one per cent fees and somebody else's fees?

No.

Did you ever once suggest that when the fund got to be over a billion dollars . . . perhaps a reduction from one-half per cent to seven-sixteenths of one per cent, or any other minute fraction?

Answer: No — and I mean the uniform answer.

. . . [T]he realities are . . . that you can't count on the unaffiliated director. . . .<sup>[1174]</sup>

. . . .

1167 *Id.* at —, 197 A.2d at 54.

1168 *Fundamental Investors, Inc.*, 41 S.E.C. 285, 295-301 (1962). The position of the SEC has been accepted by the courts. *Coran v. Thorpe*, 42 Del. Ch. 67, —, 203 A.2d 620, 623 (Ch. 1964).

1169 *See, e.g.*, *United Chemicals, Inc.*, 23 S.E.C. 456 (1946); *Chicago Corp.*, 28 S.E.C. 463 (1948).

1170 For an excellent discussion of the provision, see *Fundamental Investors, Inc.*, 41 S.E.C. 285 (1962).

1171 *Id.* at 291. The courts have recognized that this provision seems to be out of place. *Acampora v. Birkland*, 220 F. Supp. 527, 543 (D. Colo. 1963); *Coran v. Thorpe*, 42 Del. Ch. 67, —, 203 A.2d 620, 623 (Ch. 1964).

1172 *See* notes 1136-39 *supra* and accompanying text.

1173 Compare Statement of Abraham Pomerantz, *University of Pennsylvania Law School Conference on Mutual Funds*, *supra* note 1026, at 739 with *FORTUNE*, Feb. 1968, at 159.

Pending legislation, like proposals in the Ninetieth Congress, would eliminate this type of unaffiliated director and go far toward insuring some measure of real independence. S. 34 and S. 296 (identical in this respect) introduce the concept "interested person" to strengthen the provisions of sections 10, 15, and 32(a) of the Act. The definition of "interested person" includes "affiliated persons" (as presently defined) of an investment company or its advisor or its principal underwriter; members of the immediate family of these affiliated persons; any security holder (very broadly defined to embrace both legal and equitable interests in securities) of the advisor or underwriter (or controlling person of the advisor or underwriter); any registered broker-dealer and his affiliates; and legal counsel for the investment company or advisor or underwriter and partners or employees of counsel. (For purposes of section 10 of the Act, an investment company's counsel on retainer and other members of his firm are

I have one case now . . . where the adviser also gets one-half of one per cent, and the fund has over a billion dollars in assets. The adviser also gets brokerage commissions . . . of over \$1 million a year, and keeps them; gets a load of the usual 8½ per cent and its net income before taxes on all those sources is \$11½ million a year.

Now, wouldn't you imagine . . . that somewhere along the way some fellow would raise his little hand and meekly suggest that in the light of the vast growth of the fund and the accompanying fact that expenses don't go up proportionately with the rise in the assets of the fund — that some little, meek voice would just suggest that maybe there ought to be a consideration — just, please, a reconsideration whether those fees ought to be reduced?<sup>2175</sup>

## 6. Judicial Control of Fee Structure

If rubber-stamp unaffiliated directors and the virtually unbridled power of the proxy have been a source of comfort and security for advisors, they have been anything but endearing to the SEC. Unfortunately for the advisors, a few litigious minority shareholders have also been among the malcontents.

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considered "employees" of the investment company and hence ineligible to satisfy the forty per cent requirement. 17 C.F.R. § 271.214 (1968).)

"Interested person" would also include persons who have a material business or professional relationship with (1) the investment company, (2) another investment company with the same advisor or principal underwriter, (3) controlling persons of the advisor or underwriter, or (4) the chief executive of the investment company, advisor, or underwriter. This "business or professional relationship" provision, however, applies only pursuant to an order of the SEC, which would not be retroactive and would not take effect for sixty days. S. 34, 91st Cong., 1st Sess. § 2(3) (1969); S. 296, 91st Cong., 1st Sess. § 2(3) (1969).

The requirement for an administrative determination of status was not a part of the original proposals in the Ninetieth Congress, but was introduced with S. 3724. S. 3724, 90th Cong., 2d Sess. § 2(3) (1968). When S. 3724 was reported out of committee, certain valuable legislative history was included in the committee's report which would be of significant assistance in interpreting the requirements of the provision. S. REP. NO. 1351, 90th Cong., 2d Sess. 31-32 (1968). See ANALYSIS OF S. 34, at 20. If either of the pending bills should be enacted, care should be taken that the legislative history includes these guidelines.

1174 The exception to the rule is perhaps Investors Diversified Services, which acts as management of several funds. Conscientious scrutiny and consideration of management compensation by unaffiliated member of the funds' boards has resulted in several reductions and a continuous awareness of fee levels. 1967 Senate Hearings 757-58; 1967 House Hearings 467-69, 478-79, 481. Some of this "awareness" may have been pricked by Mr. Pomerantz's lawsuits, two of which involved IDS funds. *Glick v. Bradford*, 35 F.R.D. 144 (S.D.N.Y. 1964); *Ackert v. Ausman*, 198 F. Supp. 538 (S.D.N.Y. 1961), *mandamus denied*, *Ackert v. Pelt Bryan*, 299 F.2d 65 (2d Cir. 1962), *motion to remand granted*, *Ackert v. Ausman*, 217 F. Supp. 934 (S.D.N.Y. 1963); *Ackert v. Ausman*, 29 Misc. 962, 218 N.Y.S.2d 822 (Sup. Ct. 1961), *aff'd mem.*, 20 App. Div.2d 850, 247 N.Y.S.2d 999 (1964); *Ruskay v. Reed* 225 F. Supp. 581 (S.D.N.Y. 1963). *But cf.* testimony of Robert Loeffler, 1967 House Hearings 487-88; testimony of Francis Williams, 1967 Senate Hearings 201.

1175 *University of Pennsylvania Law School Conference on Mutual Funds*, *supra* note 1026, at 753-54; *compare id.* with 1967 Senate Hearings 699-700.

The SEC cites the testimony of an unaffiliated director in the case of *Saxe v. Brady*, 40 Del. Ch. 474, 184 A.2d 602 (Ch. 1962):

Q. How long has someone wanted to reduce the [fee] scale on the Board and how long has the management company been saying no?

A. Nobody on the Board has ever made a serious campaign . . . .

Q. Will you specify when these directors, or director, for the first time requested that a sliding scale be put in?

A. Nobody has requested it. . . . Nobody has suggested it, put it forward aggressively at all. . . .

[The director] thought that "inquiries as to whether satisfactory services could be obtained from some other investment manager besides [the one being used] would

a. *The Shareholder Ratification Doctrine and the Standard of Waste*

The brooding omnipresence in any modern discussion of this area is the celebrated decision of Chancellor Seitz in *Saxe v. Brady*.<sup>1176</sup> The case involved Fundamental Investors, Inc., a corporate Delaware mutual fund registered under the 1940 Act. The Fund operated under an advisory contract with Investors Management Company, Inc. [IMC], which in turn was a wholly-owned subsidiary of Hugh W. Long, Inc., the Fund's underwriter.<sup>1177</sup> Fund paid an advisory fee of one-half per cent of its average daily net assets to IMC in obedience to an unequivocal mandate of Fund's shareholders, 99.3 per cent of whom had initially approved the advisory contract in 1954<sup>1178</sup> and 99.1 per cent of whom ratified it again in 1960.<sup>1179</sup> In the interim the contract had apparently been approved annually by the Fund's board of directors, including a majority of the non-affiliates.<sup>1180</sup>

By nature a derivative action, the suit was filed by the plaintiffs in 1960 against IMC, H. W. Long, Inc., and the Fund's directors, charging that the advisory fees paid to IMC were so excessive as to constitute "waste and spolia-

have been *highly improper*." He was also asked if he had ever suggested to the adviser that the fee was unreasonable:

A. Oh, no. I have never heard such a suggestion made at a meeting of the board by myself or anyone else.

Q. Have you ever heard such a suggestion made outside a meeting of the board?

A. Not until this complaint was served in this trial.

Q. The thought had never crossed your mind. Is that correct?

A. *It doesn't exist now*, for that matter. 1967 *House Hearings* 46-47 (footnotes omitted). See 114 CONG. REC. S9426-27 (daily ed. July 25, 1968) (remarks of Senator McIntyre); 114 CONG. REC. S9496 (daily ed. July 26, 1968).

When former Chairman Cohen was asked, "Have the unaffiliated directors ever upset the regular directors' applecart?" his answer was direct: "I have never heard of it in my 25-odd years in association with these funds." 1967 *Senate Hearings* 81. This is not terribly surprising in view of the passivity of the unaffiliated directors in considering and ultimately approving the advisor's contracts. "Few of the independent directors," we are told,

[investigate] the advisory fee before voting to approve the advisory contract. Representative of the interviews with independent directors on this point was the following:

"Q. Did you ever make an investigation check into (the investment adviser) to see the type of services that were being provided for (the advisory fee)?"

"A. Did I make an investigation?"

"Q. Yes.

"A. No.

"Q. Did you ever go into the office and find out who was working for (the adviser) and rendering this advice they were supposed to render?"

"A. I did not.

Another independent director was asked to explain what was considered by the directors in renewing the advisory contract:

"A. Well, I think (naming the person who was president both of the fund and of the fund's adviser) would say, 'Well we have to renew our contract . . . again. Is the contract satisfactory?' And usually there weren't any remarks, and he said, 'Well, anybody have any objections?' If there was some discussion then a motion would be made to renew the contract and that's the way it's handled." 114 CONG.

REC. S9495 (daily ed. July 26, 1968).

1176 40 Del. Ch. 474, 184 A.2d 602 (Ch. 1962).

1177 *Id.* at —, 184 A.2d at 604.

1178 *Id.*

1179 *Id.* at —, 184 A.2d at 605.

1180 *See Id.*

tion of the Fund's assets."<sup>1181</sup> Plaintiffs also alleged that "the so-called 'non-affiliated' directors were in fact dominated by the interested directors, or, if they were not so dominated, they failed affirmatively to protect Fund's pecuniary interest by passively renewing the annual contract."<sup>1182</sup> The Chancellor was willing to assume the truth of this latter assertion in order that he might emphasize the role of shareholder ratification in setting the standard against which the fee must be measured.<sup>1183</sup>

Absent informed shareholder ratification, transactions between corporations with interlocking directorates are subject to certain equitable limitations regardless of the number of interlocking directors, the extent of their interests, or the participation or lack of participation by common board members. If the contract or transaction is unfair, or if entered into in bad faith, it will be voidable at the instance of the injured party. This proposition does not depend on principles of fraud, nor is it altered by the abstention of the interested directors.<sup>1184</sup> The rule constitutes, as it were, the lowest common denominator in the law of intercorporate dealings. But, "[w]hen the stockholders ratify a transaction," the court opined in *Saxe*,

the interested parties are relieved of the burden of proving the fairness of the transaction. The burden then falls on the objecting stockholders to convince the court that no person of ordinary, sound business judgment would be expected to entertain the view that the consideration was a fair exchange for the value which was given. *Gottlieb v. Heyden Chemical Corporation*, 33 Del. Ch. 177, 91 A.2d 57; *Kaufman v. Schoenberg*, 33 Del. Ch. 211, 91 A.2d 786.<sup>1185</sup>

Thus, under Delaware law, shareholder ratification is said to have two effects: (1) the threshold for equitable intervention is raised from "unfairness" to "waste of corporate assets,"<sup>1186</sup> and (2) the interested directors are relieved of the burden of proving fairness, the onus shifting to the stockholder to show waste.<sup>1187</sup>

Since the Chancellor was not convinced that the fees paid to IMC under the contract were so excessive as to constitute waste, the complaint was dismissed.<sup>1188</sup> In reaching this conclusion the court observed that the rate used to calculate the fee was "neither extraordinary nor uncommon" even among the larger funds.<sup>1189</sup> Moreover, the shareholder ratification of previous fees paid at

1181 *Id.* at —, 184 A.2d at 604.

1182 *Id.* at —, 184 A.2d at 605.

1183 *Id.* at —, —, 184 A.2d at 605, 616.

1184 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 961 (perm. ed. rev. repl. 1965) and authorities there collected.

1185 *Saxe v. Brady*, 40 Del. Ch. 474, —, 184 A.2d 602, 610 (Ch. 1962).

1186 As the court put it, "[w]hether a waste of assets is present here is . . . the . . . issue for decision." *Id.* at —, 184 A.2d at 605. Thus the Chancellor's use of the term *legally excessive* throughout the opinion refers directly to the standard of waste: "[T]he central issue to be decided is whether the fees paid to IMC under the advisory contract were 'legally excessive' or not. . . . Plaintiffs do not contend that there is any other ground for liability." *Id.*

1187 *But see* notes 1264-65 *infra* and accompanying text.

1188 *Saxe v. Brady*, 40 Del. Ch. 474, —, 184 A.2d 602, 617 (Ch. 1962).

1189 *Id.* at —, 184 A.2d at 611. The Chancellor noted that plaintiffs' evidence showed "a tendency for the rate among the larger funds to be less than a flat ½ of 1%." Since,

this rate and the shareholder authorization to continue paying fees at this rate were taken as "some indication that under all the circumstances the rate paid to IMC was a commercially realistic one."<sup>1190</sup> And again the judge was careful to note, quite correctly, that a fee based on a percentage of assets "provides an incentive for the manager to increase the size of the Fund." Thus, "[w]here the rate of payment has remained unchanged, one must recognize both a legitimate expectation on the part of the managers and reasonable notice to the stockholders that payments are likely to increase."<sup>1191</sup>

As to the actual dollar amounts paid by the Fund and the economies of scale reflected in IMC's profits, the Chancellor was again unwilling to characterize the fee as wasteful. Advisory fees payable under the formulae of certain other large funds were considered and found to be somewhat lower by comparison than that received by IMC. Although the difference was about sixty per cent, this was not, in the opinion of the court, "clearly excessive" on its face.<sup>1192</sup> Neither were the profits of IMC so great as to evidence a waste of Fund's assets, for the Chancellor observed that "it [is not] unusual to find service companies making large profits with relatively small costs. *If the fund-management company format is to be legally questioned, such inquiry must come from some other place.*"<sup>1193</sup> (Emphasis added.)

It has been suggested that the Saxes might have won their lawsuit — even under the waste standard made applicable in Delaware by shareholder ratification — had the case been more expertly presented and more thoroughly pre-

however, a few of the largest funds paid the one half per cent rate, the court was unwilling to "assume that each of these comparable funds paying ½ of 1% is thereby wasting its assets." Nor was the court willing to "conclude from the mere fact that others of these funds are paying less, that any increase in their payments for advisory services would necessarily constitute waste." *Id.*

1190 *Id.* at —, 184 A.2d at 612. There is some loose dicta at this point in the opinion. Having found that the rate of compensation (based on a percentage of assets) was not per se "wasteful" or "legally excessive," the Chancellor concludes that "the rate paid to IMC must favor a finding of *reasonableness*." *Id.* (emphasis added). Of course, the standard actually applied was not "reasonableness" in the conventional sense, but "waste" or "legal excessiveness." At one point in the opinion the test is said to be whether compensation is "unconscionable." *Id.* at —, 184 A.2d at 610. And again, the court observed that "the profits are certainly approaching the point where they are outstripping *any* reasonable relationship to expenses and effort even in a legal sense." *Id.* at —, 184 A.2d at 616 (emphasis added). Hence it is clear that any talk of "reasonableness" in the opinion is misplaced.

1191 *Id.* at —, 184 A.2d at 612. Unless the court contemplated an applicable estoppel by contract, it is entirely unclear what effect that "notice to stockholders" could possibly have on the issue of excessiveness. See notes 1257-59 *infra* and accompanying text.

1192 *Saxe v. Brady*, 40 Del. Ch. 474, —, 184 A.2d 602, 613 (Ch. 1962).

1193 *Id.* at —, 184 A.2d at 616. There was some controversy as to the proper method of making certain expense allocations so that IMC's profit on Fund's account could be accurately isolated. The court made all assumptions in the plaintiff's favor for purposes of this last argument. *Id.*

The italicized sentence in the above quotation betrays a certain uneasiness in the Chancellor's woollack. At another point in the opinion he says:

It is also inherent in the "percentage-of-assets" approach that at some point the relationship between admittedly reasonable expenses and net profits can become so disproportionate as to be *shocking by any pertinent standard*. *Id.* at —, 184 A.2d at 615 (emphasis added).

And again: "[T]he profits are certainly approaching the point where they are outstripping *any* reasonable relationship to expenses and effort *even in a legal sense*." *Id.* at —, 184 A.2d at 616 (emphasis added).

pared.<sup>1194</sup> In addition to the language already noted,<sup>1195</sup> there are certain other indications in the opinion that additional data might have tipped the balance. Specifically, the Chancellor evidenced a willingness, even a desire, to compare the profitability of the IMC contract to the operations of other advisory companies:

One approach to resolving this difficult question would be to compare IMC's net profits from the Fund contract for 1959 with the profits earned by other management companies on a contract with a single fund. Unfortunately, the net profits of other management companies arising from the management of particular funds are not part of this record, if indeed they exist as a matter of public information. Consequently, one cannot indulge in what would be an important comparison.

Or, one might compute IMC's ratio of expenses . . . to profits . . . and compare that ratio with those of similar management companies. Once again, however, the record unfortunately does not permit such a comparison.<sup>1196</sup>

Furthermore, even under the waste test it would seem that a one-half per cent rate should be "legally excessive" if the fund involved were significantly larger than the \$600 million fund in *Saxe*.<sup>1197</sup> This would presume, of course, that services furnished for the advisory fee are within the normal range.<sup>1198</sup> As the Chancellor recognized:

A court is confronted with inherent difficulties in determining whether payments for services are "reasonable" or "excessive." The value of services is obviously a matter of judgment on the part of the person who must pay for them. Thus, courts are often shielded by presumptions which wisely cause them to defer to decisions of directors or stockholders. *Nevertheless, it is clear both in law and in fact that compensation payments may grow so large that they are unconscionable.* See *Meiselman v. Eberstadt* (Del. Ch.), 170 A.2d 720; *Lieberman v. Becker* (Del. Supreme Ct.), 155 A.2d 596.<sup>1199</sup> (Emphasis added.)

On this view, the advisory fee paid by Dreyfus Fund, Inc. to The Dreyfus Corporation might well be considered wasteful. The fee is calculated as one-eighth per cent of quarterly average net assets, or approximately one-half per

1194 Eisenberg & Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940*, 20 RUTGERS L. REV. 181, 206 (1966):

The court was not offered comparisons of fees for similar services to other types of advisory clients, nor was the non-competitive nature of the fee structure in the fund industry demonstrated to the court. Further, no evidence comparing the profitability of the management company in question with that of other management companies was offered to the court.

1195 See note 1193 *supra*.

1196 *Saxe v. Brady*, 40 Del. Ch. 474, —, 184 A.2d 602, 615 (Ch. 1962).

1197 See note 1193 *supra*.

1198 At yet another point in the opinion the Chancellor states:

Next, it must be emphasized that the very nature of the compensation arrangement (percentage of asset value) lends itself to the payment of sums having no necessarily reasonable relationship to the "value" of . . . services . . . tested by compensation standards usually applied in the business community. *Saxe v. Brady*, 40 Del. Ch. 474, —, 184 A.2d 602, 615 (Ch. 1962).

1199 *Id.* at —, 184 A.2d at 610.

cent of average net assets annually.<sup>1200</sup> There is a contractual limitation on the fund's expense ratio of one per cent,<sup>1201</sup> but the limit has not even been approached in the last ten years.<sup>1202</sup> The fee does not cover transfer and dividend disbursing fees, legal fees, auditing expenses, some directors' fees, costs of custodianship, brokerage, stockholder reports and meetings.<sup>1203</sup> Net assets of Dreyfus Fund stood at \$2.3 billion in 1967,<sup>1204</sup> increasing to \$2.6 billion as of December 31, 1968.<sup>1205</sup> If economies of scale<sup>1206</sup> indicated that a one-half per cent levy on a \$600 million fund, as in *Saxe*, was rapidly approaching wastefulness "by any pertinent standard," then the same rate applied to a fund 300 per cent larger may well have crossed the great divide to excessiveness.<sup>1207</sup>

The decision in *Saxe* was partly based on a previous decision by the same court in the case of *Meiselman v. Eberstadt*.<sup>1208</sup> In that case, a shareholder of Chemical Fund, Inc. charged that the advisory contract between Chemical and its advisor, F. Eberstadt & Co., Inc., resulted in excessive compensation to the director-shareholders of the advisory corporation. These men also served as affiliated directors on the board of Chemical.<sup>1209</sup> The suit did not embrace a charge that the fee paid to the advisor was otherwise excessive, but sought to show that it resulted "in unreasonable compensation to those directors of the Fund who 'own' the stock of the [advisory] Company."<sup>1210</sup> The court, however, rejected plaintiff's theory that total compensation to these men must be limited to "the average annual compensation for similar positions in the mutual fund field . . . apportion[ed] . . . on the basis of the testimonial estimates by the executives as to the amount of time devoted to Fund business."<sup>1211</sup> In reaching this result, *Meiselman* had helped to formulate the standard of waste by refusing to be governed by industry averages.<sup>1212</sup>

Moreover, *Meiselman* was an exceptionally weak case on its facts.<sup>1213</sup> The unaffiliated directors had approved the contract annually, and plaintiff admitted that he could not show that these men were dominated by the affiliates. The contract itself provided a relatively liberal sliding scale<sup>1214</sup> — the product of a

1200 DREYFUS FUND, INC., PROSPECTUS, March 5, 1968, at 7.

1201 *Id.*

1202 INVESTMENT COMPANIES 1968, at 181 (L. Wessmann ed. 1968).

1203 DREYFUS FUND, INC., PROSPECTUS, March 5, 1968, at 12. These unincurred expenses totaled more than \$1 million in 1967. *Id.*

1204 INVESTMENT COMPANIES 1968, at 181 (L. Wessmann ed. 1968).

1205 INVESTMENT COMPANIES 1968 (L. Wessmann ed., Supp. Dec. 31, 1968).

1206 For an exposition of this factor in the Dreyfus case, see note 1076 *supra* and accompanying text.

1207 Cf. 51 GEO. L.J. 624, 626 (1963).

1208 39 Del. Ch. 563, 170 A.2d 720 (Ch. 1961).

1209 Three firms were involved: Chemical Fund, Inc.; F. Eberstadt & Co., Inc., Chemical's advisor-underwriter; and F. Eberstadt & Co., an investment banking partnership whose members own all the stock of the advisory corporation. The affiliated directors of Chemical Fund were, naturally, partners of the banking firm and shareholders of the advisory corporation. *Id.* at —, 170 A.2d at 721.

1210 *Id.*

1211 *Id.* at —, 170 A.2d at 722.

On motion at the close of evidence the complaint was dismissed as to the unaffiliated directors since on the evidence presented "there was no possible liability on their part." *Id.* at —, 170 A.2d at 721.

1212 Compare *id.* at —, 170 A.2d 721-23 with *Saxe v. Brady*, 40 Del. Ch. 474, —, 184 A.2d 602, 610 (Ch. 1962).

1213 See Eisenberg & Lehr, *supra* note 1194, at 209.

1214 The assets of the fund approximated \$300 million. *Meiselman v. Eberstadt*, 39 Del.

voluntary reduction made in 1956 *at the instance of the affiliated directors*.<sup>1215</sup> When the alleged "excess" was divided up among the affiliated directors<sup>1216</sup> it was hardly "shocking," and what handsome compensation was involved was rendered "more palatable" by the excellent performance of the fund.<sup>1217</sup> Furthermore, the contract had been ratified by the shareholders themselves.<sup>1218</sup> Given this situation, no standard short of waste would, under Chancellor Seitz's misconception of Delaware law,<sup>1219</sup> support an allegation that the directors had breached a fiduciary duty.<sup>1220</sup>

Although the Chancellor in *Meiselman* found the alleged excesses less than "shocking," he recognized "that there must be some limitation on the payment to persons discharging such services,"<sup>1221</sup> and further cautioned that compensation arrangements are, at least in the first instance, "the responsibility of the non-affiliated directors or stockholders of Fund. It cannot be assumed," he continued, "that they will not discharge their responsibility to make appropriate reviews of the reasonableness of the arrangements from every point of view."<sup>1222</sup>

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Ch. 563, —, 170 A.2d 720, 721 (Ch. 1961). The fee schedule called for one half per cent average daily net assets up to \$75 million, .375 per cent between \$75 million and \$125 million, and .25 per cent on the excess. *Id.* The effectiveness of the sliding scale in this case can be seen from the fact that in 1956, when the scale was first used, Chemical had net assets of \$134 million. In that year it paid advisory fees totalling .44 per cent of its net assets. In 1960, the last year involved in the lawsuit, Chemical's net assets had risen to \$269.7 million, while advisory fees then amounted to .35 per cent of net assets. PUBLIC POLICY STATEMENT 133. Chemical, as of December 31, 1967, had net assets of \$530.6 million. For the year 1967 it paid advisory fees of \$1.43 million, computed on a sliding fee scale only slightly different from that described above. (Under the new scale, there is a further reduction to .20 per cent of average net assets on amounts in excess of \$375 million.) Advisory fees as a percentage of net assets had thus declined further to .27 per cent. MOODY'S 1968 BANK & FINANCE MANUAL 866. As can be seen from Appendix B, this is a relatively low figure.

The Chancellor seems to have been aware of the modest fee rate: "[I]t appears that the basic charges appearing in the management agreements for the pertinent years are lower than the average in the mutual fund field." *Meiselman v. Eberstadt*, 39 Del. Ch. 563, —, 170 A.2d 720, 723 (Ch. 1961).

1215 *Meiselman v. Eberstadt*, 39 Del. Ch. 563, —, 170 A.2d 720, 723 (Ch. 1961).

1216 *Id.*

1217 *Id.* The court was careful to note that the performance argument was not strictly relevant, and referred to it as "gilding on the lily." *Id.*

1218 *Id.*

1219 *Cf.* note 1265 *infra*.

1220 It seems that the court is applying some sort of shifting standard, the precise level of which is unclear. The Chancellor phrased it thus:

There was much said to the effect that fiduciaries cannot pay themselves more than the average pay in the industry for similar services. Fiduciaries, of course, may not pay themselves excessive compensation, but here must be added the fact that the non-affiliated majority directors, whom plaintiff tacitly admitted he could not prove were dominated by defendants, approved the compensation arrangement yearly with knowledge of the [advisory] Company's audit. Moreover, the stockholders approved the basic compensation agreement . . . .

I conclude that plaintiff has failed to prove that the compensation paid for investment advisory service is legally excessive . . . . *Meiselman v. Eberstadt*, 39 Del. Ch. 563, —, 170 A.2d 720, 723 (Ch. 1961).

From this language it is impossible to determine the operative fact, *i.e.*, whether the standard for intervention is raised because of the vote of the unaffiliated directors, because of stockholder ratification, or whether both facts are simply treated as evidence that the contract measures up to some independent standard of fairness. Perhaps the only clue in the case as to the level of excessiveness required is that the court found "no shocking disparity" between the amounts paid by Fund and the industry norm. This leaves very little from which to generalize; and perhaps all that can be said for *Meiselman* is that it does not dictate recovery merely because compensation exceeds by some small amount an industry average.

1221 *Id.* at —, 170 A.2d 720, 722.

1222 *Id.* at —, 170 A.2d 720, 723.



This language foreshadowed the stronger admonition in *Saxe*:

Since the management contract must be re-evaluated by the board of the Fund at fixed periods, ideally a truly independent and active board would be expected to be alert to the factors I have mentioned.<sup>1223</sup> In other words, *it is not to be assumed that an independent board would wait until the fees paid under the management contract warranted a finding of waste before attempting to negotiate a better deal.* . . . [T]he profits are certainly approaching the point where they are outstripping any reasonable relationship to expenses and effort even in a legal sense. And this is so even after making due allowance for incentive and benefit presumably conferred. This is not to say that no payment is justified after a fund reaches a particular size. It is only to say that *the business community might reasonably expect that at some point those representing the fund would see that the management fee was adjusted to reflect the diminution in the cost factor.*<sup>1224</sup> (Emphasis added.)

Several questions of directorial fiduciary duty were considered in the 1963 case of *Acampora v. Birkland*;<sup>1225</sup> one is pertinent to the present discussion. The plaintiff-shareholder in *Acampora* brought a derivative action against Financial Industrial Fund, Inc., Financial Industrial Fund Management Corporation [Management], Financial Programs, Inc. [Programs], and the officers and directors of all three corporations.<sup>1226</sup>

The initial complaint had alleged, *inter alia*, that the advisory fee paid to Management, a traditional one-half per cent of average net assets annually,<sup>1227</sup> was per se excessive.<sup>1228</sup> Plaintiff, however, abandoned this approach in light of the *Saxe* decision, and took another tack. If the one-half per cent rate is not wasteful in the ordinary case, he reasoned, it may become so where fewer than average services are received in return.<sup>1229</sup> The court would have none of it. First, it noted, the waste test as applied in *Saxe* depended on a finding of shocking or unconscionable fees,<sup>1230</sup> and did not rest on industry averages. Secondly, while evidence was offered "to show that the mutual funds generally get much more for their one-half of one per cent,"<sup>1231</sup> the court rejected this test "because it is impossible to consider in depth the internal workings of the various other corporations. This would mean the trial of numerous wholly collateral matters under conditions of handicap."<sup>1232</sup> Thirdly, the business judgment rule ap-

1223 See notes 1193, 1198 *supra*.

1224 *Saxe v. Brady*, 40 Del. Ch. 474, —, 184 A.2d 602, 616-17 (Ch. 1962).

1225 220 F. Supp. 527 (D. Colo. 1963).

1226 *Id.* at 531. Management was the sponsor, advisor, and underwriter of Fund's shares. Programs was initially organized by Management to serve as the Fund's underwriter, was at all times controlled by Management, but by the time of the suit had been merged into Management. *Id.*

1227 From 1935 to 1940 Management had served as Fund's underwriter. During this period Fund was under a separate contract with Richard M. Scott, Jr., who served as investment advisor in return for the one half per cent fee. On the first of June, 1940, Fund entered into a new contract with Management whereby Management undertook to provide all administrative services for Fund and also undertook to subcontract for independent investment advice. Under this contract Management received the one half per cent fee. *Id.* at 533.

1228 *Id.* at 547-48.

1229 *Id.* at 548.

1230 *Id.*, quoting *Saxe v. Brady*, 40 Del. Ch. 474, —, 184 A.2d 602, 610 (Ch. 1962).

1231 *Acampora v. Birkland*, 220 F. Supp. 527, 548 (D. Colo. 1963).

1232 *Id.* at 549.

plied in *Saxe*<sup>1233</sup> was adopted by the court as a basis for refusing to weigh the value of the services Fund received.<sup>1234</sup> While *Saxe* admitted that such an evaluation was fraught with "inherent difficulties," *Acampora* was disposed to assert that "it is impossible to evaluate the service rendered."<sup>1235</sup> (Emphasis added.)

Just as *Saxe* had contained evidence of judicial dissatisfaction with the prevailing scheme of management compensation,<sup>1236</sup> the *Acampora* court, in an effusion of obiter dicta, vented similar misgivings:

Certainly, the one-half of one per cent. approach leaves a great deal to be desired . . . Such a guaranteed fee fails to take into account success or failure of the advisory effort. Still another bad feature is that its probable increase is disproportionate to the value of the services rendered. [Nevertheless] the fact that a more equitable scheme could be worked out, or that this writer sees potential abuses in the method, does not furnish a basis for an adjudication of excessiveness.<sup>1237</sup>

On the issue of excessiveness, the plaintiffs in the above cases were uniformly

1233 The Chancellor in *Saxe* had said:

The value of services is obviously a matter of judgment on the part of the person who must pay for them. Thus, courts are often shielded by presumptions which wisely cause them to defer to decisions of directors or stockholders. *Saxe v. Brady*, 40 Del. Ch. 474, —, 184 A.2d 602, 610 (Ch. 1962).

Whether fees are, in fact, the product of unencumbered business judgment is, of course, doubtful. In view of the historic inertia the fees have displayed, the prevalence of management control of the fund, its board of directors, its proxy machinery, and the veritable judicial immunity afforded by state law, the validity of the "business judgment" argument in this context is highly suspect. For the amount of "business judgment" actually exercised by the unaffiliated directors, see notes 1175 *supra* and 1360 *infra*. Just as there is no justification for application of the business judgment rule where directors are personally interested in their own decisions, see note 1234 *infra*, so there should be no application of the rule where directors do not actually direct. In both situations the law should recognize that there is no conscientious consideration of the good of the corporation.

1234 This application of the "business judgment rule," 3 W. FLETCHER, *supra* note 1184, § 1039, in a case of interlocking directorates evidences a very dangerous trend that may be developing in the law. The basic flaw in this development, of course, is that while shareholders may assume the risk of faulty business judgment on the part of directors, the "business judgment rule" should never be used to supplant the directors' undivided duty of loyalty. *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590 (1921); *Shlensky v. South Parkway Bldg. Corp.*, 19 Ill. 2d 268, 166 N.E.2d 793 (1960); 3 W. FLETCHER, *supra* note 1184, § 1039 at 626 n.35. Directors' first regard must be for the welfare of the corporation and its shareholders; they may not enrich themselves at the expense of the corporation. See, e.g., *Pepper v. Litton*, 308 U.S. 295 (1939); *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955); *Remillard Brick Co. v. Remillard-Dandini Co.*, 109 Cal. App. 2d 405, 241 P.2d 66 (Dist. Ct. App. 1952); *Shlensky v. South Parkway Bldg. Corp.*, 19 Ill.2d 268, 166 N.E.2d 793 (1960).

The erosion of the basic duty of fairness and good faith in cases of contracts between interlocked corporations has reached a dangerous level in *Warshaw v. Calhoun*, — Del. Ch. —, 221 A.2d 487 (Sup. Ct. 1966). This case openly applied the "business judgment rule" to a situation involving board interlock, citing as its authority *Moskowitz v. Bantrell*, 41 Del. Ch. 177, 190 A.2d 749 (Sup. Ct. 1963). *Moskowitz*, however, did not involve interlocking directorates at all, and leaves *Warshaw* without precedent. (*But cf.* *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1964); *Case v. New York Cent. R.R.*, 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (1965).)

If *Warshaw* and the other cases cited evidence a development in Delaware law, albeit poorly reasoned, litigating mutual fund shareholders will be among those to suffer most. The extension of "business judgment" to a situation so fraught with conflicts of interest seriously undercuts the common law of directorial fiduciary duty. See 45 N.C.L. Rev. 755 (1967).

1235 *Acampora v. Birkland*, 220 F. Supp. 527, 549 (D. Colo. 1963).

1236 See notes 1193, 1198 *supra*.

1237 *Acampora v. Birkland*, 220 F. Supp. 527, 548-49 (D. Colo. 1963). Moreover, the court volunteered its opinion that the fee was "high," but felt that this alone was insufficient to make it wasteful under the *Saxe* test. *Id.* at 549.

unable to survive preliminary motions. All was not lost, however, for there was one case which squarely held that a court may intervene when management fees have grown beyond justification. That case was *Saminsky v. Abbott*,<sup>1238</sup> decided in 1961 by the same Delaware chancellor who had heard *Saxe* and *Meiselman*.

*Saminsky* involved trustee's fees exacted by Keystone Custodian Funds, Inc., a Delaware corporation which acted as trustee for ten separate common-law trusts, each registered as a separate mutual fund. Keystone provided its own investment advice, but since it was a bona fide trustee it could not be classified as an investment advisor under the 1940 Act.<sup>1239</sup> Under the trust agreements, Keystone retained all the perquisites of independent management<sup>1240</sup> and charged for its services both a management fee and a "recurring charge."<sup>1241</sup> Plaintiff sued Keystone and its directors, alleging that the trustee's fees were so large as to amount to a "spoliation or waste"<sup>1242</sup> of the funds' assets. The action was rested on "general equitable principles," both sides conceding that the Investment Company Act did not govern the question.<sup>1243</sup>

The "general equitable principle" invoked was, of course, that a waste of corporate assets may not be ratified by any number of directors, no matter how independent or prudent, nor by any number of shareholders.<sup>1244</sup> The court reached back to the doctrine of *Rogers v. Hill*<sup>1245</sup> to support its thesis that a method of compensation unobjectionable per se may ultimately result in such excessive payments that a court of equity might intervene.

The *Rogers* case itself was a legal landmark, not only for its direct and pervasive impact on the practices of the business community, but also for the incredible scandal which surrounded the decision of the Second Circuit.<sup>1246</sup> Plaintiff *Rogers* challenged a stock option plan, embodied in a bylaw of the American Tobacco Company, which afforded generous bonuses, based on a percentage of the corporation's profits, to the company's president and certain other managing officers. *Rogers* acquired his stock in American Tobacco in 1916; the bylaw had been adopted in 1912. The United States Supreme Court held that compensation based on such a percentage formula was not, ipso facto, actionable, but recognized that the payments may have reached wasteful pro-

1238 40 Del. Ch. 528, 185 A.2d 765 (Ch. 1961), *settlement approved*, 41 Del. Ch. 320, 194 A.2d 549 (Ch. 1963), *aff'd sub nom.* Kleinman v. Saminsky, 41 Del. Ch. 572, 200 A.2d 572 (Sup. Ct.), *cert. denied*, 379 U.S. 900 (1964).

1239 Investment Company Act of 1940 § 2(a)(19), 15 U.S.C. § 80a-2(a)(19) (1964).

Because a trustee is not an investment advisor, Keystone is not subject to even the minimal safeguards of section 15 of the Act. The original legislative proposals in the Ninetieth Congress, S. 1659, H.R. 9510 and H.R. 9511, would have amended section 2(a)(19) of the Act to withdraw the preferential treatment accorded Keystone. S. 1659, 90th Cong., 1st Sess. § 2(4) (1967); H.R. 9510 90th Cong., 1st Sess. § 2(4) (1967); H.R. 9511, 90th Cong., 1st Sess. § 2(4) (1967).

Legislation presently before Congress would permit the Keystone arrangement to continue unchanged. That legislation, however, would also impose a "reasonableness" limit on all management compensation, including Keystone's. The pending legislation seems acceptable.

1240 *Saminsky v. Abbott*, 40 Del. Ch. 528, —, 185 A.2d 765, 768 (Ch. 1961).

1241 *Id.* at —, 185 A.2d at 767. See notes 1057-58 *supra* and accompanying text.

1242 *Id.* at —, 185 A.2d at 770.

1243 *Id.* at —, 185 A.2d at 768.

1244 *E.g.*, *Rogers v. Hill*, 289 U.S. 582, 591 (1933); *Keenan v. Eshleman*, 23 Del. Ch. 234, —, 2 A.2d 904, 909 (Sup. Ct. 1938).

1245 289 U.S. 582 (1933).

1246 The fascinating history surrounding Judge Martin T. Manton and his decision in the case is recounted in J. BORKIN, *THE CORRUPT JUDGE* 25-93 (1962).

portions as the company prospered. The significant language for present purposes is the following:

[T]he payments under the by-law have by reason of increase of profits become so large as to warrant investigation in equity in the interest of the company. Much weight is to be given to the action of the stockholders, and the by-law is supported by the presumption of regularity and continuity. But the rule prescribed by *it cannot, against the protest of a shareholder, be used to justify payments of sums as salaries so large as in substance and effect to amount to spoliation or waste of corporate property. . . .* "If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part and the majority stockholders have no power to give away corporate property against the protest of the minority."<sup>1247</sup> (Emphasis added.)

The defendants in *Saminsky* relied heavily on two aspects of the "shell theory" of investment companies — aspects which we shall call the "fragmentation argument" and the "disclosure argument." Simply stated, the shell theory identifies the investment company with its external manager (trustee in *Saminsky*), viewing the investment company itself as nothing more than a legalistic detail, a vehicle through which a product is offered to the public. That product<sup>1248</sup> is the investment company's security, embodying as it does the managerial service of the advisor.<sup>1249</sup> The ineluctable implication of the shell theory is that all negotiations of management compensation are properly between the investor and the advisor, so that once having purchased the "product" with knowledge of the fees management will exact, the investor is no longer in a position to complain. From a fund manager's point of view, it is not difficult to accept this notion, since the practice is such as to make any distinction between a fund and its management "strictly legal."<sup>1250</sup>

The shell theory is legally untenable and certainly one of the most dangerous prevarications the industry has had the audacity to advance. To adopt it is to deny that directors of an investment company have any responsibility to their stockholders. The shell theory was expressly rejected by the United States District Court for the District of Delaware in *Taussig v. Wellington Fund, Inc.*,<sup>1251</sup> but

1247 *Rogers v. Hill*, 289 U.S. 582, 591-92 (1933).

1248 Managers are fond of referring to stock in an investment corporation as their own personal "product." One such reference was made in the somewhat startling assertion: "I mean it is a product. *If we just did away with the vote for the shareholder, there really would be no problem.*" Testimony of Fred Alger, 1967 *House Hearings* 505 (emphasis added). From a management point of view, it is difficult to quarrel with the last sentence.

In the course of the argument in *Taussig v. Wellington Fund, Inc.*, 187 F. Supp. 179 (D. Del. 1960), *aff'd*, 313 F.2d 472 (3d Cir.), *cert. denied*, 374 U.S. 806 (1963), defendants similarly referred to a fund's stock as a marketable "product" of the advisor. *Id.* at 198.

1249 *Cf.* note 1128 *supra*.

1250 "To [advisors] the fund itself has little or no independent significance for it is essentially the brand name under which a particular adviser sells its services to the public." PUBLIC POLICY STATEMENT 76.

1251 187 F. Supp. 179 (D. Del. 1960). To the rhetorical question propounded by defendants, "One may ask 'What is the reason for the existence of Wellington Fund if it engages in no activities and is a mere conduit or shell?'" the *Taussig* court made extended answer, relevant excerpts of which are:

Wellington Fund is not the corporate shell defendants would have this Court find. Wellington Fund is an \$858 million corporation and has over 262,000 stockholders. There are 13 persons on the Board of Directors, seven of whom are not permitted by law to have any affiliation with either the managing or sponsoring

commentators such as Professor Lobell continued to insist that "a mutual fund is a cluster of individual service arrangements . . . ." <sup>1252</sup> It is quite true, as Professor Shipman observed, that

The Investment Company Act specifically rejects the shell theory. This lies at the heart of the management fee dispute. The Investment Company Act looks at the investment company as a separate legal entity, and the directors of the investment company have clear continuing fiduciary duties to the fund and its shareholders. . . .

[T]he first thing to do is to bury the shell theory.<sup>1253</sup> (Footnotes omitted.)

companies. Wellington Fund was formed pursuant to the corporate laws of the State of Delaware, which [demand that the board of directors manage the affairs of the corporation].

The by-laws of Wellington Fund [vest the corporate powers in the board of directors].

The Investment Company Act of 1940 declares that,

"[The advisor serves only under contract.]"

"[The contract depends for its continuance on the judgment and approval of the board of directors.]"

"[The contract may be terminated at the pleasure of the board of directors.]"

"[Underwriting contracts are similarly placed within the discretion of the board of directors.]"

Defendants recognize the Board of Directors are required to, and in fact, do function in a significant manner . . . .

Defendants describe the workings of an investment company as,

"[a collection of individual advisory accounts]."

. . . . The defendants have chosen to conduct their affairs via the corporate form. Sound policy reasons dictate, no exception be made in the instant litigation which would permit defendants to function outside the carefully delimited boundaries of corporate law. . . . The Court is thus asked to forsake 262,000 investors with holdings of \$858 million in favor of a corporation controlled by one person . . . who is also president and director of Wellington Fund. *Id.* at 195-97 (footnotes omitted).

1252 Lobell, *The Mutual Fund: A Structural Analysis*, 47 VA. L. REV. 181, 185 (1961). Professor Lobell was shocked at the idea that fund directors had continuing fiduciary responsibilities to their shareholders. "[D]isclosure and competition for investors' patronage should be the forces to adjust inequities in fee structure." *Id.* at 202 (footnotes omitted). Review of a fund's policy by its own board of directors, in his view, "sets a range of obligations seriously at variance with current understanding and practice," and if this be true, as it surely is, Lobell has condemned the very industry and directors he seeks to defend. *Id.* at 195. That a fund should be anything other than a "captive" of its advisor is, to Lobell, unthinkable. *Id.* at 199 n.55. This was bad enough, but Lobell went on to publish a very unfortunate law review article a few months later which would have the fund directors do little more than watch the advisor to see that he performed his contract. Again the house of cards is built on disclosure: "It would seem beyond doubt that no shareholder of a fund has standing to complain of any of these disclosed and accepted elements of the fund predating his purchase and unchanged . . . since his acquisition of the shares." Lobell, *Rights and Responsibilities in the Mutual Fund*, 70 YALE L.J. 1258, 1268-69 (1961). See also Jaretzki, *Duties and Responsibilities of Directors of Mutual Funds*, 29 LAW & CONTEMP. PROB. 777 (1964); Jaretzki, *The Investment Company Act: Problems Relating to Investment Advisory Contracts*, 45 VA. L. REV. 1023 (1959) (recognizing the problem of escalating fees, and purportedly suggesting that directorial responsibility be clarified to meet the problem, Mr. Jaretzki actually falls back on disclosure and shareholder approval, *id.* at 1037).

The Wharton Report had exposed the fact of management control. WHARTON REPORT 67. Lobell and others have attempted to derive from the bare fact its own legal justification.

1253 Statement of Morgan Shipman, *University of Pennsylvania Law School Conference on Mutual Funds*, *supra* note 1026, at 748.

An oft-repeated industry objection to proposals which would demand "reasonableness" in management contracts is that the cost of management to the individual fund shareholder is a bargain, even at present levels, which he could not duplicate in an individual advisory account or bank common trust. E.g., statement of Robert Loeffler, 1967 House Hearings 469. Indeed, one fund manager is so impressed with this "bargain" rationale that he flatly asserts, "[m]anagement fees are too low." Statement of Charles Steadman, 1967 House Hear-

The two arguments used by the defendants in *Saminsky*, fragmentation and disclosure, are sprits of the shell theory. The former implies that each investor in a trust (investment company) has separately contracted with the trustee (advisor). Hence, in considering the reasonableness of managerial fees, charges to the individual investors should be considered *seriatim*.<sup>1254</sup> Since the cost to the individual is quite low compared to the cost of an individual management account with an independent investment advisor, so the argument runs, the investor should not be heard to complain.<sup>1255</sup> Quite properly, the *Saminsky* court would have none of this. The investors in one of the Keystone trusts should not be considered to have settled myriad separate trusts, for to do so is to ignore the collective character of the trust as a single, unified investment company.<sup>1256</sup>

The disclosure argument, on the other hand, rests on estoppel by contract.<sup>1257</sup> If each investor has contracted individually with the manager (or, in our case, settled a separate trust), then he may not object to the fees he has voluntarily obligated himself to pay so long as these were fully disclosed to him when he

*ings* 401. This argument, in large measure, is based on a "shell theory" conception of the mutual fund.

It should be observed, however, that a comparison to an individual advisory account is misplaced. If a person is sufficiently prosperous, and has a large amount of money to invest, he may retain independent investment management and receive highly personalized, individual advice tailored to his specific needs or preferences. The investor in a mutual fund, however, foregoes the luxury of personalized advice in order that he may invest a more modest amount and receive institutionalized investment advice. The fund shareholder has a legitimate expectation that by pooling his investment with the investments of many others, he will be able to obtain management at reasonable cost. It is, after all, the *fund* which contracts for investment management of a single large portfolio. When the fund is overcharged for management services, the shareholders may justifiably complain that they are being fleeced, notwithstanding that *as individuals* they might not be able to obtain comparable service at less cost. Clearly the industry argument quite ignores the fiduciary status which fund directors and managers bear to the shareholders. Certainly these men do not discharge their duties by simply asserting that a shareholder could do no better on his own.

<sup>1254</sup> The SEC, on several occasions, addressed itself to this argument with an anecdotal *reductio*:

Of course, even the most outrageously exorbitant fees or charges can be made to seem "reasonable" if their impact is divided among a sufficiently large group. Would it be unreasonable on this basis, for instance, for each American to pay the President of the United States one cent per year for his efforts in administering our country's affairs? Based on a population of almost 200 million, this would amount to almost \$2,000,000 a year. Would it be unreasonable for each American to contribute a nickel (\$10 million a year) or a dime (\$20 million a year)? The industry cannot detract from the significance of advisory fee rates by resorting to the device of allocating the \$140,000,000 collected as advisory fees among several million investors. The division of the total advisory fees levied on investors in mutual funds into minute fragments does not in any way reduce these fees or affect the judgment that they are too high. Neither Congress nor the courts have recognized such a transparent device in determining whether or not fees or charges are unreasonable. *1967 Senate Hearings* 137. *See also 1967 Senate Hearings* 19; *1967 House Hearings* 41-42, 105.

<sup>1255</sup> *Saminsky v. Abbott*, 40 Del. Ch. 528, —, 185 A.2d 765, 769 (Ch. 1961), *settlement approved*, 41 Del. Ch. 320, 194 A.2d 549 (Ch. 1963), *aff'd sub nom. Kleinman v. Saminsky*, 41 Del. Ch. 572, 200 A.2d 572 (Sup. Ct.), *cert. denied*, 379 U.S. 900 (1964). *See* note 1253 *supra*.

<sup>1256</sup> To demonstrate the unified nature of each trust (investment company), the court pointed out that each trust is created by a single trust agreement to which Keystone and all the investors are parties. Further, a trust agreement may only be amended or modified by a majority vote of the investors, and each investor participates equally in all the assets of the entire trust. *Id.* at —, 185 A.2d at 770. This reasoning applies with all the more force to an investment company which is a single corporation.

<sup>1257</sup> *Id.* at —, 185 A.2d at 769.

accepted the offer.<sup>1258</sup> The court would have none of this either. Referring again to the *Rogers* case, the Chancellor observed that stockholder Rogers was, in legal contemplation, also aware of the compensation arrangement when he purchased his shares;<sup>1259</sup> that there was no reason to treat a business trust differently from a business corporation;<sup>1260</sup> and that the redeemability of a trust certificate should not distinguish the case.<sup>1261</sup> On the premise that what is good enough for the Supreme Court is good enough for the Delaware Chancery, the judge concluded that equitable intervention under the *Rogers* doctrine was permissible and denied the defendants' motion for summary judgment.

The effect of shareholder ratification in these cases has been to raise the threshold for equitable intervention from "fairness" to "waste" of assets. Indeed, the court in *Saxe* presumed not only a partially interlocked board, but a totally interested directorate<sup>1262</sup> in order to dramatically point up what it considered the legal effects of ratification. While it is indisputable that stockholder ratification may cut off the rights of minority shareholders to object to certain otherwise voidable transactions, it is equally clear that ratification will not save a contract which involves a breach of trust.<sup>1263</sup> The question, then, is whether the ratification rules have been improperly applied to perform absolution on breaches of fiduciary duty. It has been forcibly, and, it is submitted, convincingly argued that a shift in the applicable standard from "fairness" to "waste," as well as a shift in the burden of proof<sup>1264</sup> in the fund cases reflects an entirely unsound rule of law.<sup>1265</sup>

1258 Defendants asserted that every investor was made aware of the fact that management (the trustee) was compensated on a percentage of assets formula. Further, since information on the size of the fund and its fees was readily available and periodically reported to the investors, they were "put on notice that the amount earned by Keystone would increase . . . ." *Id.* at —, 185 A.2d at 770.

1259 In the *Rogers* case all the shareholders by purchasing their shares agreed to be bound by the by-laws passed in accordance with the corporate charter. Plaintiff in that case acquired his shares after the adoption of the by-law. Thus, in law he was deemed to have had full knowledge of the existing by-law. Yet the Supreme Court held that the subsequent growth of payments to the point where they no longer bore any reasonable relation to the services rendered justified equitable intervention. Plaintiffs in the instant case are similarly situated with respect to the terms of the trust agreements. Thus, the same result would seem to be appropriate here. *Id.* at —, 185 A.2d at 771.

1260 *Id.*

1261 *Id.* at —, 185 A.2d at 770-72; see text accompanying notes 1129-30 *supra*.

1262 This assumption, according to the minority view, renders the contract voidable at the instance of either party, without regard to the fairness of the transaction or the presence of complete good faith. Fletcher calls this the better view. 3 W. FLETCHER, *supra* note 1184, § 961, at 475 n.87. The majority view permits the contract of majority interlocked boards to stand, provided the contract is entirely fair and entered into in good faith. *E.g.*, *Corsicana Nat. Bank v. Johnson*, 251 U.S. 68 (1919); *Schlesky v. South Parkway Bldg. Corp.*, 19 Ill.2d 268, 166 N.E.2d 793 (1960). See generally 3 W. FLETCHER, *supra* note 1184, § 962, and copious authority there collected.

1263 3 W. FLETCHER, *supra* note 1184, § 982.

1264 In *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590 (1921), the Supreme Court said:

The relation of directors to corporations is of such a fiduciary nature that transactions between boards having common members are regarded as jealously by the law as are personal dealings between a director and his corporation, and *where the fairness of such transactions is challenged the burden is upon those who would maintain them to show their entire fairness* and where a sale is involved the full adequacy of the consideration. Especially is this true where a common director is dominating in influence or in character. *This court has been consistently emphatic in the application of this rule, which, it has declared, is founded in soundest morality, and we now add in the soundest business policy.* *Twin-Lick Oil Co. v. Marbury*, 91 U.S. 587, 588; *Thomas v. Brownville, Ft. Kearney & Pacific R.R. Co.*, 109 U.S.

Whatever the soundness of the rule, this much is clear: under developing state law fund managers and directors may effectively insulate themselves from any requirement of fairness by obtaining mechanical majority ratification of their contracts.<sup>1266</sup> In view of the concentration of control in the fund's management, the lack of protection offered by shareholder voting rights where proxies may be mechanically obtained from widely dispersed and unsophisticated stockholders, the inherent conflicts of interest which accompany externalized management, and the relative ease with which burdensome terms may be camouflaged in adhesive advisory contracts, the ratification development should not be countenanced.

b. "Gross Abuse of Trust" — *The Federal Standard*

Largely because of the ratification rule, it was clear that litigating fund shareholders were waging a losing battle. The *Saminsky* case, like so many others,<sup>1267</sup> was ultimately settled.<sup>1268</sup> In the course of his opinion approving the

522; *Wardell v. Railroad Co.*, 103 U.S. 651, 658; *Corsicana National Bank v. Johnson*, 251 U.S. 68, 90. *Id.* at 599 (emphasis added).

The *Geddes* rule as to burden of proof prevails in most jurisdictions and is amply supported by imposing authority from the Supreme Court on down. It would be of little use to re-examine the impressive line of case law which preceded and has followed *Geddes* on this point. See the extensive collection of excellent cases in 3 W. FLETCHER, *supra* note 1184, § 974.

As to the shift in burden of proof, see Note, *The Nonratification Rule and the Demand Requirement: The Case for Limited Judicial Review*, 63 COL. L. REV. 1086, 1099-1103 (1963), where the *Heyden* rule, relied upon by the *Saxe* court, is meticulously analyzed and found to be wanting in many respects. The commentator concludes:

The *Heyden* doctrine has been used as conclusive precedent for shifting the burden of proof in cases involving . . . compensation of a mutual fund investment adviser under a service contract.

That the *Heyden* doctrine is inconsistent with the nonratification rule purportedly embraced by the Delaware . . . courts is evident; if shareholders are powerless to absolve directors who commit alleged frauds, they should be similarly powerless to perform absolution by shackling a minority shareholder with an almost insurmountable burden of proof at trial. Further, the doctrine amounts to more than a rule of evidence; it constitutes a reappraisal of what conduct may be ratified. Theoretically, any disparity between what a corporation receives and what it gives amounts to a gift of the corporate assets. But under the *Heyden* test, as applied by the Delaware Supreme Court in *Saxe v. Brady*, [*sic*, *Saxe* was a case in chancery] liability is only imposed if "what the corporation has received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid. If it can be said that ordinary businessmen might differ on the sufficiency of the terms, then the court must validate the transaction." Such a test questions whether or not there existed, on the terms of the transaction, a reasonable basis for validating it. *Id.* at 1102-03 (footnotes omitted).

The complete lack of authority for the *Heyden* rule is pointed out in *id.* at 1102 n.140. *Saxe* also cites *Kaufman v. Schoenberg*, 33 Del. Ch. 211, 91 A.2d 786 (Ch. 1952) for its ratification doctrine, but *Kaufman*, another case decided by Chancellor Seitz himself, merely relies on *Heyden*.

1265 A shift in burden of proof is bad enough, but perhaps more important is the shift of the standard from "fairness" to waste. This application of ratification is indefensible. Eisenberg & Lehr, *supra* note 1194, at 220-25.

1266 Ratification should not have this effect when directors or advisors are charged with a breach of trust under section 36 of the 1940 Act. Section 36 establishes a federal standard of conduct, breach of which is an illegal act; and illegal conduct may not be ratified so as to cut off the rights of a minority stockholder. *Rogers v. American Can Co.*, 305 F.2d 297, 317 (3d Cir. 1962), *aff'g* 187 F. Supp. 532 (D.N.J. 1960). As will be seen, however, the section 36 standard may be somewhat lower than desirable, notwithstanding that it may be higher than suspected.

1267 PUBLIC POLICY STATEMENT 138-41. See generally, Eisenberg & Phillips, *Mutual Fund Litigation — New Frontiers for the Investment Company Act*, 62 COLUM. L. REV. 73 (1962); PUBLIC POLICY STATEMENT 154; 1967 House Hearings 750.

1268 *Saminsky v. Abbott*, 41 Del. Ch. 320, 194 A.2d 549 (Ch. 1963), *aff'd sub nom.*



settlement, Chancellor Seitz volunteered dicta which have pervaded the cases attacking management fees:<sup>1269</sup>

As to the objectors' contention that the "excessive return" reflects lack of competitive forces in the field, I can only say that the legal format involved is not illegal and if there is to be "regulation" of this so-called "built-in" control, it must come from the legislative branch unless it results in the violation of some positive principle of law, such as that applicable to a waste of assets. These observations are equally applicable to the contention that the allegedly excessive profits flow from a breach of duty by a self-dealing trustee.<sup>1270</sup>

The sentiment which is apparent here clearly reflects a judicial reluctance to interfere with a fund-external management format sanctioned by the Investment Company Act. There is some validity to this view, but there is also

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Kleinman v. Saminsky, 41 Del. Ch. 572, 200 A.2d 572 (Sup. Ct.), *cert. denied*, 379 U.S. 900 (1964). The terms of the settlement were not shocking in their generosity. *Id.* at —, 194 A.2d at 550. Objectors to the settlement asserted that the scaled down fees were still excessive, pointing out that the trustee, even with the sliding scale, would still realize a return on its own net worth of 190 per cent. *Id.* at —, 194 A.2d at 552. Thus the scale-down only cost the advisor slightly over ten per cent in his rate of return. While 190 per cent is a rather handsome return on investment, the Chancellor noted that it is not unusual or necessarily unreasonable that service corporations experience high rates of return. *Id.* The *Wharton Report* gives the rather obvious explanation that investment advice is not a capital-intensive line of activity, and that rates of return can therefore be somewhat deceptive. *WHARTON REPORT* 517.

1269 In *Saxe v. Brady*, 40 Del. Ch. 474, 184 A.2d 602 (Ch. 1962), the Chancellor had used strikingly similar language to make the same point: "If the fund-management company format is to be legally questioned, such inquiry must come from some other place." *Id.* at —, 184 A.2d at 616.

Chancellor Seitz had no monopoly on this notion. In the settlement of a suit involving the management of Axe-Houghton Fund B, Inc., a zealot named George Hillman, was bent on pursuing the lawsuit to its consummation. In Hillman's opinion there were "great evils pervading the investment company industry," which he was unwilling to see swept under the judicial rug by means of a settlement. *Kerner v. Crossman*, 211 F. Supp. 397, 401 (S.D.N.Y. 1962). He considered the terms of the settlement oppressive and contended "that it is no answer that [the fees provided in the settlement] may be in line with similar fees charged by other open-end investment funds because . . . the whole scale of such fees is outrageous." *Id.* at 401. The court, however, adopted Chancellor Seitz's view, rejecting Hillman's objection as an attack "on the industry as a whole and the way it conducts its business." *Id.* This sort of sweeping indictment, it felt, was beyond its proper sphere and should be left to Congress or the SEC. *Id.* at 401-02.

In another context the judge in *Taussig v. Wellington Fund, Inc.*, 187 F. Supp. 179 (D. Del. 1960), demonstrated the same reluctance: "The Court is mindful that seemingly many practices prevail in this industry that in other areas are *legally and economically intolerable* . . . . It would, however, be unwise at this time to sit in judgment of the entire industry . . . ." *Id.* at 197 (emphasis added).

Judge Ryan, in upholding a settlement of litigation involving Investors Diversified Services, answered objectors in similar language:

[A]bsent any finding of positive malfeasance such as violation of fiduciary duty or of statutory standards, it is quite conceivable that a Court or a jury would find that what plaintiffs were really challenging was the Fund System as a whole of which defendants were but a part rather than any wrongdoing on the part of defendants.

*Glicken v. Bradford*, 35 F.R.D. 144, 159 (S.D.N.Y. 1964).

1270 *Saminsky v. Abbott*, 41 Del. Ch. 320, —, 194 A.2d 549, 552 (Ch. 1963). How the court is able to conclude that "a breach of duty by a self-dealing trustee" is not a "violation of some positive principle of law" is completely incomprehensible. Nevertheless, it is this sort of thinking which has liberated fund managers to do as they please, provided only that they refrain from openly plundering.

When Judge Friendly was asked, "Do you feel that the usual pattern of stockholder protection exists in this industry as in other industries?" his reply was emphatic: "I don't think it exists in this industry. It might be an interesting philosophical speculation as to how far it really exists in some others, but I don't think it exists in this from what I have seen of it." 1967 *House Hearings* 616.

inherent in the cases an oversight of other applicable federal law in the Investment Company Act. It is extremely important to observe that, when considering the level of management compensation, cases such as *Saxe*, *Acampora*, and *Saminsky* proceeded on purely state law bases. When a suit, rested on the Investment Company Act, was brought in Delaware and submitted to a court for approval of its settlement, the court presumed that the federal claim would not affect the applicable standards. The case was *Rome v. Archer*,<sup>1271</sup> a derivative suit involving the Wellington Fund, its directors, advisor, and principal underwriter. Like *Saxe*, *Rome* was concerned with improper director action in overcompensating the fund's advisor.<sup>1272</sup> Unlike *Saxe*, causes of action based on the Investment Company Act were presented in *Rome*, with objectors to the settlement relying on *Brown v. Bullock*.<sup>1273</sup> The court, however, cited *Saxe* to the effect that a one-half per cent fee was judicially unassailable as a matter of common law and disposed of *Brown* by asserting that it "merely held that the fiduciary duties of investment company directors have a basis in the investment Company Act as well as in the Common Law."<sup>1274</sup> Perhaps the point was insufficiently developed by the objectors or inartfully presented, but the resulting dictum just quoted certainly seems erroneous. It will be seen that the Investment Company Act contains a standard of conduct somewhat lower than desirable, but nevertheless capable of avoiding the unfortunate ratification rule which has shackled the common law.

Whatever may have been the state of the law prior to 1961, it should have been pellucidly clear to the *Rome* court that the Investment Company Act establishes a federal standard of director responsibility.<sup>1275</sup> Moreover, that federal

1271 41 Del. Ch. 404, 197 A.2d 49 (Sup. Ct. 1964).

1272 From the standpoint of the facts, *Rome* was not an exceptionally strong case on this point. The effective fee rate paid to the advisor was only .27 per cent of net assets. In an industry which has traditionally called for one-half per cent fees, the rate in *Rome* was conspicuous by its modesty. *Id.* at —, 197 A.2d at 54. See Appendix B *infra*.

1273 194 F. Supp. 207 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961).

1274 *Rome v. Archer*, 41 Del. Ch. 404, —, 197 A.2d 49, 55 (Sup. Ct. 1964). The court also maintained that "since the Federal Act sets no maximum fee schedule, the same considerations found relevant in *Saxe* would probably also be relevant in litigation considering the Investment Company Act of 1940." *Id.*

The observation that the Act sets no maximum fee schedule was correctly characterized by the *Brown* court as "beside the point." *Brown v. Bullock*, 194 F. Supp. 207, 229 (S.D.N.Y. 1961). For Judge Herlands, the absence of mechanical statutory limits could not be read to dilute the standard of care required of investment company directors under section 37 of the Act. (It might also be noted that in at least one insignificant instance the Act does impose a maximum fee, *i.e.*, one per cent. Investment Company Act of 1940 § 10(d)(6), 15 U.S.C. § 80a-10(d)(6) (1964).)

1275 In *Aldred Inv. Trust v. SEC*, 151 F.2d 254 (1st Cir. 1945), *cert. denied*, 326 U.S. 795 (1946), an action brought by the SEC under section 36, the court turned to the classic case of *Pepper v. Litton*, 308 U.S. 295 (1939), for a statement of the fiduciary duties appropriate as a source of law under the section:

He who is in such a fiduciary position cannot serve himself first and his *cestuis* second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. . . . He cannot utilize his inside information and his strategic position for his own preferment. . . . He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestuis*. *Id.* at 311.

standard should be a potent weapon in attacking the more egregious excesses in management compensation. Though the case of *Brown v. Bullock* was ultimately reduced to a "naked question of pleading,"<sup>1276</sup> the opinion of Judge Herlands in the district court carefully considered the propriety of applying federal standards of directorial conduct in the negotiation of management compensation.

*Brown* was a representative and derivative action brought by shareholders of Dividend Shares, Inc. [Fund], against the nine directors of the Fund and the Fund's external manager, Calvin Bullock, Ltd. [Management], which served as investment advisor and principal underwriter of Fund's shares.<sup>1277</sup> Plaintiffs in the action charged, *inter alia*, that Management completely dominated and controlled Fund's business and its board of directors; that the contract between Management and Fund was dictated by Management and "acquiesced in" by Fund's directors as a result of "the arbitrary action, collusion, gross negligence or reckless disregard of duty of the individual defendants and the Management Company"; that individual defendant-directors of the Fund "abdicated their functions" by making "no effort to ascertain whether" some organization other than Management could be employed to supply the same services "on terms more advantageous to the Fund" and that they made no effort to persuade or bargain at arm's length with Management to lower its fees;<sup>1278</sup> that the advisory contract approved by the directors provided for fees that "were and are excessive and out of proportion to the value of the services performed, as the defendants [directors] knew or should have known";<sup>1279</sup> that the payment of management fees under these circumstances constituted (1) "conversion" of the Fund's assets in violation of section 37 of the Act,<sup>1280</sup> (2) "[g]ross abuse of trust, gross misconduct, willful misfeasance, bad faith, gross negligence or reckless disregard of official and contractual duties" in violation of section 36,<sup>1281</sup> and (3) a breach

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In his concurring opinion in *Aldred*, Judge Peters of the Second Circuit had set the stage for the Supreme Court:

In view of the declaration of policy set forth in the Act in question it appears that the term "gross abuse of trust," as used therein, covers a course of conduct by the officers and controlling stockholders of an investment company in violation of the standards of conduct generally applied to fiduciaries, such as would exist if they were acting with other than disinterested motives. *Aldred Inv. Trust v. SEC, supra*,

at 261.

1276 Brief for Appellees at 1, *Brown v. Bullock*, 294 F.2d 415 (2d Cir. 1961).

1277 *Brown v. Bullock*, 194 F. Supp. 207, 210-11 (S.D.N.Y. 1961).

1278 *Id.* at 212.

1279 *Id.* at 213.

1280 Investment Company Act of 1940 § 37, 15 U.S.C. § 80a-36 (1964), provides:

Whoever steals, unlawfully abstracts, unlawfully and willfully converts to his own use or to the use of another, or embezzles any of the moneys, funds, securities, credits, property, or assets of any registered investment company shall be deemed guilty of a crime, and upon conviction thereof shall be subject to the penalties provided in section 80a-48 of this title. A judgment of conviction or acquittal on the merits under the laws of any State shall be a bar to any prosecution under this section for the same act or acts.

1281 Investment Company Act of 1940 § 36, 15 U.S.C. § 80a-35 (1964), provides:

The Commission is authorized to bring an action in the proper district court of the United States or United States court of any Territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after August 22, 1940, and within five years of the commencement of the action, of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts:

of the directors' "fiduciary duties to the Fund," a "gift, waste and a spoliation of the assets of the Fund" in violation of state law!<sup>1282</sup>

The court agreed that the charge was cognizable in a federal forum, even though neither section 36 nor section 37 expressly authorizes a private suit for enforcement. Judge Herlands began by spotlighting section 1 of the Act, especially paragraphs 1(a)(5) and 1(b)(2) which respectively refer to the inherent difficulties of multiform state regulation and the adverse effects on the national interest "when investment companies are . . . operated . . . in the interest of directors, officers, investment advisers . . . rather than in the interest of all classes of such companies' security holders."<sup>1283</sup> With this overriding policy firmly in mind, the court turned to the case law to show that a private right of action could be inferred "to enforce any liability or duty created by"<sup>1284</sup> the Act, citing authority of *Cogan v. Johnston*,<sup>1285</sup> *Schwartz v. Eaton*,<sup>1286</sup> and *Taussig v. Wellington Fund, Inc.*<sup>1287</sup> Analogous cases in related areas of security regulation were

(1) as officer, director, member of an advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate.

1282 *Brown v. Bullock*, 194 F. Supp. 207, 211-13, 228 (S.D.N.Y. 1961). Defendants admitted that the complaint adequately alleged "common law charges of waste and breach of fiduciary duty." *Id.* at 219. If, therefore, the federal claims were properly within the subject-matter jurisdiction of the court, it would also be able to adjudicate the common law claims which fell within the rules of pendent jurisdiction. *Id.* at 220 (citing cases). *See also* C. WRIGHT, HANDBOOK OF THE LAW OF FEDERAL COURTS § 19 (1963).

1283 Investment Company Act of 1940 § 1(b)(2), 15 U.S.C. § 80a-1(b)(2) (1964). *See* *Breswick & Co. v. United States*, 134 F. Supp. 132 (S.D.N.Y. 1955), *rev'd on other grounds sub nom. Alleghany Corp. v. Breswick & Co.*, 353 U.S. 151 (1957): "One of the purposes of the Investment Company Act is thus to protect investors in investment companies against the managing of those companies in the interests of persons other than the investors." *Id.* at 138.

1284 *Brown v. Bullock*, 194 F. Supp. 207, 220 (S.D.N.Y. 1961).

1285 162 F. Supp. 907 (S.D.N.Y. 1958). *Cogan* was a derivative and representative suit based on sections 7 and 36 of the Investment Company Act and seeking an injunction and the appointment of a receiver. The federal court took jurisdiction under section 44 of the Act and noted that an individual plaintiff may properly sue to enforce his rights protected by the Act. *Id.* at 909.

*Cogan* also considered the section 36 allegation, but the investment company involved was unregistered. Hence the court concluded that the plaintiff could not "as an individual, sue under this section on the basis of alleged abuse of trust by an officer or director of an unregistered investment company . . ." *Id.* But *see* Nielson, *Neglected Alternatives for Investor Self-Help: The Unregistered Investment Company and the Federal Corporate Law*, 44 NOTRE DAME LAWYER 707-10 (1969).

1286 264 F.2d 195 (2d Cir. 1959). This case cited *Cogan* and held that section 44 conferred jurisdiction in a derivative suit based on violations of section 7 of the Act.

1287 187 F. Supp. 179 (D. Del. 1960), *aff'd*, 313 F.2d 472 (3d Cir.), *cert. denied*, 374 U.S. 806 (1963). *Taussig* held that a private litigant asserting a cause of action for violation of section 35 of the Act had presented a federal question for purposes of jurisdiction. Since the reasoning and authority of *Taussig* was adopted and heavily relied upon in *Brown*, it is appropriate to set forth the salient feature of Judge Wright's opinion here:

Violation of a federal statute may accord a private litigant a remedy by implication notwithstanding the absence of specific statutory authority conferring upon the injured the right to redress statutory wrongs, for the common law will supply a remedy where the statute is silent. [Citing *Bell v. Hood*, 327 U.S. 678 (1946); RESTATEMENT OF TORTS § 286.] The intention to create civil liability is presumed unless a contrary legislative intent is to be inferred from the whole purview of the Act. *Id.* at 217 (footnotes omitted).

similarly used to conclusively demonstrate the propriety of an implied right of civil action even in the absence of an express statutory grant.<sup>1288</sup>

For present purposes, the important aspect of the implied right of private action is the recognition that "[i]n certain major respects, the 1940 Act operates as a [federal] corporation law for investment companies."<sup>1289</sup> In making this statement the *Brown* court adopted the view taken in *Aldred Investment Trust v. SEC* that "§ 1(b) of the Act . . . in effect codifies the fiduciary obligations placed upon officers and directors of investment companies."<sup>1290</sup> It would follow, as the *Brown* court concluded, that "[r]egardless of their foundation in the com-

<sup>1288</sup> *Brown v. Bullock*, 194 F. Supp. 207, 224-32 (S.D.N.Y. 1961). Among the more important statements of the court are the following:

Implied rights of action are not contingent upon statutory language which affirmatively indicates that they are intended. On the contrary, they are implied unless the legislation evidences a contrary intention. . . .

Under the 1933 Act, which contains a specific civil recovery provision, a private cause of action has been implied for violations of the broader anti-fraud provisions of the statute, despite a narrower clause that expressly exempted the particular bonds from the misrepresentation provision. *Thiele v. Shields*, D.C.S.D.N.Y. 1955, 131 F. Supp. 416, 419. *Id.* at 224.

The principle of implied liability was applied directly in *Fischman v. Raytheon Mfg. Co.*, 2 Cir., 1951, 188 F.2d 783, involving a stockholders' action under section 10(b) of the 1934 Act, which forbids the use of fraudulent devices in connection with the purchase and sale of securities. No remedy is expressly granted by that provision to the person aggrieved.

Another leading case is *Baird v. Franklin*, 2 Cir., 1944, 141 F.2d 238, certiorari denied 1944, 323 U.S. 737, 65 S.Ct. 38, 89 L.Ed. 591, interpreting section 6(b) of the 1934 Act which, as judicially construed, makes it the duty of every stock exchange to expel or discipline members for unethical conduct. No private right of action is provided for violation of this duty. In *Baird v. Franklin*, 2 Cir., 141 F.2d 238, at page 245, sustaining a private right of action, it was said:

"The fact that the statute provides no machinery or procedure by which the individual right of action can proceed is immaterial. It is well established that members of a class for whose protection a statutory duty is created may sue for injuries resulting from its breach and that the common law will supply a remedy if the statute gives none. (Citing cases.)" *Id.* at 224-25.

"[W]e think a denial of a private right of action to those for whose ultimate protection the legislation is intended leaves legislation highly publicized as in the public interest in fact sadly wanting, and even delusive, to that end" . . . *Id.* at 226 [quoting *Goldstein v. Groesbeck*, 142 F.2d 442, 427 (2d Cir.), cert. denied, 323 U.S. 737 (1944)].

The implication herein of a private civil remedy under section 37 of the 1940 Act (and under other sections, as will hereinafter be shown) is only a specific application to securities legislation of a general principle recognized and expounded in such cases as *Fitzgerald v. Pan American World Airways*, 2 Cir., 1956, 229 F.2d 499, 501; *Spirit v. Bechtel*, 2 Cir., 1956, 232 F.2d 241, 243 [Judge Swan's opinion] at pages 248-251 [Judge Lumbard's concurring opinion], at pages 251-252 et seq. [Judge Frank's dissenting opinion]. *Brown v. Bullock*, 194 F. Supp. 207, 229 (S.D.N.Y. 1961).

See generally *Loomis & Eisenberg, The SEC as Amicus Curiae in Shareholder Litigation — A Reply*, 52 A.B.A.J. 749 (1966). The reply is to a preposterous article by Carl Shipley, *Shipley, The SEC's Amicus Curiae Aid to Plaintiffs in Mutual Fund Litigation*, 52 A.B.A.J. 337 (1966). Shipley relies on the now discredited case of *Brouk v. Managed Funds, Inc.*, 286 F.2d 901 (8th Cir. 1961), vacated as moot per curiam, 369 U.S. 424 (1962). *Brouk* has been overruled by implication in its own circuit. *Greater Iowa Corp. v. McLendon*, 378 F.2d 783 (8th Cir. 1967).

The Eighth Circuit's *Brouk* rule had caused no mean amount of procedural footwork. See *Ruskay v. Reed*, 225 F. Supp. 581 (S.D.N.Y. 1963); *Ackert v. Ausman*, 198 F. Supp. 538 (S.D.N.Y. 1961), *aff'd sub nom. Ackert v. Pelt Bryan*, 299 F.2d 65 (2d Cir. 1962), *remanded*, *Ackert v. Ausman*, 217 F. Supp. 934 (S.D.N.Y. 1963).

<sup>1289</sup> *Brown v. Bullock*, 194 F. Supp. 207, 232-33 (S.D.N.Y. 1961).

<sup>1290</sup> *Aldred Inv. Trust v. SEC*, 151 F.2d 254, 260 (1st Cir. 1945), cert. denied, 326 U.S. 795 (1946).

mon law, *these fiduciary obligations are granted a federal basis resting in the Act . . .*<sup>1291</sup> (Emphasis added.)

Specific duties under federal law may be derived from particular sections of the 1940 Act.<sup>1292</sup> For example, the *Brown* court carefully considered section 15 and properly concluded that it imposed a duty on directors to carefully and independently scrutinize contracts presented for their approval or annual extension. Whatever corresponding duty may be imposed by state common or statutory law, this much at least was required by the federal law in the interest of stockholder protection. Hence, a complaint which charged collusive or pro forma director approval under section 15 charged an actionable violation of federal law.<sup>1293</sup> Section 36, said the court, is likewise a repository of federal law,<sup>1294</sup> and was not inserted into the Act merely to enforce "exclusively State-created duties as prescribed and defined in multitudinous State corporation laws and their interpretive decisions."<sup>1295</sup> While other sections of the Act proscribed certain conduct in some detail, the complexity of the industry and the subtlety of the abuses to which it is particularly vulnerable required that the Act contain a "residuary" clause capable of dealing with those violations of stockholder trust

1291 *Brown v. Bullock*, 194 F. Supp. 207, 234 (S.D.N.Y. 1961).

1292 Section 17 is an illustration used by the court:

The Act contains specific prohibitions against certain transactions and imposes specific disabilities upon directors, all aimed at the more blatant abuses and breaches of trust. Thus, to prevent the wrongs inherent in "self-dealing," "sitting on both sides of the table" or "unloading or dumping" of securities upon the investment company, section 17 of the Act prohibits any transaction either as principal or agent by any affiliated person and the investment company, except to act as a securities broker at the usual commissions.

The intent to impose this fiduciary duty is evident from the fact that this disability to consummate these types of transactions transcends the common law which merely subjects the transaction to scrutiny as to fairness. *Id.* at 238 n.1.

1293 *Id.* at 235-37.

The grant of these defined powers, as specified by the Act, carries with it the imposition of corresponding duties. The power to extend the investment advisory contract necessarily carries with it the duty to determine whether or not the extension is desirable and in the best interest of the company. The power to terminate the investment advisory contract necessarily carries with it the duty to keep alert for reasons which might make termination necessary or desirable; and, in the presence of such reasons, to exercise the right of termination. *The objectives of the Act would be nullified if the directors were free to extend mechanically the contract without honestly exercising their best judgment. The objectives of the Act would be equally frustrated if the directors were free to close their eyes to any developments making the termination of the contract advisable.*

By giving the directors the right to extend and to terminate the contract, the Act necessarily also imposes upon the directors the fiduciary duty to use these powers intelligently, diligently and solely for the interests of the company and its stockholders. *These specific fiduciary duties are created by the Act.* Their violation subjects the directors to liability, which can be enforced in the federal courts under section 44 of the Act.

The reasoning of the *Baird* case applies to section 15 of the 1940 Act. If all that section 15 meant was that the directors must give their annual token approval to the extension of the advisory contract, there would have been no purpose for its inclusion in the Act. The purpose of section 15 was to protect investment companies and their shareholders from selfish mismanagement. This objective can be realized only if section 15 is construed as imposing upon the directors the duty to use diligence and honest judgment in extending the advisory contract from year to year and in giving constant consideration to the possibility of its termination. *Id.* at 235-36 (emphasis added). See *Brown v. Bullock*, 294 F.2d 415, 421 (2d Cir. 1961).

1294 That section 36 gives rise to a private right of action was also held in *SEC v. Quing N. Wong*, 42 F.R.D. 599 (D.P.R. 1967).

1295 *Brown v. Bullock*, 194 F. Supp. 207, 238 (S.D.N.Y. 1961).

not easily anticipated and specifically treated in some other section. That residuary clause was section 36.<sup>1296</sup>

Since section 36 articulates a federal standard of fiduciary duty, and since directors and advisors are within its purview, the section would seem to be a logical weapon for plaintiffs attacking excessive management compensation. While the standard of duty applicable under section 36 may leave something to be desired, there should be no doubt that the standard is higher than "waste" and *will be unaffected by purported shareholder ratification*.<sup>1297</sup> The gist of an action such as *Brown v. Bullock*, in the final analysis, is that an investment company is being operated in the interest of the advisor rather than the shareholders — a breach of that fiduciary duty "codified" in section 1(b) — and hence there is a proper subject for action under section 36.<sup>1298</sup>

To simply show that section 36 and the other sections of the Act impose certain fiduciary obligations which may be enforced privately in a federal court and which are applicable to a management compensation case is to show very little. The more important question must be: How high are these standards and when will conduct of directors or advisors be unlawful? The legislative history of the section, as thoroughly discussed in *Brown*,<sup>1299</sup> gives two clues.

First, "gross abuse of trust" embodies a statutory fiduciary duty which falls somewhat short of the fiduciary duty of a trustee. This would appear to be obvious from the use of the adjective *gross*, and is further supported by the testimony of David Schenker, counsel to the SEC's *Investment Trust* study:

When we came to draft [the] provision . . . it presented a great many problems, because if you try to impose a trustee obligation on these managers, maybe that obligation is much too strict. . . . So we took the broader approach and said that if he was guilty of gross misconduct or gross abuse of trust, then he was guilty of a crime.<sup>1300</sup>

In view of the criminal sanction which originally accompanied "gross abuse of trust," there may have been reason to set the standard of duty below trusteeship. If so, those reasons no longer obtain, and with the introduction of more flexible remedies for breaches of section 36,<sup>1301</sup> the imposition of a genuine trust relation-

<sup>1296</sup> The argument that section 36 provides merely a method of enforcement of duties specified in other sections of the Act and does not contain substantive standards of director responsibility itself, was answered forcefully by Judge Herlands:

This argument, if accepted, would emasculate section 36 and make it a superfluity, inasmuch as section 42(e) grants the Commission the broadest power to institute proceedings for injunctive relief against any person who has engaged or is about to engage in any act or practice constituting a violation of any provision of the Act. Such enjoined person would be disqualified to act as a director by operation of section 9 of the Act. *Id.* at 239 n.1.

<sup>1297</sup> See Eisenberg & Lehr, *supra* note 1194, at 216-17 and authority collected. See also note 1266 *supra* and accompanying text.

<sup>1298</sup> Mr. Jaretzki may be disposed to dispute this: "I said that an investment advisor was not in a fiduciary capacity as to the amount of his fee, not that it has no fiduciary duty. It has a fiduciary duty not to charge excessive fees." Mr. Pomerantz, understandably puzzled, replied, "That dichotomy escapes me." *University of Pennsylvania Law School Conference on Mutual Funds*, *supra* note 1026, at 753.

<sup>1299</sup> *Brown v. Bullock*, 194 F. Supp. 207, 240-45 (S.D.N.Y. 1961).

<sup>1300</sup> 1940 *Senate Hearings* 262. The prototype of section 36 was criminal. S. 3580, 76th Cong., 3d Sess. § 17(e) (1940).

<sup>1301</sup> See note 1320 *infra*.

ship might be one of the most salutary reforms that could be suggested for the investment company industry short of compulsory internalization of management. However this may be, one thing is clear — section 36 as presently constituted articulates a standard of duty which has as its upper limit the common law duty of strict trusteeship.

On the other hand, the section 36 standard of duty would certainly be above the nadir of “conversion,” which retained its criminal character when the present section 37 was carved out of the original section 17(e).<sup>1302</sup> “Conversion” within the meaning of section 37 is “[t]he willful misapplication of corporate funds by fiduciaries,” and it may be established by evidentiary circumstances surrounding the payment of management fees “such as . . . collusion [or] *the relationship of the size of payments to the value of the services . . . rendered.*”<sup>1303</sup> (Emphasis added.) This, of course, is precisely the standard of corporate waste as defined in the state law cases.<sup>1304</sup> Hence the *minimum* duty owed under section 36 lies somewhere above the standard of waste. Already there is a standard somewhat less permissive than the outright looting required after a common law ratification.

Furthermore, it is probable that section 36 presents a shifting standard of duty, and if this is true, the standard of duty for some individuals will be even further removed from that point at which section 37 is breached. As has been pointed out, the minimum standard of duty under section 36 is situated somewhere above the standards of section 37, and section 36 itself embraces all directors, *affiliated and unaffiliated*, as well as an investment company’s advisor, advisory board, and officers. Arguably, section 36 imposes upon the unaffiliated directors a higher standard of duty than is required of the affiliated directors or the advisor. Such a reading of section 36 relies upon the authority and reasoning of the federal court which decided *Escott v. BarChris Construction Corporation*.<sup>1305</sup>

*BarChris* itself dealt with the standard of duty applicable to the establishment of a “due diligence” defense to section 11 actions under the Securities Act of 1933.<sup>1306</sup> Several directors were involved, some of long standing in the corporation with intimate knowledge of the financial condition of the enterprise and others who were simply “outsiders.” Each undertook to show his own “due

1302 The legislative history indicates that there may be a considerable gap between the minimum standard of duty under section 36 and the point at which section 37 is violated. See generally *Brown v. Bullock*, 194 F. Supp. 207, 240-42 (S.D.N.Y. 1961). Especially noteworthy is the fact that the court considered larceny, embezzlement, and willful conversion — the proscriptions of section 37 — to be “[t]he worst forms of [gross] misconduct or [gross] abuse.” *Id.* at 242. If section 37 was designed to sanction more heavily the most egregious examples of section 36 violations, this would imply that certain lesser instances of “gross abuse” would remain for sanction under section 36, some of which activities would be comparatively far from the larceny or conversion level of conduct.

This conclusion is further supported by an examination of section 42(e) of the Act. That section, in substance, provides for enforcement of the various provisions of the Act through injunctions sought by the Commission. Unless section 36 proscribes conduct which is not specifically outlawed in some other section of the Act, it would be pure surplusage, for the mechanism of section 9(a) will combine with the mechanism of section 42(e) to accomplish automatic director disqualification.

1303 *Id.* at 229.

1304 *E.g.*, *Rogers v. Hill*, 289 U.S. 582, 591 (1933). See also *Gallin v. National City Bank*, 152 Misc. 679, —, 273 N.Y.S. 87, 113-19 (Sup. Ct. 1934).

1305 283 F. Supp. 643 (S.D.N.Y. 1968).

1306 Securities Act of 1933 § 11, 15 U.S.C. § 77k (1964).



diligence" in investigating the non-expertised portions of a registration statement. While section 11(c) sets the standards for a reasonable investigation as "that required of a prudent man in the management of his own property,"<sup>1307</sup> the court held that some directors would be held to a higher standard of duty than others. It is important to note that it is the standard of duty which shifts, not the standard of conduct required to fulfill that duty. Hence the "prudent man" rule applies with equal force to all the directors, though the duty owed by some will exceed the duty owed by others. In particular, referring to one director who had participated in the preparation of the registration statement and who was otherwise knowledgeable in the corporation's finances, the *BarChris* court said "more was required of him in the way of reasonable investigation than could fairly be expected of a director who had no connection with this work."<sup>1308</sup> This analysis placed the heavier burden on the "inside" directors and the underwriter in *BarChris*. With respect to the underwriters, Judge McLean noted that "the positions of the underwriter and the company's officers are adverse,"<sup>1309</sup> pointing up the duty of the underwriter to delve deeply and independently into the corporation's fiscal condition. This language is strikingly similar to that of Judge Doyle in *Acampora*:

These *non-affiliated directors* have a demanding mission and that is the protection of the assets of Fund and the shareholders. *Their position in relation to Management is adversary in character*, and if they are properly to fulfill their mission they are obliged to scrutinize the acts and doings of the advisor with great care.<sup>1310</sup> (Emphasis added.)

In the investment company context, and by a parity of reasoning, the unaffiliated directors should be held to a higher standard of fiduciary duty under section 36 than are the affiliated directors or the advisor himself. In *BarChris* the public could properly look to the more knowledgeable professionals to assure accurate preparation of the registration statement, while in the investment company, with its complement of interested managers, the public's expectation of

1307 *Id.* § 11(c).

1308 *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 690 (S.D.N.Y. 1968). See Comment, *Securities Regulation*, 44 NOTRE DAME LAWYER 122, 139 (1968), quoting H. REP. NO. 85, 73d Cong., 1st Sess. 9 (1933):

[T]he degree of diligence demanded of the different defendants varied, as the House Committee . . . felt it should, "with the importance of their place in the scheme of distributions and with the degree of protection the public has a right to expect." (Footnotes omitted.)

The language of the Supreme Court seems to be in accord and to have particular relevance to the unaffiliated directors in the mutual fund context:

[The obligation of the director] if he becomes a party to a contract with the company, to candor and fair dealing, is increased in the precise degree that his representative character has given him power and control derived from the confidence reposed in him by the stockholders who appointed him their agent. If he should be a sole director, or one of a smaller number vested with certain powers, this obligation would be still stronger, and his acts subject to more severe scrutiny, and their validity determined by more rigid principles of morality, and freedom from motives of selfishness.

*Twin-Lick Oil Company v. Marbury*, 91 U.S. 587, 590 (1876) (emphasis added). While *Marbury* speaks of self-dealing, the principle which it enunciates should have extended application, so that the duty required of a fiduciary is directly proportional to the trust reposed in him.

1309 *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 696 (S.D.N.Y. 1968).

1310 *Acampora v. Birkland*, 220 F. Supp. 527, 550 (D. Colo. 1963).

protection is properly identified with the role of the unaffiliated director. If this was sufficient to shift the duty of reasonable investigation upward in the *BarChris* case, it should also be sufficient to revise upward the duty of the non-affiliate under section 36

*c. The Evolving Duty — The Banking Industry Analogy*

Thus far it has been suggested that the section 36 standard of duty may be breached by any director before the point of "waste" or "conversion" is reached, and that in the case of the unaffiliated directors the section 36 standard should be even higher. Already it is clear that management contract cases which would fail on the "waste" standard may, as the circumstances approach "waste" or "conversion," be won if based on directorial breach of section 36 duty, and especially is this true if the attack is centered on the unaffiliated directors.

Standards of duty under section 36 for both the affiliated and unaffiliated directors as well as the advisor may be even higher than suspected. Investment companies solicit and handle the savings of myriad small investors,<sup>1311</sup> holding themselves out as competent to manage and protect other people's money. In this respect an investment company has much in common with commercial<sup>1312</sup> or savings<sup>1313</sup> banks, and it is submitted that investment company directors should be held to the same standards of duty as are applicable in these other institutions. One commentator has observed that "banks are generally considered to be quasi-public institutions, and hence their directors may be subjected to a somewhat higher degree of responsibility than directors of most other types of corporations."<sup>1314</sup>

Two cases have adopted this view and held the directors of an investment

1311 There were strong overtones of congressional concern for the protection of small investors' savings:

In the opinion of the committee, the Securities and Exchange Commission, and the industry itself, this legislation is needed to protect small investors from breaches of trust upon the part of unscrupulous managements and to provide such investors with a regulated institution for the investment of their savings. H.R. REP. No. 2639, 76th Cong., 3d Sess. 10 (1940).

1312 "The stockholder-management relationship in a Mutual Fund is akin to that of the directors of a bank with the depositors or stockholders. In each case there is a use of funds belonging to others . . ." Nielson, *Fiduciary Standards of Conduct Under The Investment Company Act*, in CONFERENCE ON MUTUAL FUNDS 154 (S. Hodes, P. Geerlings & M. Simpson eds. 1966).

1313 Directors of a savings bank, organized without capital stock, are often said to be strict trustees for depositors. *Hun v. Cary*, 82 N.Y. 65 (1880) is the leading case on this point, and is still excellent law. 3 W. FLETCHER, *supra* note 1184, § 845. While it is not being suggested that mutual fund directors are held to the standards of common law trustees under section 36, it is submitted that the body of trust law should be a primary source in ascertaining the precise standards applicable under that section. Aside from the "financial" nature of the business, there are functional similarities between a mutual fund and a common law trust which dictate this result. Note, *Rights and Obligations in the Mutual Fund: A Source of Law*, 20 VAND. L. REV. 1120, 1135-38 (1967).

1314 Wilson, *Responsibilities of a Bank Director*, BUS. LAWYER, April 1955, at 45.

Undoubtedly, a director of a bank is held to a stricter accountability than the director of an ordinary business corporation. A director of a bank is entrusted with the funds of depositors, and the stockholders look to him for protection from . . . personal liability. 3 W. FLETCHER, *supra* note 1184, § 1035.  
See also Litwin v. Allen, 25 N.Y.S.2d 667 (Sup. Ct. 1940); 3 W. FLETCHER, *supra* note 1184, § 1038; cases collected in R. BAKER & W. CAREY, CASES AND MATERIALS ON CORPORATIONS 417-18 (3d ed. 1959).

company to the same standard of duty imposed on directors of a bank. In *Goodwin v. Simpson*<sup>1315</sup> the Supreme Judicial Court of Massachusetts said:

Inasmuch as the corporation was engaged in a business in which it solicited the handling and investment of the money of others, the fiduciary obligations of its officers are not different from those of corresponding officers of a banking institution.<sup>1316</sup>

Similarly, in the case of *O'Connor v. First National Investors' Corporation*<sup>1317</sup> it was noted:

It is contended that the cases hereinbefore cited, which we think are controlling of the instant case, involved the liability of bank directors and the principles therein laid down do not apply to the case at bar. To this proposition we cannot agree. As previously said, the degree of care required of the directors of a corporation must depend upon the character of the corporation and the circumstances of each particular case. When we compare the business of this corporation with that of a bank, it seems to us that at least as much care should be required of the directors in the instant case as on the part of the directors of a bank . . . .<sup>1318</sup>

Both of these cases were decided in the pre-Act era of the thirties, but there is no reason to believe that the Act should have undermined the basic principles they stand for. Whatever may have been the standard for civil liability, the original draft of the Act, S. 3580, merely proposed a more permissive standard for *criminal purposes*. There is no indication in the legislative history that the Act was intended to dilute the civil remedies available for directorial negligence. It should still be true that investment company directors ought be held to the civil standard of bank directors under state law, and that this should serve as a source of law from which the duties imposed by section 36 can be ascertained.

One commentator has dissented from this view, insisting that the higher standards of fiduciary duty should not be applied to investment company directors, but his treatment is superficial and his authority quite weak.<sup>1319</sup>

1315 292 Mass. 148, 197 N.E. 628 (1935).

1316 *Id.* at —, 197 N.E. at 630.

1317 163 Va. 908, 177 S.E. 852 (1935).

1318 *Id.* at —, 177 S.E. at 860.

1319 The commentator is Jaretzki, who, in a footnote, contended:

It has been said that a more stringent rule is applicable to directors of banks and trust companies . . . but even if this is so, there is no logical basis for extending this more rigorous standard to investment company directors. Investment companies are organized as ordinary business corporations or business trusts, not under such special statutory provisions as those which pertain to other types of financial institutions, and, as the Massachusetts court has stated, they involve none of the special incidents peculiar to banks. *Spiegel v. Beacon Participations, Inc.*, 297 Mass. 398, 410-11, 8 N.E.2d 895, 904 (1937) . . . ; *Acampora v. Birkland*, 220 F. Supp. 527, 550 (D. Colo. 1963) . . . . In so far as the Investment Company Act is concerned, the only references to liabilities of directors of mutual funds are contained in § 36, relating to "gross misconduct, or gross abuse of trust," and § 17(h), which prohibits indemnification or exculpation for "wilful misfeasance, bad faith, gross negligence, or reckless disregard of the duties involved in the conduct of his office." Jaretzki,

*Duties and Responsibilities of Directors of Mutual Funds*, 29 LAW & CONTEMP. PROB. 777, 780 n.10 (1964).

The authority of *Spiegel* is unpersuasive, resting as it does on a single dubious sentence in that opinion: "It [the defendant corporation] involved none of the special incidents attaching to banking corporations." *Spiegel v. Beacon Participations, Inc.*, 297 Mass. 398, —, 8

The impact of *Goodwin* and *O'Connor* does not, of course, obviate the necessity of proving "gross" negligence in order to establish a violation of section 36.<sup>1320</sup> Rather, it is to recognize that "gross negligence" in the management of an investment company may involve abuses less flagrant than gross negligence in

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N.E.2d 895, 904 (1937). This is a strange observation. Further, Jaretzki's citation of *Acampora* is similarly unimpressive. That case merely stated that the applicable standard is "gross negligence," a proposition which, in the context of section 36, does not invite dispute. *Acampora*, however, goes slightly further than Jaretzki indicates, for the court was quick to add

that occupancy of the position of director of a mutual fund is not all fringe benefits, so to speak. These non-affiliated directors have a demanding mission and that is the protection of the assets of Fund and the shareholders. . . . [T]hey are obligated to scrutinize the acts and doings of the adviser with great care. *Acampora v.*

*Birkland*, 220 F. Supp. 527, 550 (D. Colo. 1963).

As to Jaretzki's "law of incorporation" approach, two highly respected commentators have observed:

Mr. Jaretzki's distinction between corporations organized under general corporation laws and those organized under "special statutory provisions" is also unpersuasive. First, the very reasons why banks, trust companies, and other financial institutions are treated separately under the law is that their assets are of a highly liquid nature—cash and securities—and the creditors or customers (or depositors) they deal with are generally not financially sophisticated. All of these factors are present with respect to the operations of a mutual fund. From this standpoint, it is irrelevant that mutual funds may be organized as "ordinary business corporations or business trusts." Second, the mere fact that banks and certain other financial institutions are organized under "special statutory provisions" only indicates that Congress (in the case of national banks) and the state legislatures (in the case of state banks and many other financial companies) were vitally concerned with protecting the interests of the public from those charged with the custody and supervision of their money and property. Similarly, mutual funds are also very much subject to "special statutory provisions." While they are initially organized under state law, mutual funds could not function as such unless registered under the Act. Furthermore, their shares must be registered under the Securities Act. An enterprise could not properly be regarded as "organized" as a mutual fund in the absence of compliance with these special statutory provisions.

The passage of the Investment Company Act in 1940 and its legislative history clearly demonstrate that investment companies are not to be treated as ordinary business corporations, but . . . require special federal regulation and treatment. Eisenberg & Lehr, *supra* note 1194, at 191-92.

1320 Proposed amendments to the Investment Company Act would have the very salutary effect of doing precisely this. In substance, the amendments would delete from section 36 the words *gross* and *guilty* (vestiges of the section's nativity as a criminal provision), and would also authorize more flexible remedies than the injunction now mandatory in case of a violation. Any appropriate remedy would be permitted.

The two bills now pending before Congress that would have this effect are S. 34 and S. 296. There is, however, a slight difference between them which should be noted. S. 34 authorizes relief against any breach or prospective breach of fiduciary duty "involving personal misconduct." S. 34, 91st Cong., 1st Sess. § 20 (1969). S. 296, identical in this respect to S. 1659, H.R. 9510 and H.R. 9511, contains no such qualification. Speaking of this limitation, the committee report on S. 3724, a bill identical to S. 34, said:

[Y]our committee does not intend to limit the Commission under this section to situations where an actual intent to violate the law can be shown or to acts of affirmative misconduct. In appropriate cases, nonfeasance of duty or abdication of responsibility would constitute a breach of fiduciary duty involving personal misconduct. S. REP. No. 1351, 90th Cong., 2d Sess. 34 (1968). *Compare id. with*

ANALYSIS OF S. 34, at 22.

The qualification does not appear to alter in any way the conduct that would be actionable under section 36 so long as a natural person is involved. Its only *raison d'être* is apparently to assure that section 36 is applied only to individuals, thus exempting companies which act as advisors or underwriters. This is an unnecessary loophole. Since advisors are fiduciaries, whether they are corporate or otherwise, and since they are entirely capable of breaching their duties through the agency of their officers (e.g., churning a fund's portfolio or appropriating for their own treasuries opportunities which belong to the fund), there would seem to be no justification for the exemption. In this respect S. 296 is the superior bill.

the management of an ordinary business corporation. In the leading case of *Hun v. Cary*,<sup>1321</sup> Judge Earle addressed the issue:

It is impossible to give the measure of culpable negligence for all cases, as the degree of care required depends upon the subjects to which it is to be applied. . . . What would be slight neglect in the care of a quantity of iron might be gross neglect in the care of a jewel. What would be slight neglect in the care exercised in the affairs of a turnpike corporation, or even of a manufacturing corporation, might be gross neglect in the care exercised in the management of a savings bank intrusted with the savings of a multitude of poor people . . . .<sup>1322</sup>

Although the court used terms which referred to a shifting standard of care, it is clear that the real shift was a shift in the standard of duty, for at a later point Judge Earle observed that “[G]ross negligence . . . has been defined to mean the absence of ordinary care and diligence *adequate to the particular case*.”<sup>1323</sup> (Emphasis added.)

It would appear, then, that section 36 holds considerable potential for checks on management compensation. The legislative history, the precedent of *BarChris* and the reasoning of *O'Connor* and *Goodwin* all demonstrate that a breach of section 36, especially on the part of the unaffiliated directors, may occur well before there is a waste of corporate assets. The SEC itself seems quite aware of this potential. In its *amicus* brief to the court of appeals in *Brown v. Bullock*, the Commission stated:

Directors, of course, owe a duty not only to refrain from profiteering from the corporation, but also to save the corporation from loss. Indeed, directors of banks, trust companies and other “companies which solicit the handling and investment of the funds of others” are held to “a higher degree of wisdom, prudence and good judgment than directors of ordinary business corporation [*sic*].”<sup>1324</sup> (Footnotes omitted.)

At another point in that brief, the SEC points out “that while the Act does not undertake to regulate management fees, it does not follow that there cannot be

1321 82 N.Y. 65 (1880).

1322 *Id.* at 71.

1323 *Id.* at 72.

1324 Brief for SEC as Amicus Curiae at 33, *Brown v. Bullock*, 294 F.2d 415 (2d Cir. 1961). The Commission’s brief here quotes H. BALLANTINE, CORPORATIONS § 63a, at 161 (rev. ed. 1946). The ellipsis, however, should be explained. The full quotation from Ballantine reads:

Directors of savings banks, trust companies, life insurance companies and companies which solicit the handling and investment of the funds of others, are by some courts declared responsible for a higher degree of wisdom, prudence and good judgment than directors in ordinary business corporations. It is doubtful, however, whether more is actually required than giving reasonable attention to the business, making proper inquiries upon the matter in hand, and exercising an honest judgment upon the information available, unless improvidence goes to the point of wilful or negligent waste.

Apparently attorneys for the SEC thought that their argument would be diluted by the inclusion of the full quotation, and a superficial reading might lead to this conclusion. On closer inspection, however, the negligence standard advocated by Professor Ballantine is not inimical to the SEC’s thesis, since the man of ordinary prudence would be expected to meet a higher standard of duty in the management of a financial institution than in the management of other affairs. Ballantine, in short, speaks of a constant standard of care—the reasonable man—but applies it to a situation demanding a higher standard of duty.

a gross abuse of trust with respect to fees."<sup>1325</sup> In its *Public Policy Statement*, the Commission acknowledged that "the duty of investment company managers to deal fairly with companies they serve is a *basic fiduciary obligation*"<sup>1326</sup> (emphasis added); that "section 1(b), the preamble to the Act, 'in effect codifies the fiduciary obligations placed upon officers and directors of investment companies'"<sup>1327</sup>; that section 1(b)(2) recognizes the impact on the national interest " 'when investment companies are . . . operated . . . in the interest of directors, officers, investment advisors'"<sup>1328</sup>; and that "section 36 should be broadly construed so as to effectuate the remedial purposes of the Act."<sup>1329</sup> Having advocated in *Brown* that the absence of express management compensation controls should not dilute the standards of section 36, the Commission in its 1966 *Statement* laments the fact that the Act "places no express limits on the amount of such compensation," which, the SEC maintains, renders section 36 "unclear and inappropriate"<sup>1330</sup> as a legal tool in the supervision of directorial duty with respect to management fees. There appears to be a measure of ambivalence in the Commission's position(s). This the Commission seeks to dismiss by saying:

[T]he very harshness of the sanction provided for in that section [36] impairs its usefulness in modifying advisory fee rates commonly charged in the industry. . . . Pending consideration by the Commission and Congress of more appropriate means for achieving more adequate controls over investment company management compensation, the Commission has been reluctant to stigmatize advisers<sup>[1331]</sup> with charges of "gross abuse of trust" . . . .<sup>1332</sup>

This has been an unfortunate position. First, the advisory organization is not the only fiduciary subject to a section 36 injunction; the provision by its very terms is equally applicable to individual directors or officers of the fund. Second, it is difficult to reconcile the Commission's characterization of the section 36 remedy as unduly "harsh" with the Commission's original view that any "gross abuse of trust" should invoke a criminal sanction.<sup>1333</sup> Third, and perhaps

1325 Brief for SEC as Amicus Curiae at 42 n.61, *Brown v. Bullock*, 294 F.2d 415 (2d Cir. 1961).

1326 PUBLIC POLICY STATEMENT 142.

1327 *Id.*, quoting *Aldred Inv. Trust v. SEC*, 151 F.2d 254, 260 (1st Cir. 1945), *cert. denied*, 326 U.S. 795 (1946).

1328 PUBLIC POLICY STATEMENT 142 n.191.

1329 *Id.* at 143.

1330 *Id.* at 142-43.

1331 The Commission's motives are possibly not so altruistic as all this. More likely the SEC's "reluctance" is at least partly attributable to a pair of judicial rebuffs, the sting of which has not fully subsided. *SEC v. Insurance Sec., Inc.*, 146 F. Supp. 778 (N.D. Cal. 1956), *aff'd*, 254 F.2d 642 (9th Cir.), *cert. denied*, 358 U.S. 823 (1958); *SEC v. Midwest Technical Dev. Corp.*, [1961-64 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,252 (D. Minn. 1963). For a more detailed treatment of the *Insurance Securities* case, see text accompanying notes 1402 *et seq. infra*.

1332 PUBLIC POLICY STATEMENT 143.

1333 As Mr. Schenker put it: "[W]e took the broader approach and said that if [a person] was guilty of gross misconduct or gross abuse of trust, then he was guilty of a crime." 1940 *Senate Hearings* 262.

Whatever may be the ultimate reason for the Commission's reluctance to invoke section 36 except in the most heinous cases, there is evidence of a judicial hesitancy to impose the rigid sanction of that provision. In *SEC v. Midwest Technical Dev. Corp.*, [1961-64 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,252 (D. Minn. 1963), a case involving improper investments in portfolio companies by directors of a closed-end, the court opined:

most important, the Commission's failure to attempt any regulation of management compensation may have played a key role in the defeat of legislation recommended to the Ninetieth Congress. Had the SEC brought a section 36 action for excessive fees and failed, its argument that section 36 "impairs rather than strengthens the fiduciary obligation of investment company managers to refrain from compensating themselves unfairly"<sup>1334</sup> might have been more convincing.

## 7. Proposed Legislation

### a. SEC Recommendations

Shareholder ratification of management contracts, which incumbents are able to obtain almost pro forma, will, under retrogressing state law, require the minority shareholder to show a waste of corporate assets — a burden tantamount to prosecuting a criminal conversion under section 37 of the Act. Clearly, this standard is far too permissive, condoning, as it does, management's ability to exclusively reap the gains from economies of scale. And while section 36 articulates a standard somewhat less stringent than this, even that section may permit the payment of unreasonably large management fees. Plainly, in light of the developing law, legislative action is imperative if there is to be any meaningful limitation on the ability of investment company fiduciaries to compensate themselves.

To this end, the SEC recommended in its 1966 *Statement*<sup>1335</sup> that the Investment Company Act be amended:

- (1) to require that advisory fees be "reasonable" in light of all relevant considerations;
- (2) to vitiate any effect of shareholder or non-affiliate director ratification on the applicability of the reasonableness standard;
- (3) to permit the SEC to bring an action to enforce this standard or to intervene in a private action to enforce it.

Presently pending before Congress are two similar bills, S. 34 and S. 296, designed to implement the Commission's recommendations<sup>1336</sup> and to attenuate some of the related conflicts of interest inherent in management compensation. The central provision of the bills, for present purposes, provides a mechanism for obtaining judicial scrutiny of the reasonableness of management compensa-

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However, an adjudication of gross abuse of trust must be based on evidence that a director is so untrustworthy that he should not be permitted to act in that capacity for any other company. The Court would not be justified in painting these directors with a broad brush of malfeasance and stigmatize them with a finding of gross misconduct and gross abuse of trust. *Id.* at 94,146.

Regardless of the correctness of the court's interpretation of section 36 and the ultimate desirability of a strict sanction, the inflexibility of the mandatory remedy does seem to impair the usefulness of the provision because of *judicial* reluctance.

1334 PUBLIC POLICY STATEMENT 143.

1335 *Id.* at 143-47.

1336 See North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME LAWYER 677, 692-96 (1969).

tion.<sup>1337</sup> While the reasonableness standard is not altered by the act of directorial approval, the judgment of the directors must be given "substantial weight,"<sup>1338</sup> while shareholder ratification is to be given "such consideration as is . . . appropriate under all the circumstances."<sup>1339</sup> If both the shareholders and a majority of the disinterested directors approve management compensation, however, there is a rebuttable presumption of reasonableness.<sup>1340</sup>

The amendment on its face seems innocuous enough; in fact it could be an extremely potent check on excessive management fees, as the industry recognizes. Objection has been both vociferous and voluminous, if not especially persuasive.

First, it is said that the amendment would be a litigation breeder, encouraging strike suits and continuously requiring management to undertake costly legal

1337 S. 34, 91st Cong., 1st Sess. § 8 (1969); S. 296 91st Cong., 1st Sess. § 8 (1969); see ANALYSIS OF S. 34, at 37-39.

1338 There was considerable concern in the industry that no weight would be attached to the determination of the directors. *E.g.*, testimony of J. Welch on behalf of the Investment Company Institute, 1967 Senate Hearings 197.

1339 Under the existing law of section 15(c), shareholder ratification may be substituted for the consideration and approval of unaffiliated directors, a practice which Professor Folk has characterized as "a convenient northwest passage around the existing statutory requirement of approval by . . . [the] non-affiliated directors." 1967 Senate Hearings 1006; 1967 House Hearings 806. The pending legislation would preclude this use of the proxy and require independent scrutiny of management contracts by the disinterested directors. S. 34, 91st Cong., 1st Sess. § 8(c) (1969); S. 296, 91st Cong., 1st Sess. § 8(c) (1969).

1340 S. 1659 and its companion bills in the House required that any party seeking a court determination of unreasonableness sustain the burden of proof on the issue. S. 1659, 90th Cong., 1st Sess. § 8(d) (1967); H.R. 9510, H.R. 9511, 90th Cong., 1st Sess. § 8(d) (1967). This language does not appear in S. 3724 or the presently pending legislation, but the requirement would remain the same. S. REP. NO. 1351, 90th Cong., 2d Sess. 15 (1968); ANALYSIS OF S. 34, at 7.

One authority is outspoken in his opinion that the burden should be upon the fiduciary to prove reasonableness. He argues that, (1) the advisor has access to the facts, which are matters internal to the advisory organization and bear on economies of scale, total brokerage and fees received, etc. The information is contained in the books of the advisor, to which the fund shareholder does not have access or inspection rights. The evidentiary burden on the plaintiff, it is concluded, would be extremely onerous and "would all but nullify the effect of the federal reasonableness standard." (2) The law should always place the burden of justification on the self-dealing fiduciary in order to provide an additional prophylaxis and an incentive to integrity. Statement of E. L. Folk, 1967 Senate Hearings 1003-04; 1967 House Hearings 803-04.

Former Commissioner Cohen replied that:

The Commission recognizes that H.R. 9510 would not go as far as many courts have gone in enforcing the fiduciary obligations of those who manage other people's money and it would not object to a change in the Bill to implement Professor Folk's suggestion. 1967 House Hearings 738.

There may be considerable merit to Professor Folk's argument, but its flaws should also be noted. First, the Federal Rules already permit liberal discovery under rule 34, and under the pending bills the federal courts have exclusive jurisdiction in section 15(d) actions. (In fairness to Professor Folk, it should be noted that the original bills on which he testified did not embody this feature.) Secondly, the distinction between the "risk of non-persuasion" and the "burden of going forward with the evidence" should be observed. While the risk of non-persuasion would remain on the plaintiff in a section 15(d) action, the fact that relevant evidence is in the possession of the defendants would often require the defendants to go forward with the evidence. *United States v. Hayes*, 369 F.2d 671 (9th Cir. 1966); *Fleming v. Harrison*, 162 F.2d 789 (8th Cir. 1947); *Zeeman v. United States*, 275 F. Supp. 235 (S.D.N.Y. 1967), modified, 395 F.2d 861 (2d Cir. 1968); *Gomes v. Eastern Gas & Fuel Associates*, 127 F. Supp. 435 (D. Mass. 1954); *Midwest Transfer Co. v. Preferred Accident Ins. Co.*, 342 Ill. App. 231, 96 N.E.2d 228 (Ct. App. 1951). This rule, however, is neither universal nor unqualified. *E.g.*, *Tortora v. General Motors Corp.*, 373 Mich. 563, 130 N.W.2d 21 (1964). Thirdly, Professor Folk's suggestion is vulnerable to a "strike suit" argument, far more so, at least, than the pending bills.



defenses.<sup>1341</sup> Closely allied to this allegation is the contention that a reasonable-ness requirement enforceable in the courts would be tantamount to governmental "rate regulation" since the SEC could, as a practical matter, force fee reductions at will by threat of suit.<sup>1342</sup>

There is very little substance to these objections. As to strike suits, it should be recognized that private litigation may be of two genera: justified lawsuits and groundless lawsuits. The justified lawsuits, be they derivative or representative, serve a useful legal function in the policing of complex modern corporations. As the Supreme Court observed in an oft-cited passage, "[p]rivate enforcement . . . provides a necessary supplement to Commission action,"<sup>1343</sup> especially in view of the limited resources in time and money at the Commission's disposal.<sup>1344</sup> More important, it is no valid objection to say that private litigants will seek to protect the rights secured to them by law.<sup>1345</sup> Further, the proposed bills are careful to allow a full year's indulgence before suit may be brought under the new section 15(d),<sup>1346</sup> and any fund manager who is justifiably apprehensive may be well advised to bring his fees within reasonable limits<sup>1347</sup> before the expiration of that grace period. Such a move should, if anything, reduce the possibility of a lawsuit.<sup>1348</sup> Further, by requiring that a shareholder first make written demand on the SEC, and then permitting him to sue only if the Commission refuses or

1341 See, e.g., 1967 House Hearings 526.

1342 See, e.g., 1967 House Hearings 241-42, 261, 530; 1967 Senate Hearings 197.

1343 J. I. Case Co. v. Borak, 377 U.S. 426, 432 (1964). See also Surowitz v. Hilton Hotels, Inc., 383 U.S. 363 (1966), *rev'g* 342 F.2d 596 (7th Cir. 1965), where the Court said: "[D]erivative suits have played a rather important role in protecting shareholders of corporations from the designing schemes and wiles of insiders who are willing to betray their company's interests in order to enrich themselves." *Id.* at 371. To the same effect, see *Brown v. Bullock*, 194 F. Supp. 207 (S.D.N.Y. 1961), where the court noted:

A private action by those aggrieved by the misconduct would furnish . . . pragmatically, an additional enforcement sanction. . . .

The possibility of multitudinous strike suits under the Act and the consequent expansion of federal jurisdiction is a spectre conjured up by defendants. The results of this court's holding will not be as horrendous as defendants would have it appear. If the fear of personal liability to the company or stockholders for gross misconduct or gross abuse of trust induces potential wrongdoers to walk in the paths of rectitude, the very availability of a private remedy will have served a desirable enforcement function. *Id.* at 245-46.

1344 Former Chairman Cohen pointed up the continued validity of this position:

We also believe it is important to retain the concept of a private right of action. . . . Administrative agencies, and the SEC is among them, are busy with different things at different times. There are limitations on its manpower. There are some cases which demand its attention, or there may be other cases that for one reason or another the Commission is unwilling to initiate. And, therefore, a private person should not be deprived of a Federal remedy under the standard to be established by Congress. 1967 House Hearings 145.

1345 [T]he industry is also worried about the small investor suing. We don't think that the courthouse door should be closed to him or that bars such as the standards of corporate waste should be erected in his path. In fact, the sum and substance of their argument is they don't want anybody reviewing the situation. *Id.* at 689-90.

1346 S. 34, 91st Cong., 1st Sess. § 29 (1969); S. 296 91st Cong., 1st Sess. § 29 (1969).

1347 [Managers] would be well advised to reduce advisory fees at least to the level marked out by settlements . . . under existing law. Funds that had not done this, particularly the large ones, would be the prime targets for private actions. Statement of Henry Friendly, 1967 Senate Hearings 1017. See also 1967 House Hearings 613-14.

1348 Such a reduction was considered favorably by the court in *Meiselman v. Eberstadt*, 39 Del. Ch. 563, —, 170 A.2d 720, 723 (Ch. 1961).

fails to act within six months, the danger of groundless suits is considerably diminished.<sup>1349</sup>

As to the allegation that the proposals would practically vest rate-making power in the SEC, there appears to be no basis in fact or law for the charge. Certainly the Commission will have a public duty to discharge its trust when a fee is, in fact, beyond the pale of reasonable toleration.<sup>1350</sup> But this is not to say that the Commission's judgment will be substituted for the business judgment of directors or that the Commission will attempt iron-handed rate fixing by resorting to the threat of litigation. Unlike H.R. 9510, H.R. 9511, and S. 1659, the pending bills explicitly require that (1) any determination of reasonableness by uninterested directors must be given "substantial weight" in a court's deliberation, and (2) if the investment company's board of directors determines in the exercise of "due care" that a fee is reasonable, no recovery may be had. "Due care" is defined in the bills as "the standard of care required of a prudent person in the management of his own property or affairs."<sup>1351</sup>

In requiring this measure of diligence from investment company directors, these amendments are breaking no new legal ground. In the words of Justice Cardozo: "The . . . director of a corporation, should [take] the same care of its property that men of average prudence take of their own property."<sup>1352</sup> Especially is this true in monetary or investment corporations. As was said in the leading case of *Hun v. Cary*:

When one deposits money in a savings bank, or takes stock in a corporation, thus divesting himself of the immediate control of his property, he expects, and has the right to expect, that the trustees or directors, who are chosen to take his place in the management and control of his property, will exercise ordinary care and prudence in the trusts committed to them—the same degree of care and prudence that men prompted by self-interest generally exercise in their own affairs.<sup>1353</sup> (Emphasis added.)

1349 S. 34, 91st Cong., 1st Sess. § 8(d) (1969); S. 296, 91st Cong., 1st Sess. § 8(d) (1969). The committee report on S. 3724, a bill identical to the pending bills in this particular, states that "[a]s a practical matter, this provision should have the effect of deterring the initiation of frivolous actions." S. REP. NO. 1351, 90th Cong., 2d Sess. 6 (1968). The requirement for shareholder demand on the SEC was not contained in the original bills in the Ninetieth Congress.

Parentetically, it is worth observing that the original 1940 bill, S. 3580, contained a section 33 which would have given the courts the benefit of an advisory report from the SEC in civil cases proceeding to settlement. S. 3580, 76th Cong., 3d Sess. § 33 (1940). This measure was designed to cope with some of the problems of "strike suit" litigation by assuring fair settlements. Testimony of Robert Healy, 1940 Senate Hearings 937-39. The provision did not survive except as a means of furnishing research data to the Commission. Investment Company Act of 1940 § 33, 15 U.S.C. § 80a-32 (1964). See 1940 Senate Hearings 1120.

1350 Former Chairman Cohen, testifying before the Senate committee, said: "We will have authority [to act where management compensation is excessive], and therefore when we have authority, we have an obligation to do our duty." 1967 Senate Hearings 64.

1351 S. 34, 91st Cong., 1st Sess. § 8(d) (1969); S. 296, 91st Cong., 1st Sess. § 8(d) (1969).

1352 *General Rubber Co. v. Benedict*, 215 N.Y. 18, 23, 109 N.E. 96, 97 (1915), followed in *Clayton v. Farish*, 191 Misc. 136, 73 N.Y.S.2d 727 (Sup. Ct. 1947). See also *San Leandro Canning Co. v. Perillo*, 84 Cal. App. 627, 258 P. 666 (Dist. Ct. App. 1927); *Nechis v. Gramatan Gardens, Inc.*, 35 Misc. 2d 949, 231 N.Y.S.2d 383 (Sup. Ct. 1962); *Gilbert v. Burnside*, — Misc. 2d —, 197 N.Y.S.2d 623 (Sup. Ct. 1959), *rev'd on other grounds*, 13 App. Div. 2d 982, 216 N.Y.S.2d 430 (1961), *aff'd*, 11 N.Y.2d 960, 229 N.Y.S.2d 10, 183 N.E.2d 325 (1962). There is admittedly a conflict among the courts on this point. 3 W. FLETCHER, *supra* note 1184, § 1036.

1353 82 N.Y. 65, 71 (1880).

Or, in the words of Chief Justice Parker of the New York Court of Appeals, "the law is settled in this state that directors of monetary corporations are held to the same degree of care that men of ordinary prudence exercise in regard to their own affairs."<sup>1354</sup>

Nor is the proposed standard of care an entirely new innovation even in the investment company field. Precisely these same men — directors, underwriters, and often the advisor as well<sup>1355</sup> — are already held to this very standard of care with respect to civil liabilities arising from materially misleading registration statements.<sup>1356</sup>

Far from substituting the business judgment of the Commission or the courts<sup>1357</sup> for that of the directors, the proposed amendment would hold inviolate the determination of the board acting with due care.<sup>1358</sup> Moreover, the proposed bills facilitate the task of the directors by assuring that they are furnished the information essential to the discharge of their duties. Specifically, the bills would require that advisory contracts "precisely and separately" describe compensation to be paid for investment advice on the one hand and non-advisory services on the other.<sup>1359</sup> Furthermore, the bills would place upon the advisor the duty to furnish information relevant to a board consideration of fee levels, and would place upon the investment company directors a corresponding duty to request

1354 *Hanna v. Lyon*, 179 N.Y. 108, 71 N.E. 778 (Ct. App. 1904). *Accord, e.g.*, *Burckhart v. Northern Nat'l Bank*, 38 F.2d 568 (9th Cir.), *cert. denied*, 281 U.S. 764 (1930); *Kavanaugh v. Gould*, 223 N.Y. 103, 119 N.E. 237 (Ct. App. 1918); *Cassidy v. Uhlmann*, 170 N.Y. 505, 63 N.E. 554 (Ct. App. 1902); *Winter v. Anderson*, 242 App. Div. 430, 275 N.Y.S. 373 (1934); *Gallin v. National City Bank*, 155 Misc. 880, 281 N.Y.S. 795 (Sup. Ct. 1935); *Goodwin v. Simpson*, 292 Mass. 148, 197 N.E. 628 (Super. Ct. 1935); *Trembert v. Mott*, 271 Mich. 683, 261 N.W. 109 (1935).

1355 Where the advisor is an individual sitting on the board of directors of the investment company, liability under the Securities Act is automatic by reason of the directorship. Where the advisor is a corporation, members of whose own board are interlocked with the board of the investment company, or members of which act as principal officers of the investment company, liability of the advisory corporation will depend on its position of control. Securities Act of 1933 § 15, 15 U.S.C. § 77o (1964). *Control* for this purpose is defined in 17 C.F.R. § 230.405 (1968), and is a question of fact to be determined upon the circumstances of the case. *Stadia Oil & Uranium Co. v. Wheelis*, 251 F.2d 269 (10th Cir. 1957).

1356 Securities Act of 1933 § 11(c), 15 U.S.C. § 77k(c) (1964).

1357 The industry objected to the 1967 bills on the ground that by leaving the determination of reasonableness to the courts, the judge would be, in effect, a "superdirector" charged with substituting his own judgment for the business judgment of the directors . . ." Statement of John Haire on behalf of the Investment Company Institute, 1967 *House Hearings* 242. The committee report on S. 3724, however, was careful to point out that "[t]he section is in no way intended to shift the responsibility for managing a corporate enterprise in the best interests of its shareholders from the directors of a corporation to the judiciary." S. REP. NO. 1351, 90th Cong., 2d Sess. 6 (1968). See ANALYSIS OF S. 34, at 7.

1358 The pending bills, in this respect, recognize the directorial function more explicitly than did bills such as S. 1659. Cf. SENATE COMM. ON BANKING AND CURRENCY, 90TH CONG., 1ST SESS., ANALYSIS OF S. 1659, at 11 (Comm. Print 1967). Under section 8(d) of S. 1659, H.R. 9510, and H.R. 9511, a directorial determination of reasonableness would probably have had some effect:

[I]f the directors really exercise a business judgment, if they do more than act as rubber stamps, if some of them change their views as to their responsibilities and do more than go through the rituals and feel that they do have an obligation to inquire and to seek justification, and they make a conscientious effort to arrive at a reasonable fee, taking into account all relevant factors, . . . and not merely rely on what the fellow down the street has been charging last year, I am certain, as I know all of you who have had any experience with the courts, whether as lawyers or as clients, must be, that the court would give appropriate weight to their judgment. Testimony of Manuel Cohen, 1967 *House Hearings* 689.

1359 S. 34, 91st Cong., 1st Sess. § 8(a) 1969; S. 296, 91st Cong., 1st Sess. § 8(a) (1969). The 1967 bills, S. 1659, H.R. 9510, and H.R. 9511 contained the same requirement.

and evaluate such information.<sup>1360</sup> This certainly seems to be a salutary requirement in view of the advisor's control of pertinent records and data, and the very inclusion of such measures serves to emphasize that the bills place the primary responsibility for reasonableness within the informed judgment of investment company directors, not the SEC.

Finally, it may not be presumed that the Commission will abuse its power to litigate. The testimony of former Chairman Cohen reflects an honest, if restrained, indignation at the industry's aspersion of the SEC's integrity:

It is in effect contended that we will engage in a sort of ratemaking by blackmail. I hope you will understand that I rather resent the suggestion. There is a suggestion made explicitly or sometimes implicitly that we will do something that we will of course not do. We will not require our opinions or the opinions of our staff about fees to be set forth in registration statements or prospectuses. We will not, we never have and we have been regulators and policemen for some 30-odd years now. We will not threaten suits unless we conclude that a suit is necessary to accomplish a statutory purpose, and that we have a case which we reasonably believe will persuade a Federal judge.

. . . [T]his Commission has never, and never will in my opinion, engage in this sort of blackmail which has been suggested.<sup>1361</sup>

The industry's second major objection to the proposal is that the standard of reasonableness is vague and unworkable.<sup>1362</sup> The original 1967 proposals contained statutory guidelines as to the factors which were relevant in arriving at a determination of reasonableness. These included the nature and extent of the

<sup>1360</sup> S. 34, 91st Cong., 1st Sess. § 8(c) (1969); S. 296, 91st Cong., 1st Sess. § 8(c) (1969). The 1967 bills were identical in this requirement.

Placing a duty on directors to evaluate the information furnished is not an exercise in legalistic superfluity. One unaffiliated director, when approached by the advisor and asked to serve on a fund board, was told "Of course, as a director, you really won't have too much to do, because I [the advisor] will take care of the S.E.C. . . ." 114 CONG. REC. S9495 (daily ed. July 26, 1968). That same director went on to testify, "[T]hen [the advisor] said that he understood the S.E.C. and what was necessary, and whatever registration was necessary, and that the company would be registered under the S.E.C., and as such would have to make regular reports to the S.E.C." *Id.* By this time the director was doubtless convinced that his responsibilities as a member of the board were purely formal, but he also admitted that "the thing which made [him] a believer" occurred when the advisor further said "You have quite a few shares in there, and if you are one of the directors, you can find out what is going on." *Id.*

It further appears that some unaffiliated directors are even ignorant of their fund's performance record:

In one fund, whose ten-year performance record was among the poorest of any of the mutual funds, two of its independent directors claimed that it always "won" in comparisons with other similar funds and that its performance looked good in relation to that of other funds. Another director of the same fund "not only recommended that the (advisory fee) contract be formally approved but also that the (adviser) be commended for the excellent investment results during the past year, the high quality of its services and the promise this arrangement offers for the future." *Id.*

Such men, one might infer, could be less than completely effective as "watchdogs," especially when they are not given the data necessary to enlighten themselves. When asked whether the board had ever been furnished any financial data in its consideration of the advisory contract, one director twice repeated his clipped response: "Never." *Id.* at S9495-96.

<sup>1361</sup> 1967 *House Hearings* 689. Judge Friendly testified, "I think we can also be confident that the SEC will not bring unjustified actions." *Id.* at 614.

<sup>1362</sup> See, e.g., 1967 *Senate Hearings* 252, 259, 298-99, 835, 863.

services rendered under the management contract, the quality of the services, the extent to which economies of scale were reflected in management fees, the value of all other benefits accruing to the manager (*e.g.*, brokerage), and the catch-all, "other appropriate and material factors."<sup>1363</sup> The pending legislation has altered this format somewhat, and now lists the following factors as pertinent: (a) the total compensation received from the investment company, (b) the nature and extent of the services rendered, and (c) all other relevant and material factors.<sup>1364</sup> Notably absent is a statutory mandate to consider the economies of scale, performance, and prevailing rates for investment advice in non-fund industries.<sup>1365</sup> The change in statutory language, while it may make the bills more palatable to certain representatives of the industry, is purely verbal and should have no effect on the ultimate interpretation of the reasonableness requirement. The mandate to consider "such other factors as are relevant and material" should clearly embrace economies of scale, performance,<sup>1366</sup> and analogous rates in other industries. The committee report on S. 3724, a bill identical to S. 34 now pending, provides valuable legislative history to support this conclusion:

The committee did not attempt by statute to specify all the factors affecting the reasonableness of advisory contracts. A determination of reasonableness must depend upon a wide variety of different factors, and it is difficult to specify all or the most relevant of these factors outside the context of a specific case. *The committee's action is not intended to suggest that the factors enumerated in S. 1659 as recommended by the Commission would not be relevant in a particular case but only to emphasize the responsibility*

1363 S. 1659, 90th Cong., 1st Sess. § 8(d) (1967); H.R. 9510 and H.R. 9511, 90th Cong., 1st Sess. § 8(d) (1967).

1364 S. 34, 91st Cong., 1st Sess. § 8(d) (1969); S. 296, 91st Cong., 1st Sess. § 8(d) (1969).

1365 See PUBLIC POLICY STATEMENT 145.

1366 The literature on fund performance, or lack of it, is voluminous and will not be catalogued here. Industry representatives, delighting in multi-colored charts and graphs, tirelessly expound the advantages of fund investing. *E.g.*, 1967 Senate Hearings 281-93. Critics point out that the funds, on balance, do no better than a portfolio of common stocks selected by lofting darts at the Wall Street Journal. (The famous experiment of Senator McIntyre is reported in 1967 Senate Hearings 803-07. A replica of the original dart, rendered in sterling and mounted on marble, graces the Senator's mantel.) Professor Wallich, perhaps the most outspoken of the critics, adamantly maintains "that the true value of investment advice is on average virtually zero," which conclusion he bases on "the random walk hypothesis" of market analysis. 1967 Senate Hearings 1060-63. See 1967 House Hearings 582-85, 589-90, 592-93. See also testimony of Paul Samuelson, 1967 Senate Hearings 452-53; Edelman, *People Aren't Random*, THE INSTITUTIONAL INVESTOR, Dec. 1967, at 41, reporting the results of a comparison between 1000 computer-selected, random portfolios and the performance of various classes of funds. Having found that the computer in random mode did as well as the professional advisors, the rest of the article attempts to explain away the obviously unanticipated results.

However the performance controversy is resolved—and there is no reason to suppose it will ever be resolved as long as investment managers exist and publish—the smoke it generates should not be permitted to obscure the fundamental legal issues. The pending legislation, like the legislative proposals defeated in the Ninetieth Congress, seeks to remedy certain deficiencies in the developing law of fiduciary duty as it relates to investment companies. The desirability of an enforceable requirement that fees be reasonable, or that directors and officers observe minimum standards of faithfulness, is a legal, not an economic issue. If an advisor wishes to defend his fee by reference to his performance, he should "tell it to the judge," and the bills are careful to permit this.

It is very unfortunate that the industry was able to fog the legal questions in legislative hearings during the Ninetieth Congress by extensive debate on "performance." If this factor contributed to the defeat of legislation in 1967, it is regrettable and care should be taken to prevent a recurrence of history.

of the courts to determine the reasonableness of advisory fees and other management compensation in the light of all relevant factors. Thus, in passing on the reasonableness of the management fee, the court will consider all services rendered to the fund or its shareholders and payments received by the management company and its affiliates whether in its capacity as investment adviser, principal underwriter, or otherwise.<sup>1367</sup> (Emphasis added.)

As to the vagueness which inheres in the word *reasonable*, it has been said in another context that "an attempt to give a specific meaning to the word 'reasonable' is trying to count what is not number, and measure what is not space."<sup>1368</sup> However this may be, the common law has dealt comfortably with the term for centuries. Whole bodies of jurisprudence have been built around its usage in various contexts, as for example, "reasonable doubt," "reasonable value," "reasonable care," "reasonable cause," "reasonable notice," "reasonable time," and "reasonable rate of return." With respect to attorneys' fees, where a multitude of factors may affect a judgment as to reasonableness, the common law has responded with a large body of precedent. Statutes, insurance policies, leases, and contracts very often require a determination of a "reasonable attorney's fee," and the courts have not despaired.<sup>1369</sup> A law professor, speaking of the reasonableness test for management fees, observed:

Despite some attack upon the supposed vagueness of the "reasonableness" standard, the test is as precise as it is possible in an area requiring fact determinations in particular cases. . . . Thus, the general standard is the only conceivable one which could do justice to all situations covered by it.<sup>1370</sup>

Perhaps the most pertinent testimony, however, was that of Judge Friendly, who

1367 S. REP. NO. 1351, 90th Cong., 2d Sess. 5, 13 (1968).

1368 *Altshuler v. Coburn*, 38 Neb. 881, —, 57 N.W. 836, 838 (1894).

1369 Among the factors which a court must juggle in fixing a "reasonable" attorney's fee are the difficulty or novelty of the questions, the time devoted to the matter, the value of opportunity lost for other employment, the attorney's professional ability and reputation, the amount in controversy, the benefits received by the client and relative success of the action, the client's ability to pay, custom in the jurisdiction, current price trends and the cost of living, as well as the attorney's overhead. See the voluminous collection of authority in Annot., 143 A.L.R. 672 (1943); Annot., 56 A.L.R. 2d 13 (1957).

The important role of the judiciary in relation to legal fees paid in the course of corporate litigation was underscored in a most amusing exchange during the 1967 legislative hearings. Thinking he was on the offensive, Congressman Keith managed to impale himself on the "reasonable" attorney's fee:

Mr. KEITH. Back in February, I think it was . . . there was an attorney up there who bragged about the fact that he received a \$500,000 fee in connection with some case that he had presented.

Mr. JENNINGS. Mr. Pomerantz?

Mr. KEITH. Yes. . . .

Mr. JENNINGS. Well, you know that —

Mr. KEITH. I mean certainly that would seem to me to be extraordinary compensation to get, if you followed your philosophy . . . .

Mr. JENNINGS. Well, in connection with fees —

Mr. KEITH. Do you believe a court would have held that fee was reasonable?

Mr. JENNINGS. Well, not only that. The court passed upon that fee.

Mr. KEITH. It did really? [!]

Mr. JENNINGS. In all derivative suit litigation, the court has to approve the reasonableness of the fee, based upon the recovery and based upon the services . . . .

1967 *House Hearings* 644. See also 1967 *Senate Hearings* 698.

1370 Testimony of Ernest Folk, 1967 *Senate Hearings* 1003; 1967 *House Hearings* 803.

made it pellucidly clear that a reasonableness standard is well within the comprehension and ability of the courts to administer. His remarks merit extended quotation:

I perceive no reason why the courts could not effectively administer section 15(d) if Congress should decide that it wants us to do so.

The question whether charges or other business practices are reasonable is not a new question for courts at all. Long before the Interstate Commerce Commission, the first Federal regulatory commission, was created in 1887, courts were deciding about overcharges by railroads and other carriers . . . .

. . . .  
In addition to that jurisdiction over public utility rates, courts frequently have to pass on questions of business reasonableness when a corporate acquisition or merger is attacked as unfair to one party or the other. Still another instance where courts have to deal with the question of reasonable value comes from the Constitution itself. I refer, of course, to the provisions of the fifth amendment that private property shall not be taken for public use without just compensation. And the problems that we sometimes encounter in fixing a fair price for a large condemnation, particularly where the property is not of the kind that is freely bought and sold, seem to me at least as hard as the task that is here proposed.

Another very well known area where courts pass on the reasonableness of business practices without aid of any previous administrative determination is in suits by the United States or by private plaintiffs relating to acts that are alleged to constitute unreasonable restraints of trade.

. . . .  
[I]here are many instances in which courts now have to decide, and for a long time have had to decide, what constitutes reasonable compensation for personal services. One instance is their role in passing on the fairness of arrangements between a fiduciary and his beneficiaries, a standard of fairness that might well apply to this very problem but for the effect that has been given to the ratification of management contracts by stockholders or unaffiliated directors.

Another instance is where a contract for personal services cannot be carried out according to its terms . . . and the court then has to step in and determine the fair value of what has been done.

. . . .  
I should also point out what may be the most relevant of all, namely, that the courts already have responsibilities as to the size of the fees of investment advisers. There is a common law liability of directors for waste, and while a plaintiff who seeks to prevail on that score may have to show that the fee is not merely unreasonable but unreasonably unreasonable, a court still has the job of comparing what has been done with what has been received, just as it would have under section 15(d).<sup>1371</sup>

Perhaps the only cogent objection to the "vagueness" of the standard arises from the multiplicity of courts which might be called upon to enforce it. As voiced by Mr. Haire, "[g]ranting this power over corporate affairs to thousands of different judges across the country would produce such uncertainty and inconsistency as to frustrate future planning by mutual fund managements.

<sup>1371</sup> Testimony of Henry Friendly, 1967 House Hearings 609-10. See also 1967 Senate Hearings 1014-15.

. . .<sup>1372</sup> Under the original bills of the Ninetieth Congress, this argument had at least a semblance of plausibility, for state and federal courts would have had concurrent jurisdiction over section 15(d) suits. The pending amendments, however, have obviated the problem to a large extent by providing exclusive federal jurisdiction in all section 15(d) actions.<sup>1373</sup> This fairly assures a measure of uniformity within the circuits, with the Supreme Court able to resolve any conflicts among appellate courts.<sup>1374</sup>

In addition, in the pending legislation, the SEC is given an unqualified right to intervene in a private action under section 15(d).<sup>1375</sup> This, coupled with the Commission's option to bring suit *sua sponte* or on demand of a shareholder, should also contribute to uniformity in the standards of reasonableness. Certainly the Commission's participation would be an invaluable aid to the courts in arriving at consistent and workable guidelines.<sup>1376</sup> If one of the proposed bills is enacted, the Commission should vigorously exercise its prerogative and assume an active role in section 15(d) litigation.

### b. Industry Recommendations

The industry's alternatives to a reasonableness rule are thinly veiled attempts to further insulate themselves from judicial inquiry. The Investment Company Institute [ICI] recommended amending the Act to:

<sup>1372</sup> 1967 House Hearings 242.

<sup>1373</sup> S. 34, 91st Cong., 1st Sess. § 8(d) (1969); S. 296, 91st Cong., 1st Sess. § 8(d) (1969).

<sup>1374</sup> There is a possible development in the law which would upset this reasoning. Mr. Pomerantz, in one of his myriad suits, was, astonishingly, able to convince a federal district court that plaintiffs in a derivative suit under the Investment Company Act had a seventh amendment right to trial by jury. *Ross v. Bernhard*, 275 F. Supp. 569 (S.D.N.Y. 1967), *rev'd*, 403 F.2d 909 (2d Cir. 1968), *cert. granted*, 37 U.S.L.W. 3354 (U.S. March 24, 1969) (No. 992). The court of appeals has reversed this remarkable reading of the seventh amendment, one judge dissenting, but the Supreme Court's granting of certiorari leaves the final determination of the question as yet uncertain. For our purposes, the impact of the case is on the uniformity that can be expected in application of the reasonableness standard. It would seem that this standard, while certainly not beyond the comprehension of a jury, would prove to involve often sophisticated issues of corporate finance. Should Mr. Pomerantz prevail in the Supreme Court, he may well expect favorable treatment at the hands of a jury on a claim founded on section 37 of the Investment Company Act, but the consequences of such a reversal in the law might render the proposed reasonableness standard subject to the objection that it would be impossible of uniform application if committed to the vagaries of financially unsophisticated juries. Only once in the trial court and once in the court of appeals was reference made to the ability of a jury to cope with the complexities of a derivative suit. *Ross v. Bernhard*, 275 F. Supp. 569, 570 (S.D.N.Y. 1967), *rev'd*, 403 F.2d 909, 915 (2d Cir. 1968) (Smith, J. dissenting). Both references are addressed to the simplicity of the instant case, opining that it is not beyond the ken of the lay jury, but no consideration is given to the more involved Investment Company Act cases or, for that matter, the many other forms of intricate derivative suits traditionally tried to the equity judge.

<sup>1375</sup> S. 34, 91st Cong., 1st Sess. § 22 (1969); S. 296, 91st Cong., 1st Sess. § 22 (1969). The same prerogative was accorded the Commission by the original bills in the Ninetieth Congress. S. 1659, 90th Cong., 1st Sess. § 23 (1967); H.R. 9510 and H.R. 9511, 90th Cong., 1st Sess. § 23 (1967).

<sup>1376</sup> The value of SEC guidance in the complex and somewhat esoteric field of securities regulation has not been unappreciated by the courts. *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954).

In previous decisions . . . we have been aided by detailed expositions of relevant factors by the Securities and Exchange Commission as *amicus curiae*, and we regret the lack of their aid in this case. Accordingly we proceed with due caution in venturing upon uncharted seas. *Id.* at 81.



- (1) define a new term, "interested person";
- (2) require a majority of disinterested persons on a fund's board of directors;
- (3) require that disinterested persons nominated for positions on the fund's board of directors be approved by the board, including a majority of the existing disinterested directors;
- (4) change "affiliated" to "interested" in section 15(c) of the Act; and
- (5) *assure that existing law on the subject of management compensation not be abrogated by the amendments.*<sup>1377</sup> (Emphasis added.)

When this "compromise" was, predictably, rejected by the SEC, the Investment Company Institute submitted a second. That proposal would amend section 15(a) by adding a new paragraph to require that the advisory contract,

(5) as to the compensation payable to the investment adviser, [be] approved as reasonable in the exercise of *business judgment* by a majority of those directors . . . who are not interested persons . . .

In any action alleging failure to comply with paragraph (5) of this subsection no person shall be liable unless the court shall find from *clear and convincing evidence* that the approval by directors required by said paragraph (5) was a *clear abuse of business judgment*. Such actions may be brought only by the company or a security holder thereof on its behalf and only in an appropriate District Court of the United States. . . . No judgment shall be granted against any person other than the recipient of such compensation unless such other person is found by the court to have acted in *bad faith*.<sup>1378</sup> (Emphasis added.)

Realizing that these proposals were rather transparently toothless, Investors Diversified Services<sup>1379</sup> fabricated an alternative which would amend the Act as follows:

- (1) Require that the *chief executive officer* of the Fund be unaffiliated with the adviser or underwriter.
- (2) At least 80% of all Fund directors to be unaffiliated with the adviser or underwriter.
- (3) The insertion of a provision to insure truly independent directors along the following lines:  
 "No person affiliated with, in control of, or affiliated with any person in control of any adviser or underwriter for any registered investment company, shall . . . influence the selection of any unaffiliated director . . . and . . . shall be ineligible to vote upon the election of any director who is required to be unaffiliated."<sup>1380</sup>

1377 1967 Senate Hearings 98-99.

1378 *Id.* at 101. See also 1967 House Hearings 526-37, 623.

1379 The submitted statement was nominally that of the various funds under IDS management, yet the proposals are certainly not antipathetic to the interests of IDS. A single suggestion, contained in item H, is included in the statement as if to suggest that the views expressed are actually independent of IDS influence. Since that suggestion, however, would impose only a paper liability on IDS (it is admitted that IDS already does what would be required) its intended effect is much diluted. 1967 House Hearings 787-88. See 1967 Senate Hearings 1182-83.

1380 1967 House Hearings 785. See 1967 Senate Hearings 1180.

The first of these three industry alternatives is the most infirm of all. It has already been seen that, regardless of their inclinations, fund directors are powerless to bargain effectively over management fees. The extreme dependence of a fund on its incumbent advisor precludes this. Moreover, it is already current industry practice to include a majority of unaffiliated directors on a fund's board,<sup>1381</sup> and yet the problem of inequitable compensation persists. As one industry representative admitted, "these outside directors hardly conceive themselves as having a special and personal responsibility to negotiate the terms of a management contract at arm's length."<sup>1382</sup> Under these circumstances, it is inconceivable that increasing the legal requirement for unaffiliated directors from forty to fifty per cent would have any effect. Obviously the IDS proposal suffers the same defects.<sup>1383</sup>

The Investment Company Institute's second proposal may, on its face, seem somewhat more demanding than the first, since it requires a finding that the fee is reasonable. In fact, this alternative is illusory. Not only is it subject to the same basic infirmity as the first proposal, but in addition it would all but render advisory contracts judicially unassailable. By requiring that a plaintiff prove "by clear and convincing evidence" that directorial approval constituted "a clear abuse of business judgment," the proposal would demand the impossible. This importation of the business judgment rule has no place in a situation already fraught with conflicts of interest,<sup>1384</sup> and the ICI version of the rule would absolutely immunize any scheme of management compensation short of open thievery. Moreover, the ICI alternative would limit the enforceability of even this totally unrealistic standard by depriving the SEC of access to the judiciary.

#### *D. Sale of Management Control*

Professor Paul Samuelson, in testimony before the Senate Banking and Currency Committee in 1967, described an early encounter with funds and observed:

I decided that there was only one place to make money in the mutual fund business — as there is only one place for a temperate man to be in a saloon, behind the bar and not in front of the bar.

And I invested in . . . [a] management company . . . .<sup>1385</sup>

To be sure, the profitability of the managerial function and the perquisites of its stranglehold on the investment companies it advises naturally makes the advisor's securities, be they publicly or closely held, a rather attractive investment. When actual control of the advisory company is on the auction block, it may command astronomical prices. As the SEC points out, "the price obtainable for the assets or stock of the adviser-underwriter depends on the ability

<sup>1381</sup> WEARTON REPORT 464.

<sup>1382</sup> 1967 Senate Hearings 867. See 1967 House Hearings 569.

<sup>1383</sup> The requirement in the IDS proposal that the fund's chief executive officer be unaffiliated with the advisor of underwriter can add nothing. Perhaps the use of italics was intended to import substance to the provision.

<sup>1384</sup> See note 1234 *supra*.

<sup>1385</sup> 1967 Senate Hearings 353. He did exceedingly well. *Id.*

of the seller to transfer to a prospective buyer the benefits derived from its relationship with the fund.<sup>1386</sup>

In "one of the greatest personal coups ever pulled off on Wall Street," the celebrated Gerald Tsai, Jr., converted himself "from a mere salaried manager into a capitalist worth around \$30 million"<sup>1387</sup> through just such a sale. Tsai, formerly a manager of Fidelity Capital Fund, had built a fast reputation as a high-performance manager through extensive public exposure. In 1965 he left Fidelity to found Manhattan Fund and its advisor, Tsai Management & Research [TMR]. Tsai, of course, owned ninety per cent of TMR's stock. On the strength of Tsai's public image, investors flocked to Manhattan Fund and TMR's advisory fees soared. By May of 1968, TMR was collecting management fees of \$2.5 million (and had taken on three other mutual funds and a closed-end company as clients). At this point Tsai decided to sell his ninety per cent interest in TMR to C.N.A. Financial Corporation, an insurance holding company whose stock is publicly traded over-the-counter. The original deal gave Tsai 650,000 shares of C.N.A. in exchange for his TMR stock, C.N.A. then trading at around 30. By the time C.N.A. shareholders ratified the deal on August 16, 1968, C.N.A. was up to mid-40's, for a total value to Tsai of nearly \$30 million. The book value of TMR's stock at the time is unavailable since the corporation was closely held, but Tsai's initial investment in the advisory company was in the neighborhood of \$450,000. Assuming TMR's net worth to have been around one-half million dollars, Tsai had reaped over \$29 million for the sale of accession to control.<sup>1388</sup>

If, at the time Tsai formed TMR and executed the management contracts with the funds, he had a provable present intention to cash in his chips by selling control of TMR at the first opportunity, an interesting question arises. This intention, being a matter of fact, could give rise to liability if not disclosed in prospectuses and registration statements under the Securities Act and if its omission would make other matters in the prospectuses or statements misleading.<sup>1389</sup> While analysis of this precise question is beyond the scope of this Survey, other problems connected with sale of management control are not.

Some of the gross abuses that early accompanied "trafficking" in advisory contracts and the advisor's stock included, *inter alia*, acquiring control of an

1386 PUBLIC POLICY STATEMENT 149.

1387 FORTUNE, Oct. 1968, at 207.

1388 *Id.* The performance of Manhattan Fund through this changeover has not been spectacular. Using per share net asset value change, adjusted for capital gains (reinvested) and income dividends (added), we have the following: (1) For calendar 1967, Manhattan shows +39.4 per cent. FUNDSCOPE, Feb. 1969, at 90. (2) For calendar 1968, Manhattan shows -9.6 per cent. *Id.* (Wiesenberger gives this last figure as -6.9 per cent, INVESTMENT COMPANIES 1968 (L. Wessmann ed., Supp. Dec. 31, 1968), but *Fundscope* again shows -9.6 per cent at another point. FUNDSCOPE, Feb. 1969, at 41.) Its 1968 performance stigmatizes Manhattan as the poorest of the "performance" funds canvassed in *Fundscope*. *Id.* at 46. Of all funds reported in *Fundscope*, only a single "growth and income" fund, Teachers Association, did worse. *Id.* at 45.

Two months after the deal with Tsai was drawn, TMR began operating a new fund, the T.M.R. Appreciation Fund, Inc. That fund showed a non-performance of -2.76 per cent through the end of August, 1968. FORTUNE, Oct. 1968, at 207.

There is always a danger, which the law should be vigilant to minimize, that a seller confronted with an attractive profit may be tempted to overlook the managerial competence of his purchasers.

1389 Securities Act of 1933 §§ 11-12, 15 U.S.C. §§ 77k-77l (1964).

investment company for resale at a handsome profit, for purposes of dumping worthless securities, for imposition of oppressive advisory contracts, or for outright looting.<sup>1390</sup> Perhaps the most celebrated transfer of control case decided at common law was *Insuranshares Corporation v. Northern Fiscal Corporation*,<sup>1391</sup> where control of an investment company was sold at a premium of about 190 per cent over the market value, and sixty per cent over the book value, of the shares sold.<sup>1392</sup> The purchasers promptly plundered the portfolio, and the company sued to recover its loss.

Defendants insisted that nothing more than a sale of stock was involved, any transfer of control being simply an unavoidable concomitant. But the court observed the premium that the purchasers were willing to pay<sup>1393</sup> and immediately recognized that this was a payment for succession to control, the transfer of stock being the mechanism used to eliminate the sellers' interest in the investment company, lest they object to the imminent looting.<sup>1394</sup> In the course of his opinion, Judge Kirkpatrick articulated the absolute minimum standard to govern such sale of dominion:

Those who control a corporation, either through *majority stock ownership, ownership of large blocks of stock less than a majority, officeholding, management contracts*, or otherwise, owe some duty to the corporation in respect of the transfer of control to outsiders. The law has long ago reached the point where it is recognized that such persons may not be wholly oblivious of the interests of everyone but themselves, even in the act of parting with control . . . [S]tating the duty in minimum terms . . . it may be said that the owners of control are under a duty not to transfer it to outsiders if the circumstances surrounding the transfer are such as to awaken suspicion and put a prudent man on his guard — unless a reasonably adequate investigation discloses such facts as would convince a reasonable person that no fraud is intended or likely to result.<sup>1395</sup> (Emphasis added.)

*Insuranshares* was not decided under the Investment Company Act, although the Act contains provisions designed to curb the "trafficking" in control.<sup>1396</sup> Section 15(a)(4) of the Act provides that an assignment of the advisory con-

1390 See generally INVESTMENT TRUSTS III 1020-31, 1278-96, 1641-64, 1918-36, 2765-66.

1391 35 F. Supp. 22 (E.D. Pa. 1940). *Insuranshares Corporation* had been the subject of considerable discussion in the Investment Trust Study and the 1940 congressional hearings due to the several changes in control and attendant abuses it had weathered. 1940 Senate Hearings 53, 71, 73-75, 229, 971; INVESTMENT TRUSTS II 95; INVESTMENT TRUSTS III 438-1201 *passim*.

1392 *Insuranshares Corp. v. Northern Fiscal Corp.*, 35 F. Supp. 22, 24 (E.D. Pa. 1940). The stock transferred represented a minority, but was a controlling interest nonetheless. *Id.* at 28. "[T]he majority, who had bought for investment," the court noted, "could be counted on to remain inert." *Id.* at 24.

1393 The sale was actually financed by the investment company itself, for the purchasers had borrowed the purchase price from third parties, promising to pledge with them as security portions of the portfolio as soon as control was won. The creditors would then liquidate the pledged securities from time to time, applying a portion of the proceeds to payment of the debt and remitting the balance to the investment company. *Id.* at 25-26. This "bootstrap" financing of the takeover was a common technique. See, e.g., *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (Sup. Ct. 1941).

1394 *Insuranshares Corp. v. Northern Fiscal Corp.*, 35 F. Supp. 22, 24 (E.D. Pa. 1940).

1395 *Id.* at 25; accord, *Gerdes v. Reynolds*, 28 N.Y.S.2d 622, 632, 649, 653-54, 658 (Sup. Ct. 1941).

1396 See SEC Investment Company Act Release No. 354 (May 11, 1942), [1941-44 Transfer Binder] CCH FED. SEC. L. REP. ¶ 75,281 (1942).

tract terminates it,<sup>1397</sup> while section 2(a)(4) defines *assignment* to include "any direct or indirect transfer . . . of a contract . . . or of a controlling<sup>[1398]</sup> block of the [advisor's] outstanding voting securities."<sup>1399</sup> Reinstatement of the contract

1397 Investment Company Act of 1940 § 15(a)(4), 15 U.S.C. § 80a-15(a)(4) (1964). For some administrative applications and explanations of the Act's termination provisions, see, e.g., Investors Diversified Services, Inc., 30 S.E.C. 273 (1949); Management Associates, 9 S.E.C. 645 (1941); T.I.S. Management Corp., 10 S.E.C. 695 (1941).

1398 "Control" is defined in the Act and entails certain presumptions:

"Control" means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company.

Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 percentum of the voting securities of a company shall be presumed to control such company. Any person who does not so own more than 25 per centum of the voting securities of any company shall be presumed not to control such company. . . . Any such presumption may be rebutted by evidence, but except as hereinafter provided, shall continue until a determination to the contrary made by the Commission by order either on its own motion or on application by an interested person. . . . Investment Company Act of 1940 § 2(a)(9), 15 U.S.C. § 80a-2(a)(9) (1964).

1399 Investment Company Act of 1940 § 2(a)(4), 15 U.S.C. § 80a-2(a)(4) (1964). One of the more difficult cases interpreting this section is *Willheim v. Murchison*, 203 F. Supp. 478 (S.D.N.Y.), *aff'd sub. nom.* *Willheim v. Investors Diversified Servs., Inc.*, 303 F.2d 276 (2d Cir. 1962) (preliminary injunction denied); *Willheim v. Murchison*, 231 F. Supp. 142 (S.D.N.Y. 1964), *aff'd*, 342 F.2d 33 (2d Cir. 1965) (dismissed on motion for summary judgment). The lawsuit was one of many growing out of the Alleghany Corporation—IDS affiliation, a veritable deluge of litigation which, in the weary words of Judge Friendly, "must be unparalleled in American corporation law." *Willheim v. Murchison*, 342 F.2d 33, 35 (2d Cir. 1965). Grossly oversimplified, Alleghany Corporation, a holding company, owned controlling interest in IDS, advisor to Investors Mutual, Inc. A band of insurgents led by the Murchisons mounted a bitterly contested proxy contest which was ultimately successful in ousting Alleghany's incumbent management, the Kirby group, and giving the Murchison group all nine seats on Alleghany's board of directors. MOODY'S 1968 BANK & FINANCE MANUAL 1083. Two shareholders of Mutual then sought a preliminary injunction to prohibit IDS from performing its management and underwriting contracts. Plaintiff's theory was that the transfer of control within Alleghany constituted an "assignment" of the management and underwriting contracts with IDS, which caused their immediate termination. *Willheim v. Murchison*, 203 F. Supp. 478, 479 (S.D.N.Y. 1962). The motion for preliminary injunction was denied on the ground that there was no transfer of a controlling block of IDS stock, nor, for that matter, had the change in Alleghany management been effected by a sale of its stock. On appeal to the Second Circuit, the denial was affirmed for the reason that no showing of irreparable injury had been made. *Willheim v. Investors Diversified Servs., Inc.*, 303 F.2d 276 (2d Cir. 1962). On later motion by the defendants for summary judgment, the district court followed its earlier reasoning and dismissed. *Willheim v. Murchison*, 231 F. Supp. 142 (S.D.N.Y. 1964). Significantly, the court conceded that had the change in control of Alleghany been effected by a transfer of its stock, there would have been an assignment terminating the IDS contracts. *Id.* at 144-45. This interpretation had been urged by the SEC. *Id.* at 144. The Court of Appeals was not so ready to accede to this proposition, but admitted its *arguendo*. *Willheim v. Murchison*, 342 F.2d 33, 37 (2d Cir. 1965). Still, there was no transfer of controlling Alleghany stock, and neither could the court find a congressional intention to remedy internal and "democratic" shifts in control with automatic termination of contracts. Accordingly, it affirmed. *Id.* at 33.

One commentator concludes that the interests of fund shareholders can only be properly protected if a transfer of real control, such as existed in *Willheim*, is interpreted to effect a termination. Comment, *Termination of Management Contracts Under the Investment Company Act of 1940*, 63 COLUM. L. REV. 733, 744-48 (1963). Certainly there was a change in the IDS management as a result of the proxy victory, for the Murchisons installed eight new directors on the IDS board, Clint Murchison, Jr., becoming chairman. *Willheim v. Murchison*, 342 F.2d 33, 36 (2d Cir. 1965). It would seem that if the Murchisons could not have done this directly by purchasing Alleghany or IDS stock (absent reinstatement by fund shareholders), the transfer of control should not be sanctioned merely because it proceeded by a different means. In the ultimate analysis, the Act is seeking to protect fund shareholders against change in management occurring without their assent. Investment Company Act of 1940 § 1(b)(6), 15 U.S.C. § 80a-1(b)(6) (1964). Rather than improper court interpretation, however, in this instance we are dealing with inartful draftsmanship or congressional oversight. (As Judge Friendly points out, Congress had little reason to consider this precise problem in 1940. *Willheim v. Murchison*, 342 F.2d 33, 40-41 (2d Cir. 1965).)

after its termination would then require shareholder approval.<sup>1400</sup> Unfortunately the Act, at least as interpreted by the courts, has been ineffective in dealing with modern problems attendant upon transfer of control.

To illustrate how a transfer of control may still operate to a fund's direct pecuniary disadvantage, though the mechanism is slightly more subtle than looting or dumping, the SEC cites the following example:

[N]ew management agreed to pay for the retirement of a class of preferred stock of the old management organization, a registered broker-dealer, for a consideration of up to \$450,000. The consideration, however, was not paid by new management but by the fund under an agreement whereby the old manager would receive approximately 50 percent of the fund's brokerage commissions for a period of 7 to 15 years. At the time of the agreement the fund had assets of less than \$10 million. Most funds of that size utilize virtually all of their brokerage to obtain supplementary investment advice, pricing services for their shares and other services commonly available from broker-dealers in return for such commissions. Thus, the creation of an obligation to use fund brokerage commissions to pay for a transfer of the advisory function meant that *an asset of the fund which should have been utilized for its benefit was used for the sole benefit of its managers*. Such an obligation also adds pressures to generate brokerage commissions irrespective of investment considerations.<sup>1401</sup> (Emphasis added.)

In a statutory context, the leading case under the Act is *SEC v. Insurance Securities, Incorporated*.<sup>1402</sup> Insurance Securities, Inc. [ISI] served as investment advisor of "Trust Fund" — a registered mutual fund — and distributed its participation certificates.<sup>1403</sup> Four of the directors of ISI collectively held over seventy per cent of its stock, each owning 30,000 of 166,000 shares outstanding.<sup>1404</sup> Though no one of these directors held more than about eighteen per cent of ISI's stock, an amount low enough to presume non-control under the Act,<sup>1405</sup> the Court of Appeals recognized that transfer of a large portion<sup>1406</sup> of their collective seventy per cent would result in a transfer of control.<sup>1407</sup> By proper timing of the sale, and by assuring continuous control of the fund's proxy machinery, the transfer was accomplished without risking the loss of the management contract. Since the purchasers would accede to the management position in spite of a technical termination and reinstatement of the contract, the controlling block

1400 Investment Company Act of 1940 § 15(a), 15 U.S.C. § 80a-15(a) (1964). Consent, of course, can be absolutely guaranteed for all practical purposes. As Professor Loss observed, and his remarks are particularly applicable to mutual funds, "[t]he widespread distribution of corporate securities, with the concomitant separation of ownership and management, puts the entire concept of the stockholders' meeting at the mercy of the proxy instruments." 2 L. LOSS, *SECURITIES REGULATION* 857-58 (2d ed. 1961).

1401 PUBLIC POLICY STATEMENT 150.

1402 146 F. Supp. 778 (N.D. Cal. 1956), *aff'd*, 254 F.2d 642 (9th Cir.), *cert. denied*, 358 U.S. 823 (1958).

1403 *Id.* at 778-79.

1404 *SEC v. Insurance Sec., Inc.*, 254 F.2d 642, 645 (9th Cir. 1958).

1405 *See* note 1398 *supra*.

1406 40.8 per cent of ISI's total outstanding shares. *SEC v. Insurance Sec., Inc.*, 254 F.2d 642, 646 (9th Cir. 1958).

1407 *Id.* at 650. The identity of the purchasers who would gain control is not disclosed in the opinions. It does appear, however, that they were a small group, affiliated among themselves, *id.* at 645, and "headed by defendant Kaiser" (not one of the four mentioned directors). *SEC v. Insurance Sec., Inc.*, 146 F. Supp. 778, 779 (N.D. Cal. 1956).

of ISI stock commanded an exorbitant price of \$50 per share, in contrast to its book value of only \$1.81.<sup>1408</sup>

The SEC brought suit against the selling directors, charging that the receipt of such a premium constituted a violation of section 36 of the Act and asking for an injunction as well as an accounting and restitution of the price in excess of book value.<sup>1409</sup> The district court dismissed the complaint with a very brief opinion, and the United States Court of Appeals for the Ninth Circuit affirmed.<sup>1410</sup>

In the opinion of Judge Hamley, the termination provision of section 15(a)(4) was the exclusive remedy provided by the Act, regardless of the price received for the transfer, and there could be no objection as long as the requisite shareholder reinstatement was obtained.<sup>1411</sup> Thus, section 36 was inapplicable<sup>1412</sup> and the SEC was out of court.<sup>1413</sup> Nevertheless, the court did engage in some discussion of the section 36 claim, and in the process formulated some questionable law.

The SEC maintained that the amount received for the ISI stock in excess of book value — which excess appears to have totaled some \$3.25 million<sup>1414</sup> — represented payment for the sale of a fiduciary office and an appropriation of an asset of the fund.<sup>1415</sup> That is, the ISI profits which could be expected to accrue after the transfer of control should not be considered a salable “good-will” asset of ISI. Since the transfer would automatically terminate the contract, and since the fund, in law, was free to negotiate elsewhere for management services, any “good-will” belonging to ISI is instantly amortized. Hence, the excess price received for the ISI stock represents a capitalization of the fund’s asset — the right to allocate its future advisory fees to whomever it may wish to engage with the corresponding opportunity to reduce its cost by the amount of the premium.<sup>1416</sup>

1408 SEC v. Insurance Sec., Inc., 254 F.2d 642, 646 (9th Cir. 1958). The Court of Appeals in the ensuing litigation admitted that “[t]he purchase price . . . necessarily reflected the value which [ISI] . . . will derive from the fees paid, and expected to be paid, by the Trust Fund.” *Id.*

1409 SEC v. Insurance Sec., Inc., 146 F. Supp. 778 (N.D. Cal. 1956).

1410 SEC v. Insurance Sec., Inc., 146 F. Supp. 778 (N.D. Cal. 1956), *aff’d*, 254 F.2d 642 (9th Cir.), *cert. denied*, 358 U.S. 823 (1958).

1411 SEC v. Insurance Sec., Inc., 254 F.2d 642, 648-49 (9th Cir. 1958).

1412 The Commission always considered section 36 applicable to the sale of an advisor’s fiduciary office. SEC Investment Company Act Release No. 354 (May 11, 1942), [1941-44 Transfer Binder] CCH FED. SEC. L. REP. ¶ 75,281.

1413 SEC v. Insurance Sec., Inc., 254 F.2d 642, 651-52 (9th Cir. 1958).

1414 This is the premium received by the four selling directors (\$48.19 per share, 68,000 shares). *Id.* at 646. The purchasers also acquired another twenty thousand shares from other stockholders of ISI. From the court’s figures, it appears that this additional stock was purchased at the same premium. *Id.*

1415 *Id.* at 647.

1416 This view of the facts brings the case into close parallel with the “diversion of corporate opportunity” cases, especially *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955). See generally Jennings, *Trading in Corporate Control*, 44 CAL. L. REV. 1 (1956). In *Perlman* control of a steel corporation was sold at a premium to persons desiring a captive source of steel. If the purchasers had simply bought the steel at a higher price, instead of paying for control, the benefits would have inured to the corporation rather than to the abdicating officer and principal stockholders. Those who sold control had thus diverted an opportunity of the corporation and were liable in an action for accounting and restitution.

Analogously, the purchasers of Insurance Securities Inc. sought, in part, an outlet for the managerial services of Leland M. Kaiser and his associates. See Record, pp. 55-88 *passim*. Thus, they paid \$4,240,720 for the controlling shares of a corporation with a service contract. 254 F. 2d at 646. Presumably, they would have been equally willing to enter into a direct agreement with the Trust Fund and to perform

The Court of Appeals was willing to assume that the defendant-directors were fiduciaries with respect to the fund,<sup>1417</sup> a proposition which is not disputable,<sup>1418</sup> but then concluded that there was no illicit sale of fiduciary office. The rationale was that since the fiduciary relationship arose from the management contract, and since that contract automatically terminated on assignment, the fiduciary obligations of the directors were immediately extinguished.<sup>1419</sup> The reinstatement of the contract by the shareholders then resulted in a new fiduciary nexus between the fund and the new management. Hence, even if section 36 did encompass the "well-established [principle] of equity"<sup>1420</sup> that an office of trust may not be sold, the SEC was still out of court. This argument is, to say the least, a bit facile.<sup>1421</sup>

Moreover, the court ignored the obvious manner in which the directors used their office — by exploiting their control of the proxy mechanism — to enrich themselves. Clearly the proxy control was an integral element of the transfer scheme, for unless reinstatement of the management contract could be assured, the directors could not have demanded the exaggerated price for their stock. The Supreme Court has said in *Pepper v. Litton*:<sup>1422</sup>

He who is in such a fiduciary position cannot serve himself first and his *cestuis second*. . . . *He cannot utilize his . . . strategic position for his own preferment*. . . . He cannot use his *power* for his personal advantage . . . no matter how meticulous he is to satisfy technical requirements. For that

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services for \$4,240,720 less than the Trust Fund was presently paying, amortized over a term of years. If this assumption is correct, the director-defendants in effect diverted a bargain purchase of managerial services to their own profit. Cf. *Pouzzner v. Westerly Theatre Operating Co.*, 67 F. Supp. 874 (D.R.I. 1946), *aff'd*, 162 F.2d 821 (1st Cir. 1947) (lease and sublease); *Paw Paw Sav. Bank v. Free*, 205 Mich. 52, 171 N.W. 464 (1919) (same); *Durfee v. Durfee & Canning, Inc.*, 323 Mass. 187, 80 N.E.2d 522 (1948) (purchase and resale); *Gilmore v. Gilmore Drug Co.*, 279 Pa. 193, 123 Atl. 730 (1924) (same). In any event, the Trust Fund was deprived of the opportunity to bargain with the purchasers. Comment, *Protecting the Interests of Mutual-Fund Investors in Sales of Management-Corporation Control (Or, Policing the Traffic in Other People's Money)*, 68 YALE L.J. 113, 127-28 n.57 (1958).

1417 *SEC v. Insurance Sec., Inc.*, 254 F.2d 642, 650 (9th Cir. 1958).  
 1418 *Brown v. Bullock*, 194 F. Supp. 207, 229 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961); *Insuranshares Corp. v. Northern Fiscal Corp.*, 35 F. Supp. 22, 25 (E.D. Pa. 1940); see the excellent discussion and collection of authority in Comment, *supra* note 1416, at 121-24.  
 1419 *SEC v. Insurance Sec., Inc.*, 254 F.2d 642, 650 (9th Cir. 1958).  
 1420 *Id.*  
 1421 The court's reasoning on this point is very ably refuted in Comment, *supra* note 1416:

Although the court accurately characterized the defendants as fiduciaries of the mutual fund, its determination that their fiduciary office was not transferred through the sale of controlling shares in Insurance Securities seems untenable. True, the sale of stock, working a technical termination of the service contract by operation of section 15(a)(4), and thus theoretically ended the fiduciary relationship between the management corporation and the investors, and discharged everyone in that corporation of his fiduciary duties to the investors. [*sic*] *In actuality, however, the renewal of the contract was a manifestation of the dominance and control over the investors upon which the director-defendants' fiduciary status was based.* The sale of control did not occur until after the transferors had utilized the investment organization's proxy machinery to frame the reinstatement issue, comment favorably upon the purchasers of control, solicit investor votes, and recommend the renewal of the service contract. . . . Since, in *Insurance Securities*, [management's proxy] control was actually exercised to achieve reinstatement of the agreement, *termination of the contract was illusory, and the powers and fiduciary duties arising from it remained throughout in the management corporation.* Defendants therefore had fiduciary positions which they effectively transferred through the sale of their controlling stock.

*Id.* at 124-26 (emphasis added).

1422 308 U.S. 295 (1939).



power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestuis*.<sup>1423</sup> (Emphasis added.)

In a situation strikingly similar to the ISI case, the Delaware Chancellor stated the law this way: “[I]f defendants [selling stockholders in a fund management company] in fact used the *power* of their fiduciary positions for personal gain they are legally responsible regardless of the form and sequence of their undertakings.”<sup>1424</sup> (Emphasis added.) This view places the emphasis not on a sale of fiduciary office, but rather on a sale of the influence and power attaching to the office of trust. If a director or trustee may not sell his office, neither may he sell his ability to install another in his place.<sup>1425</sup>

Beyond this precept of the common law, the Investment Company Act itself declares that the national interest is adversely affected “when investment companies are . . . operated, [or] managed . . . in the interest of . . . investment advisers . . . rather than in the interest of all classes of such companies’ security holders . . . .”<sup>1426</sup>

1423 *Id.* at 311.

1424 *Krieger v. Anderson*, 40 Del. Ch. 61, 173 A.2d 626,632 (Ch. 1961).

1425 *Gerdes v. Reynolds*, 28 N.Y.S.2d 622, 651-52 (Sup. Ct. 1941) (collecting authority).

1426 Investment Company Act of 1940 § 1(b)(2), 15 U.S.C. § 80a-1(b)(2) (1964). See 72 HARV. L. REV. 1176 (1959). A case quite similar to the instant case arose in Delaware and was decided purely on state law grounds. *Krieger v. Anderson*, 40 Del. Ch. 363, 182 A.2d 907 (Sup. Ct.), *aff’g*, 40 Del. Ch. 151, 177 A.2d 203 (Ch. 1962), *original motion for summary judgment denied*, 40 Del. Ch. 61, 173 A.2d 626 (Ch. 1961). Defendants in *Krieger* were the principal shareholders of Texas Management Company [TMC], which, in turn, was investment advisor of the Texas Fund. A small group of businessmen who wished to purchase TMC formed a corporation, Funds, Inc., to consummate the deal. The defendants sold their controlling TMC stock to Funds, Inc., for \$1,350,000, though the book value of TMC was only about \$126,000. The sale was conditioned upon shareholder reinstatement of the contract with TMC. The five man board of directors of Texas Fund unanimously recommended reinstatement, and the shareholders, of course, followed that recommendation. The three non-affiliated directors of Texas Fund were also made parties defendant. Plaintiff, a shareholder of Texas Fund, sought to recover the premium paid for TMC stock, charging that the amount paid over book value constituted compensation to selling defendant shareholders of TMC for the expectation of reinstatement of the contract. Plaintiff further alleged that the selling defendants dominated the board of directors of Texas Fund, procured the necessary reinstatement by means of this domination, and hence had sold their fiduciary office or influence for at least \$1 million.

Defendants’ original motion for summary judgment was denied, the Chancellor holding that there were unresolved issues of fact as to actual domination and the “fair value” of the TMC stock. *Krieger v. Anderson*, 40 Del. Ch. 61, 173 A.2d 626 (Ch. 1961). In his opinion denying the motion, the Chancellor recognized a “corporate opportunity” element in the plaintiff’s claim:

[I]t would appear that plaintiff is actually contending that defendants, by their use of their control of the Fund board, deprived Fund of the opportunity to negotiate directly with the purchaser for some or all of the “premium” it was allegedly willing to pay for securing the Management stock and thus the service contracts [management and underwriting]. *Id.* at —, 173 A.2d at 633.

The Chancellor centered his attention, however, on the issue of the “fair value” of the TMC stock, and was willing to include as an element the “good will” or “expectancy” value arising from the possibility of renewal of the contracts. According to the Chancellor, this “good will”

[W]as an element of value built up by the defendants and is not to be ignored merely because of [*sic*] the Investment Company Act requires a termination of advisory contracts when control is sold. The termination provision is to protect the investors of the Fund. If such good will value is not to be considered a legitimate element of value inhering in such stock, it is for the Congress to say so. *Id.*

It later appeared that non-control stocks of other management companies had been selling at around thirty-seven times earnings. This represented approximately the same capitalization

In the ISI case, the court's central difficulty was, perhaps, that it could not comprehend the nature of damage inflicted upon the fund.<sup>1427</sup> The trial court had concluded:

No claim has been made in the complaint or otherwise that the business of Trust Fund has not been conducted efficiently or honestly or that the investors of Trust Fund have suffered any loss or damage of any kind with respect to their interest in Trust Fund by reason of any act or conduct of [ISI] or its officers or directors.<sup>1428</sup>

The Court of Appeals experienced a similar conceptual difficulty and asserted that "[t]he price received by appellee-directors for their stock in [ISI] did not come from the coffers of the investment company, but from outside purchasers."<sup>1429</sup>

of future earning which inhered in the premium paid for the control shares sold by defendants. The Chancellor was impressed, and concluded that "fair value" had been received for the TMC stock while "fair value" in terms of satisfactory contract performance had been received by the Fund. Accordingly, defendant's renewed motion for summary judgment was granted. *Krieger v. Anderson*, 40 Del. Ch. 151, 177 A.2d 203 (Ch. 1962).

The Supreme Court of Delaware agreed with the Chancellor that the principal issue was the "fair value" of the TMC stock, and was similarly impressed with the prevailing price-earnings ratio:

[S]hares of management companies had been sold at prices ranging in the neighborhood of 37 times earnings. [Plaintiff] also conceded that the per share price paid for the [TMC] stock was within the same capitalization rate. Plaintiff further specifically conceded that if the control shares had the same value as non-control shares, he was out of court. *Krieger v. Anderson*, 40 Del. Ch. 363, —, 182 A.2d 907, 909 (Sup. Ct. 1962). Of course, plaintiff was not at all willing to admit that control shares have the same value as non-control shares. *Krieger v. Anderson*, 40 Del. Ch. 151, —, 177 A.2d 203, 204 (Ch. 1962). The transfer of control shares terminates the advisory contract, as has already been seen, and this contract is the management company's most valuable asset. Admitting that, as a practical matter, there is almost no danger of a fund going elsewhere for management, it does not follow that the expectancy of contract reinstatement belongs to the shareholders of management. Analyzed in terms of corporate opportunity, however remote that opportunity might be, the fiduciary may not appropriate gains for himself. Nevertheless, the Delaware Supreme Court was unimpressed by plaintiff's argument. Since the sale had been conditioned upon reinstatement, the court reasoned, the buyers got precisely what the sellers had—there was no diminution in value because of the statutory termination of contracts — and hence the price for the TMC stock reflected its "fair value." 40 Del. Ch. 363, —, 182 A.2d 907, 909 (Sup. Ct. 1962). This fairly admits a direct sale of fiduciary office, but that did not seem to trouble the court. In the final analysis, the decision appears to be based on an inability to comprehend the potential harm suffered by the fund. Rhetorically, the court inquires, "What wrong has been done to the Texas Fund stockholders?" *Id.* at —, 182 A.2d at 909. That question is not without an answer. (1) Legally they have been deprived of an opportunity to recapture a portion or all of the premium through direct negotiations. (2) Much more importantly, they have been deprived of a significant equitable safeguard. There is an ever-present danger that the new managers installed by the old may not be competent or even interested in the welfare of the fund shareholders. To remove the temptation that self-interest will cloud the judgment of the incumbents, the law of fiduciary obligations demands that these men not sell their influence or their office for personal gain. The fairness of the transaction to the buyer and seller is irrelevant to a consideration of the protection required for the fund shareholder.

1427 The common law applicable to breach of fiduciary duty does not depend on an element of demonstrable damage.

The rule, inveterate and uncompromising in its rigidity, does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence but upon a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation. *Guth v. Loft, Inc.*, 23 Del. Ch. 255, —, 5 A.2d 503, 510 (Sup. Ct. 1939). *Accord*, *Irving Trust Co. v. Deutsch*, 73 F.2d 121, 124 (2d Cir. 1934); *Ballantine v. Ferretti*, 28 N.Y.S.2d 668, 680 (Sup. Ct. 1941).

1428 *SEC v. Insurance Sec., Inc.*, 146 F. Supp. 778, 780 (N.D. Cal. 1956).

1429 *SEC v. Insurance Sec., Inc.*, 254 F.2d 642, 651 (9th Cir. 1958).

One might as cogently argue that a diversion of corporate opportunity is not actionable because there is no direct outlay of corporate funds.

However this may be, and without further belaboring the point, the better commentators have uniformly discommended the decision.<sup>1430</sup> Nevertheless, the effect of the case is to carve a large loophole in the law of fiduciary relations, a law which should operate to discourage *in limine* the indulgence of self-interest by those in positions of trust.<sup>1431</sup> At the very least the minimal standards of *Insuranshares* should be restored to vitality by ridding the law of the notion that automatic termination of advisory contracts instantly relieves those in control of an advisor of their obligations to the fund. Anything less leaves the law of fiduciary deterrence sadly wanting.

Perhaps the SEC had set its sights too high in the ISI case; at least the court in *Krieger v. Anderson*<sup>1432</sup> felt so about the plaintiff before it:

[P]laintiff's contention would lead to an anomalous result. Owners of stock of a management company who have built up the value of their shares through the years by the exercise of business ability and good judgment are forbidden ever to reap [rape?] the reward of their labor. . . . This conclusion offends one's sense of fairness. If overriding considerations of public policy requires [*sic*] a curb on the right of owners of management contracts to realize the full value of their assets, *it is for Congress to say so*.<sup>1433</sup> (Emphasis added.)

Possibly taking its cue from *Krieger*, and with the ISI disaster anything but forgotten,<sup>1434</sup> the SEC abandoned the courts and brought its case to Capitol Hill. The Commission was careful to point out the nature of the conflict of interest involved in the sale of management control, observing that it is in the interest of retiring management to obtain the maximum price for its control interest, even though this may result in the installation of less competent or scrupulous advisors. Moreover, the Commission noted, the excessive premiums paid by purchasing management exerts pressure on them to recoup their purchase price as swiftly as possible<sup>1435</sup> — presumably through otherwise unnecessary charges against the fund for management fees or practices which result in recapture of excessive brokerage. Clearly, there is a serious deficiency in the law of fiduciary duty here, the Commission properly argued, and something should be done about it. In the measured terms of the SEC:

1430 Eisenberg & Lehr, *supra* note 1194, at 192-95; Greene, *Fiduciary Standards of Conduct Under the Investment Company Act of 1940*, 28 GEO. WASH. L. REV. 266, 274-78 (1959); Comment, *supra* note 1416; 72 HARV. L. REV. 1176 (1959); 13 SW. L.J. 376 (1959); Statement of Richard Jennings, 1967 House Hearings 642. *Contra*, Jaretzki, *The Investment Company Act: Problems Relating to Investment Advisory Contracts*, 45 VA. L. REV. 1023, 1026-34 (1959); Note, *Mutual Funds and the Investment Advisory Contract*, 50 VA. L. REV. 141, 152-53 (1964).

1431 Ballantine v. Ferretti, 28 N.Y.S.2d 668, 680-81 (Sup. Ct. 1941).

1432 40 Del. Ch. 363, 182 A.2d 907 (Sup. Ct. 1962).

1433 *Id.* at —, 182 A.2d at 910.

1434 The impact of the ISI case may have contributed to a development appearing in the *Wharton Report*:

[A]fter the original part of the study was nearing completion, the Commission requested that it be expanded to include an analysis of the activities of investment company advisers, which had previously been considered to be outside the [statutory] scope of the study. WHARTON REPORT 1. *See id.* at 429, 461-62.

1435 PUBLIC POLICY STATEMENT 150.

The shareholders, and in many situations the unaffiliated directors, are in no position to take an active role in the selection of new management organization [*sic*] or in the determination of the terms and conditions of the sale. The shareholders and the unaffiliated directors need be consulted only in connection with the last step in the sale — approval of the new advisory contract. At that point their alternatives are limited. They must either accept the new contract, continue with an existing management that may be unable or reluctant to perform its duties or have no management at all. Under these circumstances any concern over possible unfairness to the fund resulting from the sale is likely to be outweighed by the prospects of having no manager at all or having to retain a manager who has been deprived of an opportunity for an advantageous sale of the management organization and who may be unwilling or unable to function properly.

The manager of a mutual fund is unquestionably in a fiduciary relationship to it. Consequently, the transfer of that relationship for a price has some elements of the sale of a fiduciary office. Sale of a fiduciary office is strictly prohibited at common law because of the conflicts of interest which are involved. In the transfer of mutual fund management, however, as in the related area of management compensation, certain of the protective provisions of the Act have had the somewhat ironical, and presumably unintended, effect of diluting the protections provided by common law principles of fiduciary responsibility.<sup>1436</sup>

The lessons of *ISI* and *Krieger* were not wasted, for by 1966 the Commission had adopted a "soft line" on transfer of management control. In language strongly reminiscent of the Delaware Supreme Court's reaction in *Krieger*,<sup>1437</sup> the SEC sought to avoid the somewhat visceral objection that had been interposed: "[A]pplication of the strict common-law principle might well be unfair insofar as it denies to the retiring management any compensation for the elements of value in the relationship which they may have built up over the years."<sup>1438</sup> Accordingly, its legislative proposals to the Ninetieth Congress sought only to deal with management transfers that would be affirmatively burdensome or inequitable to the fund.<sup>1439</sup> This approach would at least restore the law to a level just below the minimum standard of *Insuranshares*, if nothing more. The proposed subsection 15(g) advocated by the Commission, however, was conspicuously absent from the Senate substitute bill, S. 3724. Nor is it to be found in either of the bills presently before Congress. Nevertheless, this should not be cause for great alarm in view of the proposed amendments to section 36 of the Act.

The committee report on S. 3724 makes it clear that the deletion of the subsection 15(g) recommendation was not intended to leave the present loophole in the law of fiduciary duty. Rather, the subsection was considered surplusage in view of the requirement that total compensation be reasonable (thus preventing new management from overcharging a fund in order to recoup its

1436 *Id.* at 151. See also 1967 House Hearings 77; 1967 Senate Hearings 170.

1437 See text accompanying note 1433 *supra*.

1438 PUBLIC POLICY STATEMENT 152.

1439 S. 1659, 90th Cong., 1st Sess. § 8(e) (1967); H.R. 9510 and H.R. 9511, 90th Cong., 1st Sess., § 8(e) (1967). The subsection was drafted so that its applicability to a situation such as the Alleghany-IDS relationship could not be disputed. Cf. note 1399 *supra*.

outlay) and the broad powers given under section 36 to counter *any* breach of fiduciary duty arising in connection with a transfer of control.<sup>1440</sup>

If the pending legislation is not amended to include a provision similar to the originally recommended subsection 15(g), care should be taken that the legislative history clearly discloses an intention to include the substance of subsection 15(g) within the scope of section 36. If this is done, amended section 36 should be an adequate remedy.

## VII. Conclusion

This Survey has attempted to trace the development of the mutual fund industry, depict its modern contours, and explore the role of federal legislation within the industry's operational framework. In 1940 the nauseating litany of abuses catalogued by the SEC in its monumental *Investment Trusts Study* incited Congress to pass the Investment Company Act. The prosperity and integrity of the post-Act industry testifies to the perspicacity of Congress in so discharging its duty to the investing public.

That the 1940 Act is broad in scope and comprehensive in nature is undeniable; yet it cannot reasonably be asserted that the Seventy-sixth Congress intended for it to serve as the *ne plus ultra* of effective federal legislation within the investment company sphere. Indeed, Congress included a provision in the Act that authorized the SEC to examine future industry developments and "report the results of its studies and investigations and its recommendations to the Congress."<sup>1441</sup>

The Commission utilized the power granted it by the Seventy-sixth Congress when it engaged the Wharton School of Finance to conduct a study of the mutual fund industry. The conclusions of that study, embodied in the *Wharton Report*, were supplemented by the findings of the SEC's Special Study task force, which were enunciated in the *Special Study*. Jointly these documents provided the foundation upon which the Commission's own report to Congress, the *Public Policy Statement*, was built, and upon which the legislation now pending before Congress rests. Simply put, the SEC's position, manifest in the current legislative proposals, is that while the modern investment company shareholder is not losing money in exactly the same manner as his pre-Act predecessors did — through outright looting, for instance — he is losing money through high sales loads and overly generous management fees.

The proposals now pending before Congress propose to remedy his plight. One wonders if the present Congress will have the fortitude to follow the lead of its 1940 antecedent and enact regulatory measures to remedy existing inequities, or choose to remain on the sidelines, entrusting the fortune of over five million citizens to "haphazard voluntary solutions."<sup>1442</sup>

1440 S. REP. No. 1351, 90th Cong., 2d Sess. 12 (1968).

1441 Investment Company Act of 1940 § 14(b), 15 U.S.C. § 80a-14(b) (1964). For a discussion of the history of that subsection, see notes 412-21 *supra* and accompanying text.

1442 In introducing S. 3580 before the Seventy-sixth Congress in 1940, Senator Wagner noted that "[t]he problem of the protection of the investor and the national economy is too vital to permit of *haphazard voluntary solutions*." 86 CONG. REC. 2845 (1940) (emphasis added).

If Congress does opt for playing the role of a passive bystander, it is to be fervently hoped that the reasons conjured up to excuse its idle posture are less superficial than those proffered by several distinguished senators who opposed the passage of S. 3724 in 1968. Lamenting the lack of a "public outcry" in support of the bill,<sup>1443</sup> and asserting that the proposal rested on inadequately researched underpinnings,<sup>1444</sup> they supported a motion to recommit the measure to the Senate Committee on Banking and Currency.<sup>1445</sup>

As for the "outcry" argument, it need only be noted that President Johnson's Commission on Law Enforcement and Administration of Justice found the American public "indifferent" to the threat that organized crime poses to our society.<sup>1446</sup> Would any Congressman advocate suppressing a measure designed to eradicate organized crime because of a lack of popular support? In the same vein it may be observed that Reverend Martin Luther King's death roused Congress to pass a bill to provide "fair housing throughout the United States,"<sup>1447</sup> and Senator Robert Kennedy's assassination precipitated a step towards effective firearms control.<sup>1448</sup> In light of this morbid precedent one may ponder what sort of financial cataclysm must occur before congressional disciples of the "outcry" argument are afforded the clamor they demand.

The argument that the legislation has been inadequately studied is equally absurd. The industry's ills have been meticulously analyzed and are documented in three reports prepared over a span of eight years before being transmitted to Capitol Hill. Congress will soon enter its third year of study regarding mutual fund legislation and a wealth of material has already been churned out by the appropriate congressional gristmills. Indeed, the hearings on S. 1659, and its identical House counterparts, H. 9510 and H. 9511 — bills that embodied the

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1443 The Senators from Illinois seemed to be especially eager to correlate the popular support granted the legislation with the desirability of aiding in its passage. In the course of the Senate debate on the proposal Senator Percy observed that "if conditions in the [mutual fund] industry are as unwholesome as they are painted by the proponents of this legislation, I think I would have received at least a letter or two." 114 CONG. REC. S9477 (daily ed. July 26, 1968). A short time later Senator Dirksen intoned:

There have been no scandals, certainly no major scandals, no abuses, and no widespread public interest or demand for legislation. If there has been, I have not seen it. I have not seen it reflected in the mails or by telephone calls, or from any other source that I know. *Id.* at S9479.

Said Senator Bennett:

[T]here is no public outcry for this legislation. . . . I requested the SEC to send me all of the communications favoring and opposing this legislation because all of my mail was opposed to it.

I did receive from the SEC less than 400 communications in which some comment could be considered favorable to some legislation in the mutual fund industry was given. I do not consider 400 letters out of more than 4½ million shareholders — less than 1 in more than 10,000 — as representing a consumer outcry for the proposed legislation. 114 CONG. REC. S9413 (daily ed. July 25, 1968). *See also* S. REP. No. 1351, 90th Cong., 2d Sess. 57 (1968).

1444 *See* 114 CONG. REC. S9475, S9477 (daily ed. July 26, 1968) (remarks of Senator Percy); *id.* at S9473 (remarks of Senator Bennett); *id.* at S9479 (remarks of Senator Dirksen).

1445 The motion was made by Senator Bennett. 114 CONG. REC. S9429 (daily ed. July 25, 1968).

1446 PRESIDENT'S COMMISSION ON LAW ENFORCEMENT AND ADMINISTRATION OF JUSTICE, *THE CHALLENGE OF CRIME IN A FREE SOCIETY* 188 (1967).

1447 42 U.S.C.A. § 3601 (Supp. 1969).

1448 The Gun Control Act of 1968, 82 Stat. 1213, *amending* Omnibus Crime Control and Safe Streets Act of 1968 tit. IV, 18 U.S.C.A. §§ 921-28 (Supp. 1969), became law on October 22, 1968.

ideals propounded by the SEC in its *Public Policy Statement* — consist of over two thousand pages of printed matter. That Congressmen should bemoan a lack of research with such resources literally at their fingertips proves again that slow grind the wheels of bureaucracy.

With no less at stake than the welfare of five million investors and the integrity of the securities markets, it is submitted that Congress must not fail to discharge its duty to the American investor. The tools, either S. 34 or S. 296, are at hand.

*Richard H. Farina*<sup>1449</sup>

*John P. Freeman*<sup>1450</sup>

*James Webster*<sup>1451</sup>

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1449 Text accompanying notes 1006-1448 *supra*, Appendices A-C *infra*.

1450 Text accompanying notes 1-456 *supra*, Appendices A-C *infra*.

1451 Text accompanying notes 457-1005 *supra*.

APPENDIX A  
PERFORMANCE FEE RATES OF FORTY-THREE INVESTMENT COMPANIES  
(Some funds which may have performance fees are not included in this schedule.)

	Basic Fee Per Cent	Index	Capital Gains Realized	Unrealized	Dividend	Income	Interest	Penalty	Performance Per Cent	Maximum Fee Total
Leon B. Allen Fund, Inc.	.75	S&P 500						Yes <sup>1</sup>	.5	1.25
Alpha Fund, Inc.	.5	DJIA						No	1.3	1.03
Aurora Equity Fund, Inc.	.5	S&P 500						Yes	1.3	2.0
Competitive Capital Fund, Inc.	.375	DJIA						No	3	3.875
Compufund, Inc.	.5	NYSECI						Yes	2.5	3.84
Comstock Fund, Inc.	.6	NYSECI						Yes <sup>1</sup>	2.2	6.0
The Dikewood Fund, Inc.	.4	NYSECI	X <sup>6</sup>	X <sup>6</sup>	X <sup>6</sup>	X <sup>6</sup>	X <sup>6</sup>	Yes	5.6	.6
Doll Fund, Inc.	1.0							No	.2	.84
Enterprise Fund, Inc.	.6	DJIA						Yes	.25	.754
Fairfield Fund, Inc.	.375	DJIA						No	.375	.54
First Multifund of America, Inc.	.25	DJIA						No	.2	.84
Fletcher Capital Fund, Inc.	.6	DJIA						Yes	.375	.754
Fletcher Fund, Inc.	.375	DJIA						No	1	.64
Fund for Growth, Inc.	.5	DJIA	X <sup>6</sup>		X <sup>6</sup>		X <sup>6</sup>	No	3.5	4.0
Gibraltar Growth Fund, Inc.	.5	DJIA						No	3.5	4.0
Hartwell & Campbell Fund, Inc.	.5	NYSECI						Yes <sup>1</sup>	.25	.8754
Hartwell & Campbell Leverage Fund, Inc.	.5	S&P 500						Yes <sup>1</sup>	.25	.8754
Hedge Fund of America, Inc.	.625	NQBOTGIA						Yes <sup>1</sup>	.25	.8754
The Herold Fund, Inc.	1.0	DJIA	X <sup>6</sup>		X <sup>6</sup>		X <sup>6</sup>	No	3.0	4.0
Hushman Fund, Inc.	.5	DJIA						No	.25	.6254
Ivest Fund, Inc.	.48	DJIA						Yes <sup>1</sup>	4.0	6.0
Knowledge-Communication Fund	.375	DJIA	X <sup>6</sup>		X <sup>6</sup>		X <sup>6</sup>	No	5.5	6.0
Mates Investment Fund, Inc.	.5	NYSECI						No	3	.84
The Medtel Fund, Inc.	.5	S&P 500						No	.625	1.044
Neurwirh Fund, Inc.	.375	S&P 500						No	.5	.8754
Ocean Technology Fund, Inc.	.375	S&P 500						No	.25	.754
Olympus Fund	.3	S&P 500						Yes <sup>1</sup>	.5	1.04
Omega Fund, Inc.	.3	DJIA						Yes	.375	.754
O'Neil Fund	.375	DJIA						No	3	.64
The One Hundred Fund, Inc.	.5	S&P 500	X <sup>6</sup>					Yes	4.0	4.0
Oppenheimer Fund	.375	DJIA						No	1.0	1.04
Pennsylvania Mutual Fund, Inc.	.375	DJIA						No	1.0	1.04
Pension Equity Fund, Inc.	.375	DJIA						No	1.0	1.04
Putnam Income Fund, Inc.	.375	DJIA						No	1.0	1.04
Republic Technology Fund, Inc.	.36	S&P 500	X <sup>6</sup>					No	1.0	1.04
Samson Fund, Inc.	.375	DJIA			X <sup>6</sup>		X <sup>6</sup>	No	.375	.754
Schuster Fund, Inc.	.375	DJIA	X <sup>6</sup>	X <sup>6</sup>	X <sup>6</sup>		X <sup>6</sup>	No	.25	.754
Securities Fund, Inc.	.5	S&P 500						Yes	.375	.8754
Sherman, Dean Fund, Inc.	.5	S&P 500	X <sup>6</sup>		X <sup>6</sup>		X <sup>6</sup>	No	.5	1.0
The Side Fund, Inc.	.4	S&P 500	X <sup>6</sup>		X <sup>6</sup>		X <sup>6</sup>	No	.6	1.04
TMR Appreciation Fund, Inc.	.35	S&P 500						No	.2	.7
The Technical Fund, Inc.	.35	S&P 500	X <sup>6</sup>	X <sup>6</sup>	X <sup>6</sup>	X <sup>6</sup>	X <sup>6</sup>	Yes <sup>1</sup>	.2	.7
The Tower Fund, Inc.	.625	S&P 500	X <sup>6</sup>		X <sup>6</sup>		X <sup>6</sup>	No	.25	.8754

1 Compensation increases and decreases proportionately with investment performance.  
 2 The investment advisor contractually limits the expenses of the fund (excluding taxes and interest) to 1.5 per cent of the fund's average net assets.  
 3 The fee is related to the highest of DJIA, S&P 500, NYSECI.  
 4 The fund's expense ratio is contractually limited to one per cent.  
 5 Performance fee added to basic fee such that the advisor receives ten per cent of the increase in the fund's net assets computed without regard to sales and redemptions.  
 6 Maximum performance fee limited to five per cent of highest monthly net assets of the fund during the year.  
 7 Negative performance adjustment may be carried over from year to year since annual fee may not be reduced below zero.  
 8 Compensation to the advisor is twenty per cent of the percentage gain in net assets over the index.  
 9 Compensation to the advisor is six per cent of the fund's gross annual investment income.



## APPENDIX B

Advisory Fee Rates and Expense Ratios of Externally Managed Mutual Funds with June 30, 1968 Net Assets of \$100 Million and Over for Their Fiscal Years Ended July 1, 1967 — June 30, 1968<sup>1</sup>

Name of Fund (In Order of Net Assets at June 30, 1968)	Net Assets June 30, 1968 (millions)	Average Net Assets (millions) <sup>2</sup>	Advisory Fee Rate (per cent) <sup>3</sup>	Expense Ratio (per cent) <sup>3</sup>
	(1)	(2)	(3)	(4)
1. Investors Mutual, Inc.	\$3,017	\$2,939	0.30	0.30
2. Dreyfus Fund, Inc. (The)	2,464	2,116	.50	.55
3. Investors Stock Fund, Inc.	2,215	1,947	.30	.30
4. Wellington Fund, Inc.	1,817	1,911	.25	.39
5. Affiliated Fund, Inc.	1,615	1,393	.23	.31
6. Fidelity Trend Fund, Inc.	1,402	1,273	.39	.50
7. United Accumulative Fund	1,400	1,355	.36	.38
8. Fundamental Investors, Inc.	1,362	1,284	.40	.48
9. Investors Variable Payment Fund, Inc.	1,076	770	.31	.31
10. ISI Trust Fund (Formerly: Insurance Securities Trust Fund)	986	1,028	.60 <sup>4</sup>	.60
11. Investment Company of America (The)	918	726	.34	.50
12. Fidelity Fund, Inc.	834	695	.39	.49
13. United Income Fund	779	714	.36	.39
14. Fidelity Capital Fund, Inc.	740	589	.44	.56
15. Puritan Fund, Inc.	720	520	.38	.48
16. Hamilton Fund, Inc.	675	600	.50	.62
17. Technology Fund, Inc. (Formerly: Television-Electronics Fund, Inc.)	611	527	.43	.59
18. Putnam Growth Fund (The)	608	440	.41	.53
19. Enterprise Fund, Inc.	582	117	.63 <sup>5</sup>	1.07 <sup>5</sup>
20. Keystone Custodian Fund, Series S-4	557	446	.54 <sup>6</sup>	.54
21. Diversified Growth Stock Fund, Inc.	550	344	.47	.63
22. Chemical Fund, Inc.	548	500	.29	.37
23. Manhattan Fund, Inc.	493	538	.48	.70
24. Price, T. Rowe Growth Stock Fund, Inc.	463	315	.40	.55
25. Delaware Fund, Inc.	451	367	.50	.69
26. George Putnam Fund of Boston (The)	448	426	.35	.44
27. United Science Fund	435	377	.36	.39
28. State Street Investment Corporation	422	373	.43	.49
29. American Mutual Fund, Inc.	404	366	.43	.59
30. Dividend Shares, Inc.	402	376	.30	.45
31. Financial Industrial Fund, Inc.	382	342	.66 <sup>7</sup>	.66
32. National Securities Series — Stock Series	371	341	.50	.60
33. Channing Shares — Growth Fund Series	344	259	.50	.63
34. Keystone Custodian Fund, Series K-2	330	266	.55 <sup>6</sup>	.55
35. Axe-Houghton Fund B, Inc.	328	282	.55 <sup>8</sup>	.71
36. Ivest Fund, Inc.	325	80	.73 <sup>5</sup>	.92 <sup>5</sup>
37. Boston Fund, Inc.	307	334	.47	.56
38. Putnam Investors Fund, Inc.	307	279	.41	.56
39. Group Securities — Common Stock Series	293	274	.50	.71
40. One William Street Fund, Inc. (The)	291	262	.32	.46
41. American Investors Fund, Inc.	285	181	.60	.88
42. Eaton & Howard Stock Fund	276	258	.50	.57
43. National Securities Series — Growth Stock Series	272	224	.50	.61
44. Colonial Fund, Inc. (The)	252	195	.47	.60

## Continued

Name of Fund (In Order of Net Assets at June 30, 1968)	Net Assets	Average	Advisory	Expense
	June 30, 1968 (millions)	Net Assets (millions) <sup>2</sup>	Fee Rate (per cent) <sup>2</sup>	Ratio (per cent) <sup>2</sup>
	(1)	(2)	(3)	(4)
45. Washington Mutual Investors Fund, Inc.	246	224	.48 <sup>9</sup>	.64
46. Selected American Shares, Inc.	231	215	.50	.60
47. Value Line Special Situations Fund, Inc. (The)	206	68	.75	.94
48. Oppenheimer Fund, Inc.	200	119	1.24 <sup>5</sup>	1.65 <sup>5</sup>
49. Keystone Custodian Fund, Series S-3	199	155	.56 <sup>6</sup>	.56
50. Eaton & Howard Balanced Fund	193	200	.50	.58
51. Commonwealth Investment Company	192	186	.48	.58
52. Institutional Investors Mutual Fund, Inc.	189	154	.14	.25
53. Massachusetts Fund (Formerly Massachusetts Life Fund)	188	163	.50	.54
54. Windsor Fund, Inc.	185	115	.45	.70
55. Federal Street Fund, Inc.	180	159	.50	.56
56. Diversified Investment Fund, Inc.	176	168	.49	.65
57. Putnam Income Fund, Inc.	171	171	.28 <sup>10</sup>	.45
58. Stein Roe & Farnham Balanced Fund, Inc.	161	133	.48	.54
59. Winfield Growth Fund, Inc.	161	81	.45	.77
60. Scudder, Stevens & Clark Common Stock Fund, Inc.	161	146	.50	.61
61. Loomis-Sayles Mutual Fund, Inc.	156	144	.46	.60
62. Bullock Fund, Ltd.	154	132	.24	.38
63. Penn Square Mutual Fund	152	157	.49	.57
64. Dow Theory Investment Fund, Inc.	151	124	.50	.69
65. Scudder Special Fund, Inc.	149	55	.50	.64
66. Keystone Custodian Fund, Series S-2	148	128	.56 <sup>6</sup>	.56
67. Pioneer Fund, Inc.	140	105	.50	.67
68. Mutual Investing Foundation — MIF Fund	133	113	.43	.64
69. Keystone Custodian Fund, Series K-1	133	129	.54 <sup>6</sup>	.54
70. Price, Rowe New Horizons Fund, Inc.	131	77	.52	.70
71. Keystone Custodian Fund, Series B-4	131	133	.56 <sup>6</sup>	.56
72. Security Equity Fund, Inc.	129	30	.50	.85
73. Energy Fund, Inc.	126	68	.50	.85
74. Colonial Equities, Inc.	122	17	.48	.88
75. Istel Fund, Inc.	119	82	.50	.75
76. Commonwealth Capital Fund, Inc.	115	36	.50	.69
77. Channing Shares — Balanced Fund Series	114	109	.50	.65
78. Johnston Mutual Fund, Inc.	112	84	.50	.67
79. Shareholders' Trust of Boston	112	92	.50	.65
80. Scudder, Stevens & Clark Balanced Fund, Inc.	111	115	.50	.62
81. Supervised Investors Growth Fund, Inc.	111	43	.50	.93
82. National Securities Series — Dividend Series	107	100	.50	.62
83. Depositors Fund of Boston, Inc.	104	95	.50	.56
84. Texas Fund, Inc.	103	92	.50	.62
85. Diversification Fund, Inc.	102	94	.50	.57
86. Value Line Income Fund, Inc.	102	95	.51	.80
87. Lexington Research Investing Corporation	100	76	.60	.85
Average			.47	
Mean			.47	.61
Median			.50	.59

1 Not including four funds (Fletcher Capital Fund, Inc., Putnam Equities Fund, Inc., Putnam Vista Fund, Inc., and Second Fiduciary Exchange Fund, Inc.) which were in operation for less than the entire fiscal year.

## APPENDIX C

## H.R. 8980 — THE STUCKEY BILL

## I. Introduction

On March 13, 1969, Congressman W. S. (Bill) Stuckey introduced H.R. 8980<sup>1</sup> in the House of Representatives.<sup>2</sup> The bill proposes to amend the Investment Company Act of 1940 to provide, in its sponsor's words, "a much larger measure of consumer and investor protection for shareholders in investment companies — mutual funds — while at the same time preserving the principles of free enterprise and corporate democracy."<sup>3</sup>

Like each of the recent mutual fund reform bills,<sup>4</sup> H.R. 8980 deals with many of the problems spotlighted by the SEC in its *Public Policy Statement*.<sup>5</sup> Indeed, the bill contains several provisions which are identical to those contained in S. 3724 and the two pending Senate bills, S. 34 and S. 296. Lest the House bill be classed with the Senate bills that trace their ancestry to the *Public Policy Statement*, one must hasten to add that H.R. 8980, designed as it is to protect the industry from its investors, is clearly the black sheep of the fund reform family.

Mr. Stuckey has attempted to justify this remarkable transposition by waving the twin banners of "full disclosure" and "corporate democracy."<sup>6</sup> As to full

1 H.R. 8980, 91st Cong., 1st Sess. (1969).

2 115 CONG. REC. H1764 (daily ed. March 13, 1969).

3 *Id.* at H1727 (remarks of Mr. Stuckey).

4 The bills are reducible to three categories: (1) three identical bills submitted to Congress by the SEC and introduced on May 1, 1967 — S. 1659, 90th Cong., 1st Sess. (1967); H.R. 9510, 90th Cong., 1st Sess. (1967); and H.R. 9511, 90th Cong., 1st Sess. (1967); (2) the two amended versions of those bills introduced in 1968 — H.R. 14742, 90th Cong., 2d Sess. (1968); S. 3724, 90th Cong., 2d Sess. (1968); and (3) the pending Senate bills — S. 34, 91st Cong., 1st Sess. (1969); and S. 296, 91st Cong., 1st Sess. (1969).

5 *E.g.*, management fees, *see* text accompanying notes 13-50, *infra*; sales loads, *see* text accompanying notes 51-55 *infra*; and contractual plans, *see* text accompanying notes 56-61 *infra*.

6 Mr. Stuckey's esteem for the philosophy of disclosure and the principle of corporate democracy has a familiar ring about it. Reprinted in the *1967 House Hearings* is a letter written by Mr. Robert Augenblick to Congressman John E. Moss concerning mutual fund management fees. At the time he wrote the letter, Mr. Augenblick was the President of the Investment Company Institute, a group that one Senator has characterized as "the principle

2 Average net assets (approximate) for fiscal years ended July 1, 1967 to June 30, 1968, calculated by dividing operating expenses by the expense ratio appearing in column (4).

3 Ratio to average net assets for fiscal years ended July 1, 1967 to June 30, 1968, on the basis shown in the Commission's PUBLIC POLICY STATEMENT 98.

4 The fee is a combined investment management, administrative, and trusteeship fee of 0.50 per cent of the aggregate amount which the investor pays or agrees to pay into the fund. As a per cent of net assets, this arrangement results in a lower rate if the net asset value of the investment increases and a higher rate if such value decreases. *See* note 1053 *supra* and accompanying text.

5 Includes a performance fee. *See* Appendix A *supra*.

6 Includes investment management and recurring fees paid to the trustee. *See* notes 1057-58 *supra* and accompanying text.

7 Includes investment supervisory fee and administrative service charge paid to the investment adviser.

8 Includes management fee paid to the investment adviser and a continuing fee paid to the principal underwriter, which is closely affiliated with the adviser. *See* notes 1063-64 *supra* and accompanying text.

9 Includes both the fees paid to the fund's investment adviser and to its business manager.

10 The fee is based on the fund's income.

disclosure, the Congressman noted: "The truth-in-mutual-funds law enacted by Congress in 1940—the Investment Company Act of 1940—like the other Federal securities laws, embodies the principle of 'full disclosure' as the main bulwark of investor and consumer protection in the field of mutual funds."<sup>7</sup> Proceeding from that fantasy,<sup>8</sup> he briefly outlined the Act's key disclosure requirements, and gave them his unqualified endorsement:

Under present law, mutual fund shareholders are provided complete information about each fund in a prospectus approved by the SEC as to full disclosure, by four quarterly reports and an annual report filed with the SEC and various State agencies[,] by a SEC approved proxy statement before each shareholders meeting, by the requirement that management and sales compensation must be approved annually by a majority of the shareholders or the directors, including a majority of the unaffiliated directors, and if this is not enough the SEC has ample authority now to require more disclosures.

. . . .  
 . . . And, if the SEC needs more authority to insure fuller disclosure, I will support such legislation.<sup>9</sup>

Addressing himself to the need for additional legislation to strengthen the 1940 Act, Mr. Stuckey was at pains to identify his bill with the disclosure approach to mutual fund reform:

Last year, there were many good features of the SEC's proposals, which I have included in my bill. These will update the Investment Company Act of 1940, and will tighten up some loose areas where disclosure could be more complete and managerial responsibility more distinctly defined.<sup>10</sup>

The rationale behind Mr. Stuckey's fixation for disclosure, as opposed to regulation, lies in his esteem for the principle of corporate "democracy." "[T]he basic assumption of corporate democracy," we are told, is

that each shareholder buys into a company voluntarily and can sell his shares at any time he does not like the company or its management, but that while

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lobbying organization for the entire [mutual fund] industry . . ." 114 CONG. REC. S9426 (daily ed. July 25, 1968) (remarks of Senator McIntyre). Mr. Augenblick stated in part:

We . . . believe [that certain testimony quoted from the 1940 Senate Hearings] makes clear what Congress "intended to achieve in 1940" with respect to management fees — namely, *full disclosure* and the right of shareholders to decide for themselves within the framework of the traditional modes of *corporate democracy*. 1967 House Hearings 822. (Emphasis added.) As will be seen from the perusal of the major "reforms" incorporated into Mr. Stuckey's bill, the bill could not be more self-serving from the industry's point of view had it been drafted by the Investment Company Institute.

<sup>7</sup> 115 CONG. REC. H1727 (daily ed. March 13, 1969).

<sup>8</sup> If Mr. Stuckey was suggesting that the Investment Company Act is primarily a disclosure statute he was wrong. See, e.g., *Testimony of Commissioner Hugh F. Owens of the Securities and Exchange Commission Before the Senate Committee on Banking and Currency on S. 34*, April 15, 1969, at 10 [hereinafter cited as 1969 Senate Hearings]:

It is true that [certain information is] disclosed to the shareholder. This, however, is a federally regulated industry and that regulation goes beyond disclosure. That policy decision was made by the Congress in 1940 — and with ample basis. The question now is what must be done . . . to make the existing regulatory scheme more effective. (Citations omitted.)

See also text accompanying notes 197-200, 339-42 *supra*.

<sup>9</sup> 115 CONG. REC. H1728 (daily ed. March 13, 1969).

<sup>10</sup> *Id.*

he is a shareholder, a majority of the shareholders and the directors they elect each year will run the company.<sup>11</sup>

When combined, the Congressman's dual ideals result in the following questionable premise which pervades H.R. 8980: Any law that empowers the SEC and the courts

to substitute their judgment for that of the shareholders and elected directors on such matters as management compensation and sales commissions. . . . would do violence to the constitutional right of the majority shareholders . . . and let the minority shareholders or the SEC and courts make the most important decisions a company makes, i.e., management and sales compensation.<sup>12</sup>

Thus surfaces the enigma of H.R. 8980. On the assumption that investors who purchase and hold fund shares have at their disposal "complete information about each fund," Mr. Stuckey finds it a simple matter to bring the rules of corporate "democracy" into play, thereby subjecting fund control to majority rule and requiring that the members of the dissenting minority suffer in silence or sell out. To the Congressman, suits brought by dissenting shareholders to remedy evils perpetrated by the unjust stewards of the modern fund scene are anathema. This contempt for an oppressed minority's judicially amplified voice manifests itself in the bill's management fee and sales load provisions.

## II. Management Fees

The provisions of H.R. 8980 dealing with management contracts are transparently designed to unqualifiedly immunize any conceivable scheme of compensation short of open thievery. This rather remarkable result is achieved by raising a *conclusive* presumption that all terms of an advisory contract are fair and equitable if approved "by all of the unaffiliated directors" and by those shareholders holding two-thirds of the outstanding shares.<sup>13</sup> We have already seen that the *Wharton* sample of 107 fund stockholder meetings did not include a single example of a management proxy committee which would have failed to deliver the two-thirds ratification demanded by the Stuckey bill.<sup>14</sup> The *Wharton* results are not unexplainable.<sup>15</sup> As to directorial approval, it is interesting that the Stuckey bill requires the vote of the *unaffiliated* directors in order to put the contract beyond the law,<sup>16</sup> even though the same bill would retain, with some dilution, a definition of interested persons contained in the bona fide reform bills of the other chamber.<sup>17</sup> Directorial approval, then, will be obtained

11 *Id.* Mr. Stuckey underscored his reverence for the principle of corporate democracy thusly: "I believe in corporate democracy just as I believe in political democracy." *Id.*

12 *Id.* The Congressman's premise is not made less questionable by the presence of provisions in the Investment Company Act that permit the SEC to prescribe management fee payments and sales load levels for certain investment companies in certain instances. *See* Investment Company Act of 1940 § 27(a)(5), (b), 15 U.S.C. § 80a-27(a)(5), (b) (1964).

13 H.R. 8980, 91st Cong., 1st Sess. § 8(a) (1969).

14 *See* note 1126 *supra* and accompanying text.

15 *See* notes 1102, 1105-10, 1121-32 *supra* and accompanying text.

16 H.R. 8980, 91st Cong., 1st Sess. § 8(a) (1969).

17 *Compare* H.R. 8980, 91st Cong., 1st Sess. § 2(3) (1969) *with* S. 34, 91st Cong., 1st Sess. § 2(3) (1969) *and* S. 296, 91st Cong., 1st Sess. § 2(3) (1969) *and* S. 1659, 90th Cong., 1st Sess. § 2(3) (1967).

from precisely the same men under the Stuckey bill as at present. We have seen that the farce which now surrounds the vote of the unaffiliated directors<sup>18</sup> results from the close relationships permitted by the Act's definition of affiliated person<sup>19</sup> and the complete practical and economic impotence of these men to bargain on an arm's length basis with the advisor.<sup>20</sup> In the pervasive effect it assigns to approval by unaffiliated directors, H.R. 8980 enshrines further an already ludicrous exercise in form.

It should be further noted that the Stuckey bill dilutes in every possible way the role of the directors in the negotiation of management contracts. The Investment Company Act presently requires that the contract "precisely" describe management compensation,<sup>21</sup> and the Senate bills would require further precision in order that the contract may be carefully and intelligently considered by the fund's directorate.<sup>22</sup> Congressman Stuckey's bill, on the other hand, cripples an already weak provision of the Act by deleting all requirements for exactitude in the contract.<sup>23</sup> The Georgian is obviously troubled by the thought that the Senate bills would permit the fund directors' judgment to be "supplanted" in a judicial proceeding.<sup>24</sup> Actually, the Senate bills emphasize the role of fund directors by articulating their duty to request and evaluate data pertinent to an informed judgment of the contract while his own bill does not.<sup>25</sup> And again, the Senate bills both assure that fund directors will be furnished the information relevant to their deliberations, while the Stuckey bill prefers to permit the directors to consider the contract in total ignorance or only in light of the selective data which the advisor wishes to present.<sup>26</sup> H.R. 8980 is, in short, difficult to reconcile with the Congressman's notion that the "principles . . . of corporate democracy"<sup>27</sup> require responsibility for the terms of the agreement to rest on the judgment of the directors.

The Stuckey bill, as noted, borrows the concept of "interested person" from the genuine reform bills,<sup>28</sup> and then emasculates it. The Congressman betrays an inherent distrust for men "corrupted" by the SEC,<sup>29</sup> for his bill declares former employees of the Commission unfit for the office of disinterested director,<sup>30</sup> perhaps on the premise that these people are a bit too likely to understand

18 See notes 1019, 1056, 1136, 1175, 1360 *supra* and accompany text.

19 See notes 1136-41, 1154-59, 1163-65, 1169-75, *supra* and accompanying text.

20 See notes 1100-02 *supra* and accompanying text.

21 Investment Company Act of 1940 § 15(a), 15 U.S.C. § 80a-15(a) (1964).

22 S. 34, 91st Cong., 1st Sess. § 8(a) (1969); S. 296, 91st Cong., 1st Sess. § 8(a) (1969).

23 H.R. 8980, 91st Cong., 1st Sess. § 8(a) (1969).

24 115 CONG. REC. H1728 (daily ed. March 13, 1969).

25 Compare H.R. 8980, 91st Cong., 1st Sess. § 8(c) (1969) with S. 34, 91st Cong., 1st Sess. § 8(c) (1969) and S. 296, 91st Cong., 1st Sess. § 8(c) (1969).

26 Compare H.R. 8980, 91st Cong., 1st Sess. § 8(c) (1969) with S. 34, 91st Cong., 1st Sess. § 8(c) (1969) and S. 296, 91st Cong., 1st Sess. § 8(c) (1969); see also notes 1357-60 *supra* and accompanying text.

27 115 CONG. REC. H1727 (daily ed. March 13, 1969).

28 Compare H.R. 8980, 91st Cong., 1st Sess. § 2(3) (1969) with S. 34, 91st Cong., 1st Sess. § 2(3) (1969) and S. 296, 91st Cong., 1st Sess. § 2(3) (1969). See also note 1173 *supra*.

29 115 CONG. REC. H1728 (daily ed. March 13, 1969). Cf. Shipley, *The SEC's Amicus Curiae Aid to Plaintiffs in Mutual Fund Litigation*, 52 A.B.A.J. 337 (1966). But see Loomis & Eisenberg, *The SEC as Amicus Curiae in Shareholder Litigation—A Reply*, 52 A.B.A.J. 749, 753 n.25 (1966).

30 H.R. 8980, 91st Cong., 1st Sess. § 2(3) (1969).

the industry's workings and might undertake to review demands of the mercenary managers. Apparently the taint of SEC employment is vicariously visited upon members of a Commission employee's family and further infects relatives of "former [Commission] personnel within the past two fiscal years of such company."<sup>31</sup>

Even W. S. (Bill) Stuckey recognizes that a director's judgment may be somewhat clouded by a substantial financial interest in the subject matter of his deliberations,<sup>32</sup> and hence he retains a provision of the 1967 bills which would classify such persons as "interested."<sup>33</sup> S. 3724 represented a compromise with the industry since it required a non-retroactive Commission order determining this status,<sup>34</sup> while the House bill picks up the language of S. 3724 and further requires a mandatory administrative hearing before any such order may issue.<sup>35</sup> For practical purposes, the hearing requirement should effectively stymie SEC implementation of this provision.

Mr. Stuckey's SEC phobia is carried to its ultimate in section 19 of his bill. That section would make it a criminal offense for former employees of the Commission to participate in any manner in a lawsuit against an investment company, its advisor, or its underwriter.<sup>36</sup> The prohibition is not limited to SEC attorneys in possession of otherwise unobtainable information, but apparently extends to all SEC staff as well as to the receptionist, switchboard operator, or maintenance man who may own shares in a fund and wish to bring suit for even the most patent mismanagement.

So long as Congressman Stuckey was closing courthouse doors to the SEC, he was not prepared to stop with management fees and sales loads. Accordingly, H.R. 8980 lifts language from the Senate bills, especially S. 34, which would amend section 36 of the Act to proscribe breaches of fiduciary duty involving personal misconduct.<sup>37</sup> The House bill, however, attempts to raise the level of proof presently required to establish a section 36 action, and also seeks to restrict the effectiveness of any injunctive relief which might be granted by limiting the injunction so that it may operate upon a person only in respect to his functioning in one of the enumerated capacities.<sup>38</sup> Presumably, an advisor-underwriter would not be divested of control if an injunction were obtained against him, for

31 *Id.* The specific language is somewhat puzzling: "[A]ny member of the immediate family or any present Securities and Exchange Commission personnel, or former personnel within the past two fiscal years of such company . . . ."

32 *Cf.* note 1165 *supra* and accompanying text.

33 *Compare* H.R. 8980, 91st Cong., 1st Sess. § 2(3) (1969) with S. 34, 91st Cong., 1st Sess. § 2(3) (1969) and S. 296, 91st Cong., 1st Sess. § 2(3) (1969).

34 S. 3724, 90th Cong., 2d Sess. § 2(3) (1968). *See also* S. 1659, 90th Cong., 2d Sess. § 2(3) (1967); H.R. 9510 and 9511, 90th Cong., 1st Sess. § 2(3) (1967).

35 H.R. 8980, 91st Cong., 1st Sess. § 2(3) (1969). That the hearing is intended to be mandatory is in conformity with Mr. Stuckey's general intention to further eviscerate this section. Moreover, a change made in drafting section 4(b) of Congressman Stuckey's bill makes it abundantly clear that the intent of the draftsman is that the hearing may not be waived. *Compare* H.R. 8980, 91st Cong., 1st Sess. § 4(b) (1969) with S. 34, 91st Cong., 1st Sess. § 4(b) (1969).

36 H.R. 8980, 91st Cong., 1st Sess. § 19 (1969). *Cf.* note 29, *supra* and accompanying text, this Appendix.

37 *Compare* H.R. 8980, 91st Cong., 1st Sess. § 20 (1969) with S. 34, 91st Cong., 1st Sess. § 20 (1969). *See also* note 1320 *supra*.

38 *Compare* H.R. 8980, 91st Cong., 1st Sess. § 20 (1969) with S. 34, 91st Cong., 1st Sess. § 20 (1969).

he could continue to act in the other capacity. Moreover, the Stuckey bill may purport to insure that available remedies for violation of section 36 are restricted to injunctions,<sup>39</sup> but the proposal is entirely unclear on this point since the pertinent language has been omitted by the draftsman.<sup>40</sup> The important innovation, however, as far as Mr. Stuckey is concerned,<sup>41</sup> is contained in a proviso which he would append to section 36 mandating "[t]hat the Commission before instituting . . . action shall have accorded defendants a fair opportunity to comply as required by the Administrative Procedure Act."<sup>42</sup> This proviso is incomprehensible. Injunctions are permitted, even under H.R. 8980, for isolated acts which occurred up to five years before the relief is asked, making it somewhat difficult for the Commission to afford an "opportunity to comply" prior to bringing suit.<sup>43</sup> This would seem to preclude SEC resort to section 36 for any violation which it discovers after the fact, but in view of the tenor of the rest of the bill, this may be the intended result. More importantly, there is nothing in the Administrative Procedure Act which, in the wildest flight of imagination, might be applied to SEC action under section 36. The only conceivable provisions Mr. Stuckey may contemplate are contained in sections 4 and 8 of the Administrative Procedure Act.<sup>44</sup> The former section deals with the opportunity for voluntary adjustments and consent decrees in cases where an *administrative adjudication* is required by statute to be determined on a record after opportunity for an *agency hearing*;<sup>45</sup> and the second, section 8, requires an agency to give an "opportunity to . . . achieve compliance" with the law before the agency may suspend or revoke a license which it has granted.<sup>46</sup> Congressman Stuckey's citation of the Administrative Procedure Act appears devoid of rhyme or reason.

The Commission has not been completely written out of the Investment Company Act by the Congressman from Georgia, for the SEC is permitted to "intervene . . . in any action or suit to enforce any liability or duty created by . . . section 15(d) of [the Act] . . ." <sup>47</sup> This language is not in the present Act, but is to be found in all the genuine reform bills,<sup>48</sup> for each of the legitimate bills also amends section 15(d) of the Act to contain an enforceable standard of reasonableness for management fees. Since H.R. 8980 does not alter a jot or tittle of section 15(d), the grant of this right of intervention is either a meaningless gesture intended to disguise the Stuckey bill by maximizing its similarity to the Senate bills, or simply matter copied from the bona fide bills and inserted

39 Compare H.R. 8980, 91st Cong., 1st Sess. § 20 (1969) with S. 34, 91st Cong., 1st Sess. § 20 (1969).

40 Compare H.R. 8980, 91st Cong., 1st Sess. § 20 (1969) with S. 34, 91st Cong., 1st Sess. § 20 (1969). The House bill reads "award such injunctive against such person." There are two possible interpretations. The draftsman may have intended to write "award such injunctive relief against such person" or "award such injunctive or other relief against such person." It is possible that some language was intentionally omitted, and that the error lies in omitting too much. This would favor the validity of the first reading.

41 115 CONG. REC. H1728 (daily ed. March 13, 1969).

42 H.R. 8980, 91st Cong., 1st Sess. § 20 (1969).

43 *Id. Cf.* S. 34, 91st Cong., 1st Sess. § 20 (1969); S. 296, 91st Cong., 1st Sess. § 20 (1969).

44 Administrative Procedure Act §§ 4, 8, 5 U.S.C. §§ 554, 558 (Supp. III, 1967).

45 *Id.* § 4, 5 U.S.C. § 554 (Supp. III, 1967).

46 *Id.* § 8, 5 U.S.C. § 558 (Supp III, 1967).

47 H.R. 8980, 91st Cong., 1st Sess. § 22 (1969).

48 S. 34, 91st Cong., 1st Sess. § 22 (1969); S. 296, 91st Cong., 1st Sess. § 22 (1969); S. 1659, 90th Cong., 1st Sess. § 23 (1967). See notes 1375-76 *supra* and accompanying text.



into the bogus bill with neither concern for nor appreciation of its significance.

Having made SEC participation in court actions meaningless and having also made it impossible for a private litigant to draw a sufficient complaint by reason of the conclusive presumption, the Congressman takes a further step to discourage any form of shareholder suit. The mechanism is not terribly sophisticated — he simply makes it a federal crime for a plaintiff or his lawyer to bring a “strike” suit.<sup>49</sup> The quotation marks are Mr. Stuckey’s and appear in his bill, which neglects to define the term. It gives pause that the Georgian is willing to make criminal conduct which he does not define more precisely than by punctuation. The marks themselves indicate that the word is either (1) a technical word used in a non-standard sense, (2) ironical, or (3) slang.<sup>50</sup> Under these circumstances, it is submitted that this provision of Mr. Stuckey’s bill suffers some imperfection.

### III. Sales Loads

H.R. 8980 promises to leave unchanged the sales load levels now extant in the fund industry and further undertakes to insure the legality of future load hikes. It may be observed that the Stuckey bill’s approach to fund sales charges is at variance with the SEC’s recommendation that “mutual fund sales charges should be lowered.”<sup>51</sup> The language which effects this paragon of congressional obstinacy is found in section 12 of the bill.

Subsections (a) and (b) of that section empower the NASD and the SEC to promulgate rules

in order that the price at which [shares issued by unit investment trusts and mutual funds are] offered or sold to the public shall not include an excessive sales load but shall allow for fair and equitable compensation for sales personnel, broker-dealers, and underwriters, and for fair and equitable sales loads to investors, *unless such sales load is included in a written contract approved by all of the unaffiliated directors and two-thirds of the shareholders as provided in [this Act].*<sup>52</sup> (Emphasis added.)

As is apparent, any mutual fund may escape the bill’s “fair and equitable” requirement if the underwriting contract is approved by all of the fund’s unaffiliated directors as well as those investors holding two-thirds of the fund’s shares.

Perhaps this voting requirement is one of the provisions Mr. Stuckey was referring to when he observed that one of the objectives of H.R. 8980 was the preservation of “corporate democracy.” Given the mechanics of the fund industry’s operational structure, coupled with the demonstrated prowess of fund management blocs to entrench themselves by stocking the fund’s board with “friendly” unaffiliated directors,<sup>53</sup> one wonders if an exclusion such as that

49 H.R. 8980, 91st Cong., 1st Sess. § 19 (1969).

50 THE UNIVERSITY OF CHICAGO PRESS, A MANUAL OF STYLE 143-44 (12th ed. 1969).

51 PUBLIC POLICY STATEMENT 222.

52 H.R. 8980, 91st Cong., 1st Sess. § 12(a) (1969).

53 See notes 1019, 1056, 1136-41, 1154-65, 1169-75, 1360 *supra* and accompanying text.

created by Mr. Stuckey might not be more appropriately classified under a less patriotic guise — corporate totalitarianism, for instance. It surely may not be argued that the shareholder approval quota contained in the exclusion serves any purpose other than that of increasing the power of the fund's controlling group. The proven ability of the management-dominated proxy committee to shuffle through the mindless blob of paperwork accumulated through a proxy solicitation — and come up with the necessary votes — testifies to the uselessness of any scheme that puts faith in the voting formality engaged in by the industry's shareholders.<sup>54</sup> Moreover, the very fact that the mutual fund shareholder has entrusted his savings to "experts" for investment on his behalf tends to impeach the merit of any proposal which seeks to provide investor protection by depending on the investor to exercise an expertise he neither has nor cares to acquire.

If Mr. Stuckey's sales load provisions are enacted, it is submitted that the fund industry's czars will enjoy a discretionary reign unparalleled since the pre-Act era, when the robber barons of the investment company industry succeeded in bilking the investing public out of 1.1 billion dollars.<sup>55</sup>

#### IV. Contractual Plans

The most noxious facet of the contractual plan sales scheme is the front-end load. The SEC recommended the "penalty" load's abolition in the *Public Policy Statement*,<sup>56</sup> a course of action already undertaken by three states that ban the sale of plan shares within their borders.<sup>57</sup> The Commission has since endorsed S. 34, section 16 of which proposes to amend section 27 of the Investment Company Act in such a way that the impact of the front-end load is somewhat cushioned.<sup>58</sup> The SEC has recognized that its present stance represents a compromise from its original position, but views the projected effect of S. 34 "as a significant improvement of the present situation."<sup>59</sup>

Unlike the Senate bill, H.R. 8980 eschews a confrontation with the front-end load, opting instead for a series of milktoast refund right provisions. Accord-

<sup>54</sup> See notes 1102, 1105-10, 1121-32 *supra* and accompanying text.

<sup>55</sup> The parade of horrors that lend substance to this assertion is discussed at length in Part III of the Survey. See generally notes 266-346 *supra* and accompanying text.

<sup>56</sup> The Commission's position was not equivocal: "The Commission therefore recommends that the Act be amended to prohibit the deduction of front-end loads in future sales of investment company securities." *Public Policy Statement* 247.

<sup>57</sup> See notes 124-126 *supra* and accompanying text.

<sup>58</sup> The analysis of section 16 in the Senate's committee print of S. 34 explains how the "cushioning effect" would be achieved:

This proposed section provides that not more than 20 per centum of any 1 year's payments may be deducted for sales load, and the entire deduction during the first 4 years may not exceed 64 per centum. This change would permit the seller of a plan to continue to collect approximately the same amount of sales load over the first 3 or 4 years (at the seller's election) as he does under present law. However, the load would be spread out more evenly over that period. ANALYSIS OF S.

34, at 9.

<sup>59</sup> 1969 Senate Hearings 11. It should be noted that S. 296 the other Senate fund reform bill now pending, contains a provision that would outlaw the imposition of the front-end load. S. 296, 91st Cong., 1st Sess. § 16(a)(1) (1969). Though the bill's ban of the front-end load is in accordance with the SEC's wish, its rather *avant-garde* approach to fund sales loads (proposing to repeal section 22(d) of the Act), caused the Commission to endorse the somewhat more temperate tenor of S. 34. See 1969 Senate Hearings 11.

ingly, section 16 of the House bill adds a new subsection to section 27 of the 1940 Act providing that:

"(a) the purchaser has an absolute right of refund within sixty days of purchase of the full amount of the first two payments, including the full amount of the sales charge, and the net asset value of any additional payments made plus the full amount of the sales charge on such additional payments, and

"(b) refund within the first twelve months after purchase of the full amount of the sales charge if the planholder chooses to withdraw by reason of financial hardship caused by —

"(1) disability as a result of injury or illness of the planholder which prevents him from engaging in gainful employment for thirty consecutive days;

"(2) the illness or injury to a dependent member of the planholder's family which requires the hospitalization of the dependent member for a consecutive period of thirty days; or

"(3) unemployment for thirty consecutive days of the planholder or the head of the household of the planholder.

"(c) any planholder's monthly payments may be stretched out or indefinitely postponed, without penalty, in order to assist a planholder over periods of other more urgent cash needs;

"(d) up to 90 per centum of any planholder's net asset value may be withdrawn in cash at any time and also reinvested at a later time without any charge whatever; and

"(e) any planholder may terminate his plan and redeem his shares for cash at net asset value at any time without any charge whatever."<sup>60</sup>

The inclusion of the refund right provisions in H.R. 8980 seems to evidence an intent on the part of the bill's draftsman to assuage the plight of the beleaguered victims of the penalty load. However well intentioned may have been the draftsman's motives, it cannot be reasonably asserted that the amendatory language will have a pronounced effect on the plan companies. An array of companies that account for ninety-eight per cent of the plan industry's business have already *voluntarily* adopted a refund right framework identical to that embraced by the House bill.<sup>61</sup>

## V. The Entry of Banks into the Investment Company Industry

One of the primary objectives of the two bills now pending before the Senate is to amend "various provisions of the securities laws to permit banks to operate commingled managed agency accounts in competition with mutual funds."<sup>62</sup> To that end, both bills contain provisions designed, *inter alia*, "to make it clear that no provision of law prohibits a bank from creating or operating a registered investment company which is a collective fund for the investment of

<sup>60</sup> H.R. 8980, 91st Cong., 1st Sess. § 16 (1969).

<sup>61</sup> Compare *id.* with 114 CONG. REC. S9411 (daily ed. July 25, 1968) (remarks of Senator Bennett).

<sup>62</sup> ANALYSIS OF S. 34, at v. Although the statements in the Committee Print speak only to the language of S. 34, it may be noted that the provisions of S. 296 which relate to the entry of banks into the investment company industry are identical to those of S. 34.

managing agency accounts and for funding direct investments by individual members of the public."<sup>63</sup> The amendatory networks found in S. 34 and S. 296 which are crafted to permit the banking community to compete with the funds for the investor's dollar are conspicuously absent from Mr. Stuckey's proposal.

## VI. Fund Holding Companies or "Super Funds"

Like all recent fund reform bills, H.R. 8980 contains a section designed to regulate the super funds. The House bill's super fund provisions are contained in section 7 of the bill, and are similar to those in section 7 of S. 34 and S. 296. The lone difference between the House bill and its Senate predecessors is that H.R. 8980 proposes to ban the operation of all super funds that sell their securities to the public at a price that includes a load, and would further limit the acquisition of shares by such companies to an amount not in excess of one per cent of the "acquired company's" shares.<sup>64</sup> The Senate bills take a slightly more liberal tack. They would grant exclusions from prohibition to any super fund that did not impose a sales load in excess of one-and-one-half per cent, so long as the fund did not acquire more than three per cent of the total outstanding stock of the acquired company.<sup>65</sup>

The comparative stringency of the House bill's super fund provisions makes it the bill which most nearly approaches the position that the SEC's *Public Policy Statement* called upon the Congress to take: to amend the 1940 Act "so as to prevent the creation and operation of [super funds]."<sup>66</sup> It may be added that this is the only instance where Mr. Stuckey's bill hugs the SEC line more closely than its fund reform predecessors.

The House bill's "harder line" approach to the super funds is, however, impossible to reconcile with the objectives of the bill as announced by its sponsor: "[T]o provide a much larger measure of consumer and investor protection for shareholders in investment companies — mutual funds — *while at the same time preserving the principles of free enterprise and corporate democracy.*"<sup>67</sup> (Emphasis added.) If it is "free enterprise and corporate democracy" Mr. Stuckey seeks to maintain, he should be informed that if his bill is enacted in its present form, its super fund provisions will make the sale of shares by at least one mutual fund now registered under the Investment Company Act a criminal offense. This is so because First Multifund of America, Inc., a super fund registered under the 1940 Act, charges a one-and-one-half per cent sales load on its shares,<sup>68</sup> and

63 *Id.* at 12. The section referred to is section 12(d) of S. 34. The language of S. 296 on the point is identical.

64 H.R. 8980, 91st Cong., 1st Sess. § 7 (1969).

65 S. 34, 91st Cong., 1st Sess. § 7 (1969); S. 296, 91st Cong., 1st Sess. § 7 (1969). The Senate bills contain a further restriction to the effect that no super fund may require that any portfolio fund redeem more than one per cent of the portfolio fund's shares held by the super fund within any thirty day period. This language is not included in section 7 of the House bill, probably because it was felt that the House bill's one per cent ceiling on super fund acquisitions would adequately safeguard portfolio companies from onslaughts of redemptions by capricious super funds.

66 PUBLIC POLICY STATEMENT 323.

67 115 CONG. REC. H1727 (daily ed. March 13, 1969) (remarks of Mr. Stuckey).

68 As recently as April 23, 1969, First Multifund was advertising itself as "The Fund with a portfolio of at least 15 Growth Funds." *Wall Street Journal*, April 23, 1969, at 32, col. 1 (midwest ed.). The notation "1½% LoLoad" was also present in the ad. *Id.*

hence will be unable to qualify under the House bill's exemption.<sup>69</sup> The Senate bills, on the other hand, have been constructed by less shortsighted draftsmen and have made provision for First Multifund, permitting super funds to sell their shares so long as the sales load imposed does not exceed one-and-one half per cent.<sup>70</sup>

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69 See text accompanying note 64 *supra*, this Appendix.

70 See text accompanying note 65 *supra*, this Appendix.