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## The Investment Company Amendments Act of 1970 -- An Analysis and Appraisal After Two Years

Gerard H. Manges

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## THE INVESTMENT COMPANY AMENDMENTS ACT OF 1970—AN ANALYSIS AND APPRAISAL AFTER TWO YEARS

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### INTRODUCTION: THE LEGISLATIVE HISTORY

The Securities and Exchange Commission's Study of Investment Companies and Investment Trusts, made pursuant to section 30 of the Public Utility Holding Company Act of 1935,<sup>1</sup> brought into public

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<sup>1</sup> The study, H.R. Doc. No. 707, 75th Cong., 2d Sess. (1938), fulfilled the requirements of section 30 of the Public Utility Holding Company Act, 15 U.S.C. § 79z-4 (1970) (originally enacted as ch. 687, tit. I, § 30, 49 Stat. 837 (1935)), which directed the Securities and Exchange Commission to make a study of investment companies and investment trusts and to report its recommendations to the Congress by January 4, 1937.

focus a variety of abuses and unregulated practices present in the investment company industry in 1938. The study led to lengthy congressional hearings, substantial debate over a detailed regulatory framework and, ultimately, to enactment of a measure imposing controls on investment company operations, transactions and management—the Investment Company Act of 1940.<sup>2</sup> The section 1 preamble declares the policy and purpose of the Act to be the mitigation and elimination of certain conditions found by the SEC to affect adversely the national public interest and the interest of investors, including: (1) the failure of investment companies to provide investors with adequate, accurate and explicit information, fairly presented, concerning the character of their securities and the circumstances, policies, and financial responsibility of their companies and management; (2) the organization, operation and management of investment companies in the interest of their directors, officers, investment advisers, underwriters or other affiliated persons rather than in the interest of all the company's shareholders; and (3) the use, by investment companies, of unsound methods of keeping accounts, maintaining reserves, and computing earnings and asset values.<sup>3</sup>

At the time of the passage of the 1940 Act, Congress recognized that the subsequent growth of the investment company industry might require a later re-examination of the industry practices which prompted its passage and a re-evaluation of the statutory scheme embodied in the Act. Accordingly, in section 14(b), Congress directed the SEC to study the specific effects of such growth on the industry, the securities markets, and the American industrial economy and to report its findings and recommendations to the Congress.<sup>4</sup> The provision proved to be prophetic. In the next thirty years, the investment company industry evolved from a \$1 billion industry to a \$50 billion industry,<sup>5</sup> and the regulated investment company emerged as one of the major financial institutions in the United States.

In 1958, the SEC retained the Securities Research Unit of the Wharton School of Finance and Commerce of the University of Pennsylvania to make a thorough investigation of investment company activities. The Wharton Study Report, submitted in 1962, focused on the structure and control of open-end investment companies, commonly

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<sup>2</sup> 15 U.S.C. §§ 80a-1 et seq. (1970). Concurrently with enactment of the Investment Company Act of 1940, Congress enacted the Investment Advisers Act of 1940, which required registration and reporting by investment advisers and provided a statutory basis for their regulation. 15 U.S.C. §§ 80b-1 et seq. (1970). The 1970 Amendments affected the Advisers Act as well as the Investment Company Act. See text at notes 186-203 *infra*.

<sup>3</sup> 15 U.S.C. § 80a-1 (1970).

<sup>4</sup> 15 U.S.C. § 80a-14(b) (1970).

<sup>5</sup> Investment Company Institute, 1971 Mutual Fund Fact Book 3, 7.

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known as mutual funds.<sup>6</sup> The SEC itself directed its attention to the selling and distribution practices of the industry in its 1963 Report of the Special Study of Securities Markets.<sup>7</sup> The findings of these studies led to a third SEC report, issued in 1966, that embodied specific legislative recommendations. This report, *Public Policy Implications of Investment Company Growth*,<sup>8</sup> concluded:

The Investment Company Act of 1940 has substantially eliminated the serious abuses at which it was aimed, but 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>9</sup>

The legislative recommendations embodied in these three studies were incorporated in the SEC's draft of the Investment Company Amendments Act, which was introduced in identical form in the Senate and House of Representatives in May, 1967.<sup>10</sup> Additional mutual fund reform bills were subsequently introduced in both houses.<sup>11</sup> The Investment Company Institute, representing a major segment of the mu-

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<sup>6</sup> Wharton School of Finance and Commerce, *A Study of Mutual Funds*, H.R. Doc. No. 2274, 87th Cong., 2d Sess. (1962). The Wharton Study's focus on open-end companies, or mutual funds, was apparently motivated by the fact that these companies comprise the major segment of the investment company industry. For the same reason, this article will concentrate primarily on the impact of the Amendments on the mutual fund industry.

<sup>7</sup> Securities and Exchange Commission, *Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess., pts. 1-4 (1963).

<sup>8</sup> Securities and Exchange Commission, *Public Policy Implications of Investment Company Growth*, H.R. Rep. 2337, 89th Cong., 2d Sess. (1966) [hereinafter cited as SEC 1966 Public Policy Report].

<sup>9</sup> *Id.* at vii (Letter of Transmittal from Chairman, Securities and Exchange Commission to President, United States Senate, December 2, 1966).

<sup>10</sup> S. 1659, H.R. 9510, and H.R. 9511, 90th Cong., 1st Sess. (1967). Although no final action was taken by either house during the first session of the Ninetieth Congress, extensive hearings were held. The Senate held seven days of hearings beginning on July 31, 1967, hearing 70 witnesses and accumulating 1200 pages of testimony. Hearings on S. 1659 Before the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. (1967). The House held eight days of hearings beginning on October 10, 1967. Hearings on H.R. 9510 and H.R. 9511 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 90th Cong., 1st Sess. (1967).

<sup>11</sup> Amended versions of the original bills, *supra* note 10, were introduced in 1968. H.R. 14742 and S. 3724, 90th Cong., 2d Sess. (1968). After modifications, a "clean bill" passed the Senate and died in the House Committee on Interstate and Foreign Commerce. S. 3724, 90th Cong., 2d Sess. (1968). In 1969, at the start of the 91st Congress, S. 3724 was reintroduced as S. 34, 91st Cong., 1st Sess. Additional related bills were also introduced: S. 296, H.R. 8980, H.R. 12867, H.R. 13754 and H.R. 14737, 91st Cong., 1st Sess. (1969). For a description of a large number of measures introduced to amend the 1940 Act from the Eighty-Sixth Congress (1959) through the first session of the Ninetieth Congress (1967), see North, *A Brief History of Federal Investment Company Legislation*, 44 *Notre Dame Lawyer* 677, 690-92 (1969).

tual fund industry, met with the SEC staff in an attempt to reach an agreement with respect to controversial areas of the legislation, including the fairness of management fees and sales charges, contractual plan charges and the tightening of the watchdog function of the independent fund director, but an accord was not easily reached. The provisions with respect to regulation of management fees proved to be the major stumbling block. A further review of fund operational problems was made by the SEC in connection with its Institutional Investor Study.<sup>12</sup> Serious congressional work on the proposed amendments was delayed while the SEC and industry representatives endeavored to reach a consensus. The industry emphasized its desire for a self-regulatory approach through a new industry association. This proposal was rejected by the SEC<sup>13</sup> and, shortly thereafter, a final agreement was reached with respect to the major provisions of the new legislation.

In May, 1969, S. 2224, drafted after lengthy hearings before the Senate Committee on Banking and Currency, was passed by the Senate,<sup>14</sup> and an identical bill, H.R. 11995, was introduced in the House shortly thereafter.<sup>15</sup> The House Committee on Interstate and Foreign Commerce held extensive hearings of its own and reported out a new bill, H.R. 17333,<sup>16</sup> which was passed by the House in September, 1970.<sup>17</sup> A joint conference committee was formed to settle the differences between the Senate- and House-passed bills, and on December 14, 1970, the Senate bill, incorporating major House amendments, was enacted as the Investment Company Amendments Act of 1970 (1970 Amendments).<sup>18</sup>

Passage of the 1970 Amendments was not heralded as an event that would radically alter the structure or practices of the investment company industry, and no comprehensive analysis of their legislative background and substantive provisions was immediately undertaken

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<sup>12</sup> Institutional Investor Study Report of the Securities and Exchange Commission, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. (1971). Although not completed until 1971, the study was begun in 1968.

<sup>13</sup> The SEC felt that a self-regulatory association would (1) insulate investment advisers from stockholder litigation, (2) require an exemption from the antitrust laws, (3) encourage an industry-wide standard as to permissible fees and expense ratios which would not be suitable for funds of differing sizes and investment objectives, (4) require rate-making as an incident to effective SEC oversight, and (5) fragment the role of the NASD by shifting the regulation of sales loads to the new organization. Hearings on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 1st Sess. 428-53 (1969) [hereinafter cited as 1969 House Hearings].

<sup>14</sup> 115 Cong. Rec. 13700 (1969).

<sup>15</sup> *Id.* at 15351.

<sup>16</sup> H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. (1970) [hereinafter cited as 1970 House Report].

<sup>17</sup> 116 Cong. Rec. 33296 (1970).

<sup>18</sup> Pub. L. No. 91-547, 84 Stat. 1413 (1970).

in the legal journals. However, as a result of subsequent SEC rules, interpretative releases, and staff no-action letters implementing the new sections of the Act, much of the industry has begun to feel the regulatory impact of the Amendments. The effect on the day-to-day operations of investment companies and their investment advisors, underwriters, broker-dealers and other financial institutions, particularly banks and insurance companies subject to the provisions of the 1970 Amendments, is expected to be increasingly significant.

This article will focus upon those provisions of the 1970 Amendments that are expected to have the greatest immediate practical impact upon operations of investment companies, especially mutual funds. As a prelude to an examination of each section and of any administrative implementation it has undergone since 1970, the legislative background and language of the provision will be analyzed in greater detail than has hitherto been available.<sup>19</sup> The timeliness of a consideration of these factors, two years after enactment of the Amendments, is assured by the current lack of judicial interpretation and underlined by the critical role that such factors have played in recent litigation in the securities field.<sup>20</sup> For those sections of the Amendments that have been the subject of SEC rules, releases and no-action letters, such administrative implementation will be analyzed in detail. Throughout the article, the author has endeavored to emphasize the practical importance of the Amendments and any subsequent administrative implementation for individual investment companies and for the industry as a whole.

## I. MANAGEMENT CONTRACTS AND REGULATION OF ADVISER COMPENSATION

### A. *Structure and Operational Problems*

Registered investment companies ordinarily enter into a contract with an investment adviser for management of the fund's assets. For its services, the adviser receives a management fee which is usually calculated as a percentage of the fund's total assets.<sup>21</sup> In 1940, mutual

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<sup>19</sup> A previous article by the present author surveyed the provisions of the 1970 Amendments shortly after their passage, but in considerably less detail. See Manges, *Investment Company Amendments Act of 1970*, 26 *Bus. Lawyer* 1113 (1971).

<sup>20</sup> See, e.g., *Bath Industries, Inc. v. Blot*, 427 F.2d 97 (7th Cir. 1970), and *GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971), cert. denied, 406 U.S. 910 (1972), involving the Williams Act Amendments to the Securities Exchange Act. The importance of the legislative history of the Amendments to the outcome of these cases in both the federal district courts and circuit courts of appeal is discussed in Comment, 13 *B.C. Ind. & Com. L. Rev.* 149, 164-66 (1971) and Comment, 13 *B.C. Ind. & Com. L. Rev.* 1113, 1151-62 (1972).

<sup>21</sup> The fee is usually set at a fixed percentage of the total assets of the fund and does not vary with the size of these assets. Glick, *Mutual Fund Management Fees: In*

fund advisory fees were not an area of principal concern, but the subsequent dramatic increase in total fund assets and the number of mutual fund investors revealed a need for more serious regulation of advisory compensation.<sup>22</sup>

The organizational structure of mutual funds creates compensation patterns which differ markedly from those of ordinary business corporations. While internal management is characteristic of the typical corporation, mutual funds contract with "independent" advisers for management and investment services, and this "independent" adviser has typically played a leading role in establishing the fund and will continue to dominate the fund's operations and policies through control of the fund's board of directors. Thus the negotiations between the fund and the adviser leading to the advisory contract may not always occur at arm's length.

The 1940 Act dealt only tangentially with the potential problems created by the relationship between fund and investment adviser. Rather than dealing directly with the problems involving advisory compensation, the Act attempted to prevent them merely by requiring a degree of independence on the part of investment company boards. First, the Act prohibited most transactions in securities and other property between investment companies and their advisers or affiliated persons.<sup>23</sup> Second, at least forty percent of a fund's directors had to be "unaffiliated" (as defined by the Act) with the adviser.<sup>24</sup> Third, all advisory contracts had to be initially approved by a vote of the fund's shareholders and reapproved annually by a majority of either the unaffiliated directors or the shareholders.<sup>25</sup>

This regulatory scheme, however, did not prove entirely effective. For example, fund managers might propose for election a slate of directors who, although not technically "affiliated persons" as defined in section 2(a)(3) of the Act, were their personal friends and could be counted upon to vote with management, thus raising a question as to the adequacy of the Act's definition of "affiliated person." In any event, the only contracts presented to the unaffiliated directors for their approval might be those upon which the affiliated directors had already

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Search of a Standard, 25 *Bus. Lawyer* 1471, 1473 (1970). Of those advisers charging a fixed fee, one-half of one percent is the fee most commonly charged. SEC 1966 Public Policy Report, *supra* note 8, at 46, 99. See also *The Mutual Fund Industry: A Legal Survey*, 44 *Notre Dame Lawyer* 881 (1969).

<sup>22</sup> Fund shareholders periodically challenged advisory fees as constituting excessive payments to fund management and a waste of fund assets. See, e.g., *Brown v. Bullock*, 294 F.2d 415 (2d Cir. 1961), *Tanzer v. Huffines*, 314 F. Supp. 189 (D. Del. 1970), *Saxe v. Brady*, 40 Del. Ch. 474, 184 A.2d 602 (1962).

<sup>23</sup> 15 U.S.C. § 80a-17(a)(1) (1964), as amended, 15 U.S.C. § 80(a)-17(a)(1) (1970).

<sup>24</sup> 15 U.S.C. § 80a-10(a) (1964), as amended, 15 U.S.C. § 80(a)-10(a) (1970). For the 1940 Act's definition of "affiliated person," see note 46 *infra* and accompanying text.

<sup>25</sup> 15 U.S.C. § 80a-15 (1964), as amended, 15 U.S.C. § 80a-15 (1970).

agreed and, with no real option presented to them, unaffiliated directors and fund shareholders would routinely ratify advisory contracts. In addition, the unaffiliated directors could not be completely effective in checking abuses, of which they might be unaware, resulting from a variety of plans for indirectly compensating affiliated brokers or distributors. The regulatory mechanism, then, was weak, and mutual fund management fees did not reflect the economies of scale that fund growth might have been expected to provide. If a fund's assets grew from \$250 million to \$500 million, the management fee—based on one-half percent of total assets—would double, despite the lack of any such proportional increase in the costs of managing the fund.

The development of mutual fund "complexes," in which a single adviser creates and advises a number of individual mutual funds,<sup>26</sup> presented additional opportunities for increasing advisory compensation. Economies of scale realized by the advisers of a fund complex were sometimes not passed on to their funds. Brokerage business generated by fund transactions was sometimes directed to selected brokers in payment for minimal services provided to the adviser or for fund sales which increased the funds' assets and thus the advisory fees. Frequently the firm receiving brokerage business as compensation for generating fund sales was affiliated with the adviser, whose fee was based upon a percentage of fund assets which in turn was dependent upon fund sales. As long as fund sales exceeded redemptions, the advisory fee was likely to increase regardless of the funds' performance. The provisions of the original 1940 Act were not sufficiently comprehensive to deal with such unforeseen developments.

### B. *The New Fiduciary Standard*

The mutual fund-investment adviser relationship was first scrutinized in connection with section 36 of the original 1940 Act, under which an advisory contract could be found invalid where its consummation constituted "gross misconduct or a gross abuse of trust."<sup>27</sup> In light of this statutory language, some courts interpreted shareholder ratification of an advisory contract as imposing upon a plaintiff shareholder the heavy burden of proving waste of corporate assets.<sup>28</sup> These courts would refrain from interfering with the ratified contract unless

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<sup>26</sup> SEC 1966 Public Policy Report, *supra* note 8, at 47-49. For a comprehensive discussion of mutual fund complexes, see Glazer, *A Study of Mutual Fund Complexes*, 119 U. Pa. L. Rev. 205 (1970).

<sup>27</sup> 15 U.S.C. § 80a-35 (1964), as amended, 15 U.S.C. § 80a-35 (1970). See also Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 U. Pa. L. Rev. 1058 (1967).

<sup>28</sup> See, e.g., *Saxe v. Brady*, 40 Del. Ch. 474, 184 A.2d 602 (1962), and *Meiselman v. Eberstadt*, 39 Del. Ch. 563, 170 A.2d 720 (1961).



it appeared that no reasonable board of directors could have agreed to the proposed contract. In addition, the SEC may have been reluctant to exercise its power to attack advisory contracts due to the nature of the sanction provided by the 1940 Act—an injunction against acting in an advisory capacity<sup>29</sup>—which may have appeared particularly harsh when the sole basis for the Commission's attack was adherence by the adviser to the traditional fee structure of the industry.

The demonstrated inability of existing law to deal satisfactorily with these problems prompted the SEC to seek broader statutory controls. The revision of section 36 by the Investment Company Amendments Act of 1970<sup>30</sup> is the culmination of the SEC's efforts in this area. In an effort to bring a degree of regulation to management compensation, the SEC had proposed in 1968 that a "reasonableness" test be statutorily imposed upon the compensation provisions of advisory contracts. Segments of the investment company industry strenuously opposed this test and successfully blocked enactment of such an amendment by the Ninetieth Congress. The introduction of the concept in the Ninety-First Congress as part of the 1970 Amendments produced similarly polarized positions. However, the SEC and industry representatives agreed, after lengthy discussions, that the investment adviser should have an affirmative *fiduciary duty* to its fund with respect to compensation received from the fund by the adviser or its affiliates for services rendered or for payments of a material nature. The "fiduciary duty" standard was then substituted for the "reasonableness" test by the Senate Committee. The SEC believed the substitution to be of procedural rather than substantive significance, since, as a fiduciary, the adviser, and others who may receive compensation from the adviser's fee, were already subject to lawsuits which might be instigated by shareholders or by the SEC in the event that the fee received was considered to be so unreasonable and excessive as to constitute a breach of fiduciary duty.<sup>31</sup> New section 36 thus replaced the gross-misconduct-or-abuse-of-trust standard of former section 36 with a federal statutory fiduciary duty standard.

Under new section 36(a) the SEC, and possibly a shareholder of a registered fund suing on behalf of the fund, may institute an action in federal court against individuals who are officers, directors, and advisory board members of an investment company, its investment adviser, or its principal underwriter, if these individuals have engaged or are about to engage in any act or practice constituting a breach of

<sup>29</sup> 15 U.S.C. § 80a-43 (1964), as amended, 15 U.S.C. § 80a-43 (1970).

<sup>30</sup> 15 U.S.C. § 80a-35 (1970), amending 15 U.S.C. § 80a-35 (1964).

<sup>31</sup> Memorandum from SEC to Chairman, House Interstate and Foreign Commerce Committee and Chairman, Senate Banking and Currency Committee, November 13, 1969. 1969 House Hearings, *supra* note 13, at 187-90.

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fiduciary duty involving personal misconduct.<sup>82</sup> Liability under this section is not restricted to violations which occur with respect to advisory compensation but encompasses the full range of transactions in which individuals serving a registered fund in certain designated capacities may be involved. The requirement that there be evidence of personal misconduct before the Commission may act is the result of a congressional intention that this section not serve as a license for general revision of industry practices by the Commission.<sup>83</sup>

Section 36(b), added by the Amendments, specifically imposes a fiduciary obligation upon investment advisers with respect to compensation received by them from an investment company or its shareholders.<sup>84</sup> An action for breach of fiduciary duty may be brought either by the SEC or by a shareholder of the investment company acting on behalf of the company against the investment adviser and any affiliated person of the investment adviser, as well as any officer, director, advisory board member or depositor, or principal underwriter of the investment company who has a fiduciary duty concerning the receipt of such compensation or payments received.<sup>85</sup> A 36(b) action may be brought only in the federal courts, and damages or other relief granted only against a recipient of advisory compensation or payments.<sup>86</sup> However, the fiduciary duty of the adviser with respect to compensation received is extended to include compensation received by its affiliated persons so as to prevent an investment adviser from evading liability by arranging for excess compensation to be paid to it through an affiliated person acting as a conduit. Damages are limited to the actual injury resulting from the breach of fiduciary duty and may not exceed the amount of compensation received by the adviser or its affiliate from the investment company or its shareholders.<sup>87</sup> No damages may be re-

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<sup>82</sup> 15 U.S.C. § 80a-35(a) (1970), amending 15 U.S.C. § 80a-35 (1964). The House Committee report on § 36(a) implies that a private right of shareholder action is also contemplated. 1970 House Report, *supra* note 16, at 37-38. See also *Brown v. Bullock*, 294 F.2d 415 (2d Cir. 1961), and *Tanzer v. Huffines*, 314 F. Supp. 189 (D. Del. 1970). In addition, the Chief Counsel of the SEC's new Division of Investment Management Regulation has stated that there is no reason to suppose that any court would seriously entertain an argument that amended section 36(a) excludes a private right of action merely because Congress provided a stricter standard of duty and expanded the scope of relief. *Freedman & Rosenblatt, Duties to Mutual Funds*, 4 Rev. of Sec. Reg. 937 (1971).

<sup>83</sup> The House report on this section indicates that it is intended to deal with violations committed by individuals. It stated that in appropriate cases, nonfeasance of duty or abdication of responsibility would constitute a breach of fiduciary duty involving personal misconduct. 1970 House Report, *supra* note 16, at 37.

<sup>84</sup> 15 U.S.C. § 80a-35(b) (1970), amending 15 U.S.C. § 80a-35 (1964).

<sup>85</sup> *Id.*

<sup>86</sup> 15 U.S.C. § 80a-35(b)(3) (1970), amending 15 U.S.C. § 80a-35 (1964).

<sup>87</sup> Section 36(b) does not impose any limitations, however, on suits or damages with respect to compensation or payments made to affiliated persons in connection with transactions subject to § 17 of the Act. 15 U.S.C. § 80a-35 (1970).

covered for any period prior to one year before the institution of the action.<sup>88</sup>

By amending the restrictive "gross abuse of trust" language,<sup>89</sup> and thus eliminating the ground on which courts had relied to find a presumption favoring ratified advisory contracts, new section 36 gives broad discretion to the courts to grant such relief as is necessary and appropriate.<sup>40</sup> This new judicial flexibility is not without limitation, however. While the amendment vests exclusive jurisdiction in the federal courts under section 36(b) to determine whether an investment adviser has breached its fiduciary duty in setting or receiving a fee, the section is not intended to authorize a court to substitute its business judgment in the area of management fees for that of a mutual fund's board of directors.<sup>41</sup> Under section 36(b)(2), the approval of a management compensation or advisory contract by a fund's board or by its shareholders is to be given such weight by the court as is "deemed appropriate under all the circumstances" of the particular case.<sup>42</sup> In short, a reasonable determination of the management fee made by a fund's directors, including a majority of the disinterested directors, would be entitled to substantial weight.

The legislative history of the 1970 Amendments indicates that a court, in reaching a determination as to whether an adviser has properly acted as a fiduciary in relation to compensation it received, is to look at all the facts in connection with the determination and receipt of such compensation, including: (1) the nature, quality and extent of the services rendered to the fund; (2) the extent to which economies of scale and common management were shared with the fund; (3) the size of the fund and its investment advisory fee in comparison with that of comparable funds or clients and comparable advisers; (4) the ratio of fund expenses to net assets; (5) other income received by the adviser from the fund (i.e., brokerage commissions, payments for research services, subsidiaries' underwriting fees); (6) the extent of fund recapture of brokerage commissions; (7) the nature and sophistication of the inquiry, consideration and analysis of the investment advisory contract by the fund's directors and the nature of the advisory fee

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<sup>88</sup> 15 U.S.C. § 80a-35(b)(3) (1970), amending 15 U.S.C. § 80a-35 (1964).

<sup>89</sup> 15 U.S.C. § 80a-35(a) (1970), amending 15 U.S.C. § 80a-35 (1964).

<sup>40</sup> Language in old section 36 to the effect that the court "shall" issue an injunction upon certain findings was changed to "may." 15 U.S.C. § 80a-35(a) (1970), amending 15 U.S.C. § 80a-35 (1964).

<sup>41</sup> "This section is not intended to shift the responsibility to manage an investment company in the best interest of its shareholders from the directors of such company to the judiciary." S. Rep. No. 91-184, 91st Cong., 1st Sess. 7 (1969) [hereinafter cited as 1969 Senate Report].

<sup>42</sup> 15 U.S.C. § 80a-35(b)(2) (1970), amending 15 U.S.C. § 80a-35 (1964).

negotiations; and (8) the existence and circumstances of any ratification or approval by the independent directors or stockholders.<sup>43</sup>

One effect of new section 36(b) on the mutual fund industry, then, may be an increase in litigation by fund shareholders and the SEC attempting to establish breaches of fiduciary duty with respect to compensation received by advisers. Judicial application of the new fiduciary standard for advisory compensation may initially require some lengthy proceedings in order to assemble the economic information necessary for making a determination as to the reasonableness of advisory fees. Such proceedings could require considerable expenditures by funds and a substantial commitment of time by fund personnel who might otherwise be endeavoring to improve the fund's investment performance. In the meantime, the uncertainty created by the 1970 Amendments over the mechanics of establishing management fees and income levels consistent with a "fiduciary duty" will make management planning difficult for funds. Where fund advisers are affiliated with brokerage firms, some incentive will exist to recapture, consistent with rules of national stock exchanges, commissions for the funds in order to ensure that benefits received by the adviser from the brokerage operation do not provide a basis for attacking the advisory fee paid by the fund. A successful suit against an adviser for recovery by a fund of retained brokerage commissions might also significantly affect the solvency of the investment adviser. In order to avoid litigation, funds may lower management fees as well as eliminate external investment advisers by internalizing advisory functions and delegating such functions directly to fund officers.

### C. *The Role of the Independent Director and the New "Interested Person" Standard*

In an effort to supplement the new statutory standard of adviser responsibility, the 1970 Amendments place new responsibilities upon independent fund directors. Experience under the original 1940 Act indicated the inability of some independent directors to function as effective watchdogs over management activities.<sup>44</sup>

Section 10 of the 1940 Act<sup>45</sup> provided that at least forty percent of the directors of a registered fund had to be persons who were not

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<sup>43</sup> S. 34, 91st Cong., 1st Sess. § 8(d)(2) (1969); 1969 House Hearings, supra note 13, at 188; 1970 House Report, supra note 16, at 37; 1969 Senate Report, supra note 41, at 15. See also Securities and Exchange Commission, Memorandum to the Chairman of the House Interstate and Foreign Commerce Committee, 1969 House Hearings, supra note 13, at 188.

<sup>44</sup> See text at notes 23-26 supra.

<sup>45</sup> 15 U.S.C. § 80a-10 (1964), as amended, 15 U.S.C. § 80a-10 (1970).

officers or employees of the fund, investment advisers of the fund or affiliated persons of such investment advisers. It also provided that if any officer, director or employee of the fund acted as, or was affiliated with, the fund's principal underwriter, the fund's regular broker or any investment banker, a majority of the fund's board had to be unaffiliated with such underwriter, broker or investment banker. Section 2(a)(3) of the 1940 Act defined an "affiliated person" to include:

- (1) any person directly or indirectly owning, controlling or holding voting power over five percent or more of the outstanding voting shares of another person [i.e., fund];
- (2) any person five percent or more of whose outstanding voting shares were directly or indirectly owned, controlled or held with voting power by another person;
- (3) any person directly or indirectly controlling, controlled by, or under common control with another person;
- (4) any officer, director, partner or employee of another person; and
- (5) a fund's investment adviser.<sup>46</sup>

The function of section 10 was to provide an independent check on management and a vehicle for representation of shareholder interests in investment company affairs. The House and Senate Committees which handled the 1970 Amendments stated in their reports<sup>47</sup> that the definition of an "affiliated person" in Section 2(a)(3) of the original 1940 Act was insufficient to enable section 10 to accomplish its intended purpose. Under the section 2(a)(3) definition, a fund director might own 4.99 percent of the adviser's stock, have substantial business, professional or personal ties with the fund or its adviser, and even be related by blood or marriage to one of the fund's directors or officers, and still be classified as unaffiliated.<sup>48</sup> To assure more complete independence of directors who are purportedly independent, the 1970 Amendments substituted the term "interested person" for the term "affiliated person" in section 10 (composition of fund boards), section 15 (approval of advisory and underwriting contracts), and section 32(a) (selection of accountants).<sup>49</sup> The definition of an "interested person," contained in section 2(a)(19),<sup>50</sup> is far more comprehensive than its predecessor. Under this definition, the following

<sup>46</sup> 15 U.S.C. § 80a-2(a)(3) (1970).

<sup>47</sup> 1970 House Report, *supra* note 16, at 13; S. Rep. No. 91-184, 91st Cong., 1st Sess. (1969), reprinted in U.S. Code Cong. & Ad. News 4927 (1970).

<sup>48</sup> 1970 House Report, *supra* note 16, at 13-14.

<sup>49</sup> Significantly, the new "interested person" concept does not expand the scope of sections 10(f) and 17 of the 1940 Act, which prohibit transactions between investment companies and their affiliated persons without prior SEC approval. See 1970 House Report, *supra* note 16, at 14, and 1969 Senate Report, *supra* note 41, at 33.

<sup>50</sup> 15 U.S.C. § 80a-2(a)(19) (1970).

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persons are considered interested persons of a fund and are disqualified from serving as disinterested directors for purposes of meeting the forty percent requirement of section 10, as amended:

- (1) affiliated persons of the fund, its investment adviser and principal underwriter;
- (2) members of the immediate family of persons so affiliated, including any parent, spouse of a parent, child, spouse of a child, spouse, brother or sister, including step and adoptive relationships;
- (3) persons acting as legal counsel for the fund, its adviser or principal underwriter within the last two fiscal years, and partners and employees of such counsel;
- (4) registered brokers or dealers and their affiliated persons;
- (5) persons who knowingly have any direct or indirect legal or beneficial interest in securities issued by the fund's adviser, or principal underwriter, or by any corporation controlling one of these;
- (6) persons designated by SEC order as interested persons by reason of a material business or professional relationship, existing within the last two fiscal years, with the fund or its investment adviser or principal underwriter, with another fund having the same adviser or principal underwriter, or with the principal executive officer or any controlling person of one of these.<sup>51</sup>

A number of interpretative questions have been raised regarding the application of the "interested person" definition, particularly with respect to category (6) above.<sup>52</sup> Questions as to what constitutes a "material business or professional relationship" have been raised by fund management internally and in formal applications to the SEC for administrative interpretations. The legislative history of the "interested person" sections indicates that a relationship is to be con-

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<sup>51</sup> Id. With respect to the prohibitions upon brokers and dealers, the SEC, in a published no-action letter, Massachusetts Investors Growth Stock Fund, Inc., May 3, 1971, 2 CCH Mutual Funds Guide ¶ 9237 (1971), ruled that a fund director who was an officer, director and 25% shareholder of a corporation which owned a broker-dealer subsidiary registered under the Securities Exchange Act of 1934, was an "interested person" of an investment company under section 2(a)(19)(A)(v) of the Investment Company Act, as amended, even though the broker-dealer did not deal with the investment company. See also SEC no-action letters: Loomis-Sayles Mutual Fund, Inc., October 27, 1971, [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,319; Alpha Investors Fund, Inc., January 9, 1972, [Current] CCH Fed. Sec. L. Rep. ¶ 78,618 (1972); S&P Counselors Fund, Inc., January 2, 1972, id. at ¶ 78,619.

<sup>52</sup> SEC no-action letters: CG Fund, Inc., Jan. 7, 1972, 2 CCH Mutual Funds Guide ¶ 9440 (1972); Alpha Investors Fund, Inc., Dec. 10, 1971, id. at ¶ 9378 (1971); Creative Capital Corp., Nov. 24, 1971, id. at ¶ 9424; Loomis-Sayles Mutual Fund, Inc., Oct. 27, 1971, id. at ¶ 9323; GAC Growth Fund, Inc., Oct. 26, 1971, id. at ¶ 9380; and Southwestern Investors, Inc., May 14, 1971, id. at ¶ 9232. The portion of the definition referred to is found at 15 U.S.C. §§ 80a-2(a)(19)(A)(vi), and (B)(vi) (1970).

sidered material if it "might tend to impair the independence of a director, but [that it] would not be deemed to impair independence where the benefits flow from the director of an investment company to the other party to the relationship" since such relationship is not likely to make the director beholden to that party.<sup>53</sup>

Determination of "disinterested" status is often a close question. For example, a director would not be considered to have a material business relationship with a fund adviser-broker simply because the director is a brokerage customer accorded no special treatment.<sup>54</sup> In one case, exemplifying a particularly difficult interpretation of a "material business relationship," a proposed fund director was the president of a savings and loan company in which another fund director, who was also principal executive officer of the investment adviser and principal underwriter, was a director, and the latter director had the power to vote on matters affecting in a substantial way the first director's status as president. The SEC staff determined that the first director's independence might be impaired, and indicated that it could give no assurance that it would not recommend a proceeding under section 2(a)(19)(B)(vi) to declare the director to be an "interested person."<sup>55</sup>

Once issued by the SEC, an administrative order involving a determination as to an individual's "interested person" status may not take effect until at least sixty days after entry, may have no retroactive effect, and may be modified or revoked at a subsequent time should factual changes occur.<sup>56</sup> In addition, the SEC can exempt any person otherwise classified as "interested" upon an "appropriate showing that he, in fact, is in a position to act independently on behalf of the investment company and its shareholders in dealing with the company's investment adviser or principal underwriter."<sup>57</sup> This case-by-case application of the "material business or professional relationship" test was intended to eliminate any danger of inadvertent violations of the requirements of the Act: the House and Senate committees indicated in their reports their belief that the SEC had adequate exemptive authority under section 6(c) of the Act to administer the new provisions in a flexible manner, particularly where persons involuntarily

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<sup>53</sup> 1970 House Report, *supra* note 16, at 14-15; see also 1969 Senate Report, *supra* note 41, at 33-34.

<sup>54</sup> 1969 Senate Report, *supra* note 41, at 33.

<sup>55</sup> SEC no-action letter, Southwestern Investors, Inc., May 14, 1971, 2 CCH Mutual Funds Guide ¶ 9232 (1971).

<sup>56</sup> 15 U.S.C. § 80a-2(a)(19) (1970), amending 15 U.S.C. § 80a-2(a) (1964).

<sup>57</sup> 1969 Senate Report, *supra* note 41, at 34, and 1970 House Report, *supra* note 16, at 15. See also SEC no-action letter, Massachusetts Investors Growth Stock Fund, Inc., May 3, 1971, 2 CCH Mutual Funds Guide ¶ 9237 (1971).

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became "interested persons."<sup>58</sup> Such an exemption would appear to be appropriate, for example, where a fund director is named as executor of an estate which holds stock in the investment adviser or is the beneficiary of a trust which acquires and holds such stock without his knowledge. The application of the new term "interested person" is expected, however, to pose continuing problems for fund operations, and funds will look to counsel and to the SEC for greater certainty with respect to individual interpretative problems. Compliance is absolutely necessary, since improper composition of a board under section 10 and/or improper approval of a transaction under sections 15 or 32(a) could result in a shareholder or SEC suit.

Having thus taken steps to strengthen the independence of "disinterested" fund directors from fund management, the 1970 Amendments imposed new obligations on such directors with respect to the approval of advisory and distribution contracts and selection of the fund's accountants. First, with respect to the approval of contracts, section 15(c) of the Act,<sup>59</sup> added by the 1970 Amendments, requires that the terms of all contracts between the fund and an investment adviser or principal underwriter must be approved by a majority vote of the disinterested directors, and the independent "disinterested" directors are required to cast their votes in person at a meeting called for the purpose of voting on such approval.<sup>60</sup> Section 15(c) must be read in conjunction with section 10: the directors whose votes are necessary to approve an advisory or underwriting contract must be members of a board of directors the composition of which complies with section 10.<sup>61</sup> In addition, section 15 as amended no longer provides for the alternative approval of a contract by the vote of a majority of the outstanding voting securities of a fund<sup>62</sup>—under new subsection

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<sup>58</sup> 1970 House Report, *supra* note 16, at 15; S. Rep. No. 91-184, 91st Cong., 2d Sess. (1970), reprinted in U.S. Code Cong. & Ad. News 4927, 4929 (1970).

<sup>59</sup> 15 U.S.C. § 80a-15(c) (1970), amending 15 U.S.C. § 80a-15 (1964).

<sup>60</sup> 15 U.S.C. § 80a-15(c) (1970). A memorandum dated Dec. 10, 1969, from the SEC to Chairman of the House Interstate and Foreign Commerce Committee noted the finding of the SEC 1966 Public Policy Report that in some investment companies absentee approval by board members is not uncommon, and the memorandum indicated that the provisions of the new amendments were meant to "assure informed voting on matters" which the Committee considered to be a practical necessity if stockholder interests were to be effectively protected by independent directors. An SEC release makes it clear that the new requirement that votes be cast in person imposed by the 1970 Act "cannot be complied with by voting over the telephone, through the use of a closed-circuit television conference, by proxy, or otherwise than by personal appearance." SEC Investment Company Act Release No. 6336 (Feb. 2, 1971), reprinted in [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,951.

<sup>61</sup> Letter from SEC Division of Corporate Regulation to the Investment Company Institute, August 13, 1971, 2 CCH Mutual Funds Guide ¶ 9244 (1971).

<sup>62</sup> 15 U.S.C. § 80a-15(a)(2) (1964), as amended, 15 U.S.C. § 80a-15(a)(2) (1970).



(c); every contract must be approved by a majority of the disinterested directors.

New section 15 also sets forth additional requirements for approval of advisory contracts. Such requirements are designed to assist fund directors in the discharge of their fiduciary duty with respect to approval of an advisory compensation contract. Section 15(c) now imposes a duty upon fund directors to solicit and evaluate "such information as may reasonably be necessary to evaluate the terms" of, and thus make an informed decision with respect to, a proposed advisory contract.<sup>63</sup> It is the duty of a fund's adviser to furnish this information to the directors.<sup>64</sup> Implicit in this duty is the obligation to review the adviser's operations, expenses and total services to the fund. Thus, in cases where the facts show that the adviser furnishes only a minimum of information, it may be unable to justify asking any substantial fee in the contract renewal negotiations.

With respect to the annual selection of an accountant for a fund, new section 32(a) of the Act<sup>65</sup> makes it unlawful for a registered fund to file any financial statements with the SEC signed or certified by an independent public accountant unless such accountant was selected by a majority vote of the disinterested directors, cast in person and ratified by the fund shareholders at their next annual meeting. Any vacancy that occurs between annual meetings due to the death or resignation of the accountant may be filled by a majority vote of the disinterested directors cast in person at a meeting called for such purpose, with no ratification required. Retention of the accountant is subject to the right of the fund, by a majority of voting securities, to terminate such employment without penalty.<sup>66</sup> Consistent with the policy of the 1970 Amendments to increase independent review of major fund transactions, the expansion of the power of independent directors over selection of fund accountants is expected to encourage a continuing review of fund financial reporting requirements and more careful evaluation of the services provided by the accounting firm retained.

#### D. *Incentive Fees*

The performance fee reflects an arrangement whereby the compensation received by the investment adviser is tied to the change in

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<sup>63</sup> 15 U.S.C. § 80a-15(c) (1970), amending 15 U.S.C. § 80a-15 (1964). In this connection, see Eisenberg & Lehr, *Directorial Responsibility under the Investment Company Act of 1940*, 20 Rutgers L. Rev. 181 (1966), and Miller & Carlson, *Recapture of Brokerage Commissions by Mutual Funds*, 46 N.Y.U.L. Rev. 35 (1970).

<sup>64</sup> 15 U.S.C. § 80a-15(c) (1970).

<sup>65</sup> 15 U.S.C. § 80a-31(a), amending 15 U.S.C. § 80a-31(a) (1964).

<sup>66</sup> *Id.*

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the net asset value of the fund. The most common performance fee is based upon a comparison between the fund's investment performance and the record of an index of securities prices. Such an arrangement provides an incentive for the adviser to concentrate on portfolio management, especially net asset value, rather than depend upon fund sales to increase the advisory fee. Congress expressly dealt with incentive compensation in the 1970 Amendments by amending section 205 of the Investment Advisers Act of 1940 [Advisers Act].<sup>67</sup>

Before 1970, section 205 of the Advisers Act contained a general prohibition against compensation of investment advisers based upon a share of realized or unrealized capital appreciation in the advised accounts.<sup>68</sup> However, the section contained an exemption from this prohibition for advisory contracts made with a registered investment company.<sup>69</sup> Many of the performance fee arrangements which developed under this exemption were heavily weighted in favor of the adviser, often providing for substantial increases over the basic advisory fee when net asset value appreciated, but little if any decrease in the basic fee when value declined. When decreases in the fee were provided for, they were frequently not proportionate to comparable increases for good investment performance. Such arrangements provided ample upside potential and little downside risk for the adviser.

The 1970 Amendments narrowed the scope of the section 205 performance fee exemption in order to limit arrangements that might be unfair to the investment company.<sup>70</sup> Contracts with registered investment companies and certain other persons now qualify for exemption only if they meet four requirements:<sup>71</sup>

- (1) the contract must relate to the investment of assets in excess of \$1 million;
- (2) the advised person must not be a trust, a collective trust or a separate insurance account as these terms are defined in the Investment Company Act;<sup>72</sup>
- (3) the compensation arrangement must be based on the asset value of the managed fund averaged over a specified period of time;
- (4) the incentive portion of the fee must increase or decrease

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<sup>67</sup> 15 U.S.C. § 80b-5 (1970), amending 15 U.S.C. § 80b-5 (1964). See also Fink, *Performance Fees*, 5 Rev. of Sec. Reg. 829 (1972).

<sup>68</sup> 15 U.S.C. § 80b-5 (1964), as amended, 15 U.S.C. § 80b-5 (1970).

<sup>69</sup> 15 U.S.C. § 80b-5 (1964), as amended, 15 U.S.C. § 80b-5(B)(i) (1970).

<sup>70</sup> 15 U.S.C. § 80b-5 (1970), amending 15 U.S.C. § 80b-5 (1964). See also SEC Investment Advisers Act Release No. 316 (April 6, 1972), reprinted in [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,693, at 81,460.

<sup>71</sup> 15 U.S.C. § 80b-5 (1970).

<sup>72</sup> The terms referred to are defined at 15 U.S.C. §§ 80a-3(c)(11) and -2(a)(37) (1970).

in proportion to the *investment performance* of the fund over a *specified period*. Performance must be measured in relation to the *investment record* of an appropriate index of securities prices. (The point from which increases or decreases in compensation must be measured is the fee payable when the investment performance of the fund equals the performance of the index—called the “fulcrum fee.”<sup>78</sup>)

In August 1972, after surveying existing incentive arrangements,<sup>74</sup> the SEC adopted rule 205-1 under amended section 205 of the Advisers Act.<sup>75</sup> Rule 205-1, defining the terms “investment performance” of a fund and “investment record” of an appropriate index of securities prices, is designed to clarify the section 205 requirements for measuring investment performance for those investment companies that include performance fee arrangements in their advisory contracts.<sup>76</sup> The rule requires that the “investment performance” of a fund and the “investment record” of the selected index to which fund performance is to be compared must be similarly computed. In addition, all increments (e.g., all cash contributions) must be considered in measuring the performance of the fund and the index.<sup>77</sup> Specifically, a fund’s investment performance is to be calculated as the percentage change in net asset value per share over the period specified—adjusted to reflect an assumed reinvestment of any realized capital gains distributed by the fund, capital gains taxes per share paid or payable on undistributed realized capital gains, and any dividends paid by the fund out of its investment income—expressed as a percentage of net asset value per share at the beginning of the period.<sup>78</sup> This measure gives effect to all increments in value received by the investment company’s shareholders during the specified period. Similarly, the investment record of the relevant index for any period is to be calculated as the percentage change in the level of the index over the specified period—adjusted to reflect an assumed reinvestment of all cash

<sup>78</sup> Rule 205-2(a)(1), 37 Fed. Reg. 24896 (1972); SEC Investment Company Act Release No. 7484 (Nov. 10, 1972), reprinted in [Current] CCH Fed. Sec. L. Rep. ¶ 79,080, at 82,338 (1972).

<sup>74</sup> SEC Investment Company Act Release No. 7113 (April 6, 1972), reprinted in [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,694, at 81,463. Of 999 investment companies surveyed by the SEC, 103 had performance fee arrangements on Jan. 3, 1972. Many of these arrangements were found by the SEC to contain features not in conformity with the provisions of § 205 of the Investment Advisers Act, as amended. *Id.*

<sup>75</sup> Rule 205-1, 37 Fed. Reg. 17648 (1972); SEC Investment Advisers Act Release No. 327 (Aug. 8, 1972), reprinted in [Current] CCH Fed. Sec. L. Rep. ¶ 78,934 (1972).

<sup>76</sup> The SEC made it clear that it was not its intention to prescribe an industry standard for computing rates of return. SEC Investment Advisers Act Release No. 327 (Aug. 8, 1972), *supra* note 75, at 82,021 n.1.

<sup>77</sup> *Id.* at 82,020.

<sup>78</sup> Rule 205-1(a). *Id.* at 82,021.

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distributions of the companies whose stocks comprise the index—expressed as a percentage of the index's level at the beginning of the period.<sup>79</sup>

Under rule 205-2,<sup>80</sup> adopted in November 1972, in determining the incentive compensation to be paid, the specified period over which a fund's asset value is averaged in determining the base fee must be identical with the period used to compute the investment performance of the fund and the investment record of the selected index. An exemption permitting the use of different reference periods is included, however, for compensation arrangements utilizing a moving average or "rolling period"<sup>81</sup> to compute the advisory fee. A rolling period contains a specified number of subperiods of definite length (e.g. months, quarters), the oldest of which is periodically dropped as the most recent subperiod is substituted.

Rule 205-1 becomes effective with respect to any particular fund sixty days after its next regular annual shareholders' meeting following September 30, 1972, but in no event later than September 1, 1973.<sup>82</sup> Rule 205-2 becomes effective on December 1, 1973 or 60 days after the next regular shareholder meeting following December 1, 1972, whichever is sooner.<sup>83</sup> Unless administrative relief is granted, some funds whose shareholders have voted to amend investment advisory agreements to meet the requirements of rule 205-1 will have to alter the agreement further to comply with rule 205-2 and submit the agreement to a second shareholder vote.

To aid persons having a fiduciary duty to investment companies in matters involving advisory compensation, the SEC announced guidelines detailing certain factors which must be considered in arranging incentive fees in accord with the 1970 Amendments.<sup>84</sup> These guidelines indicate that the fairness of any incentive fee arrangement is primarily dependent upon the fairness of the base or fulcrum fee from which

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<sup>79</sup> Rule 205-1(b). *Id.*

<sup>80</sup> 37 Fed. Reg. 24895 (1972), SEC Investment Company Act Release No. 7484 (Nov. 10, 1972), reprinted in [Current] CCH Fed. Sec. L. Rep. ¶ 79,080 (1972).

<sup>81</sup> Rule 205-2(c). SEC Investment Company Act Release No. 7484 (Nov. 10, 1972), *supra* note 80, at 82,339.

<sup>82</sup> SEC Investment Advisers Act Release No. 327 (Aug. 8, 1972), *supra* note 75, at 82,021.

<sup>83</sup> SEC Investment Company Act Release No. 7484 (Nov. 10, 1972), *supra* note 80, at 82,339.

<sup>84</sup> SEC Investment Company Act Release No. 7113 (April 6, 1972), reprinted in [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,694, at 81,463. See also SEC Investment Company Act Release No. 6336 (Feb. 2, 1971), reprinted in [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,951, with respect to approval of advisory contracts under the 1970 Act, and SEC Investment Company Act Release No. 6480 (May 10, 1971), reprinted in 3 CCH Fed. Sec. L. Rep. ¶ 49,809 (1971), regarding the views of the SEC's Division of Corporate Regulation (now the Division of Investment Management Regulation) on the fiduciary duties of investment company directors.

performance increments will be measured. In considering the fairness of such a fulcrum fee, fund directors must consider the same factors as those that are relevant in establishing a proper advisory fee where no incentive compensation is involved.<sup>85</sup> Another critical factor is the selection of an appropriate index of securities prices to which the fund's investment performance may be compared. In determining whether a proposed index is appropriate for a particular fund, directors should consider the volatility, diversification of holdings, types of securities owned and objectives of the fund.<sup>86</sup> The character of the index should match insofar as is possible the character of the fund's assets.

Although section 205 of the Advisers Act does not require that the period over which performance is measured be of any particular length, the SEC has found a fiduciary obligation to use a period sufficiently long to provide a reasonable basis for indicating the adviser's performance, and to minimize the possibility that payments will be based upon random or short-term fluctuations.<sup>87</sup> If, for example, assets were averaged and investment performance were computed over too short a period, the amount of compensation supposedly paid for performance could be significantly related to accumulated sales. A period of at least one year is considered by the Commission to be sufficient to guard against this problem. The fiduciary obligation apparently imposes both a duty on the adviser not to seek a shorter period and upon fund directors not to approve one.

In order to provide further protection against imposition of significant fee increases based upon random or insignificant differences between a fund's investment performance and the performance of the selected index, the SEC has cautioned fund directors to structure incentive fee scales with great care. Specifically, the Commission advocates the use of: (1) "null zones" or intervals around the fulcrum point in which no performance fee adjustments are made;<sup>88</sup> (2) "continuous fees" in which incentive payments are scaled down for slight performance differences, with fractional differences being prorated;<sup>89</sup> (3) measurement of performance differences between a fund and the selected index in terms of *percentage points* rather than *percents* (use of percent differences, possibly misleading in the SEC's view, may result in a maximum fee adjustment for small absolute differences in performance);<sup>90</sup> and (4) a specified minimum performance difference,

<sup>85</sup> SEC Investment Company Act Release No. 7113 (April 6, 1972), *supra* note 84, at 81,464.

<sup>86</sup> *Id.* For example, directors should consider whether the fund holds a broad range of securities, "blue chips," speculative securities or specialized securities. *Id.*

<sup>87</sup> *Id.* at 81,464-65.

<sup>88</sup> *Id.* at 81,467.

<sup>89</sup> *Id.*

<sup>90</sup> For example, where an index increases by 1%, a fund whose net asset value

measured in percentage points, which must exist before the maximum fee adjustment can result. While the Commission declined to recommend the use of any particular numerical difference, it did indicate that as a "rule of thumb" a difference of ten percentage points provides a ninety percent probability that the maximum fee adjustment will not result from random or insignificant differences between the performance of the investment company and the index.<sup>91</sup>

Measurement of adviser performance based on a rolling period, although not required by section 205, is recommended by the Commission as having advantages for both fund shareholders and investment advisers.<sup>92</sup> If a flat period is used, no compensation can be computed or paid until the period has ended and the investment performance for the period is known. Interim payments based on interim performance are not permitted.<sup>93</sup> Where a rolling period is used, however, rule 205-2(c)(1) permits the total fee to be computed and paid at the end of each subperiod.<sup>94</sup> In addition, the performance portion of the advisory fee must be computed based on the average assets over the entire rolling period in which the performance was achieved, while the fulcrum fee must be computed based upon the average assets over the most recent subperiod of the rolling period.<sup>95</sup> The effect of this portion of the rule is to permit the fulcrum fee to relate closely to current fund assets, while ensuring that any incentive or performance fee relates directly to the assets in which the performance was achieved. Thus, compensation paid for investment performance is substantially separated from the amount of fund sales or redemptions.

The Commission has also stated its policy with respect to the computation of fees during transitional periods surrounding the initiation or termination of incentive fee arrangements.<sup>96</sup> In order to ensure that performance compensation be based only upon results obtained after the effective date of an incentive contract, such contracts may be instituted on a *prospective basis* only.<sup>97</sup> This is meant to ensure that the adviser does not, during the "start-up" period, receive compensation for successful *past* performance. Where an incentive contract has

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increased by 3% would outperform the index by 200%, although the absolute difference is only two percentage points. *Id.* at n.14.

<sup>91</sup> *Id.* at 81,468.

<sup>92</sup> *Id.* at 81,465.

<sup>93</sup> *Id.* An exception is made where an advisory contract provides for payment of a minimum fee regardless of performance in which case interim payments based on this minimum fee may be made. *Id.* at n.9.

<sup>94</sup> Rule 205-2(c)(1), SEC Investment Company Act Release No. 7484 (Nov. 10, 1972), reprinted in [Current] CCH Fed. Sec. L. Rep. ¶ 79,080, at 82,339 (1972).

<sup>95</sup> *Id.*

<sup>96</sup> SEC Investment Company Act Release No. 7113 (April 6, 1972), *supra* note 84, at 81,465.

<sup>97</sup> *Id.* at 81,466.

been renegotiated during the contract term and the substituted contract provides for a flat percentage fee, fairness to the fund requires that the new contract provide that the fee payable for the remainder of the period of the original incentive contract be the lesser of the amount that would have been paid under the original contract or the fee payable under the new contract.<sup>98</sup> Such a "winding down" period serves, in the case of a rolling performance fee contract, to ensure substantial advance notice to the fund (not less than half of the fee computation period specified in the contract) of the adviser's intent to cancel the contract. Thus it prevents an adviser whose investment performance during the first part of a contract period has been significantly worse than the relevant index from artificially increasing, during such "winding down" period, his total fee for the contract period by changing the incentive fee or by switching from an incentive to a non-incentive fee basis.

Under section 205 of the Advisers Act, the SEC may rule on the appropriateness of an index for judging the performance of a specific fund's portfolio. The SEC may also broadly apply the antifraud provisions of section 205 to attack incentive fees which are disproportionate or which permit compensation in excess of that viewed as appropriate by the SEC staff. As a result, investment companies may expect performance fees disclosed in registrations filed under the Securities Act of 1933 and the Investment Company Act of 1940, and in proxy statements, to be carefully reviewed by the SEC. The difficulty of applying rule 205-2, as presently interpreted by the SEC,<sup>99</sup> may well deter advisers and their funds from using performance fees. Also, the problems involved in shareholder voting on amendments to complex advisory contracts and the possibility of new SEC performance fee requirements based on the Commission's 1971 Institutional Investor Study proposal for incentive fees relating to volatility-adjusted investment returns,<sup>100</sup> may deter use of such types of advisory fees. It is possible that either the SEC or the courts may establish a ceiling, creating a rebuttable presumption that only performance fees at or below the ceiling are reasonable and appropriate.

Although the impact of the rules and guidelines under section 205 of the Advisers Act will not be fully felt by the industry until the rules become finally effective in December 1973,<sup>101</sup> questions concerning the difficulty of operations within the new rules as well as the usefulness

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<sup>98</sup> *Id.*

<sup>99</sup> SEC Investment Company Act Release No. 7113 (April 6, 1972), *supra* note 84.

<sup>100</sup> Letter of Transmittal, SEC Institutional Investor Study Report, H.R. Doc. No. 92-64, 92d Cong., 1st Sess., pt. 8, at *xiv* (1971).

<sup>101</sup> See text at notes 82-83 *supra*.

of *any* limitations on compensation for performance are already being raised.

### E. *Insider Trading*

An additional problem area, insider trading, although distinct from the management contract, is related indirectly to the area of adviser compensation. Because of the tremendous financial assets of the mutual fund industry as a whole<sup>102</sup> and of numerous individual funds in particular,<sup>103</sup> when a decision is made by a fund manager to take a position in a given security, the market laws of supply and demand dictate that such a decision is likely to affect the market price of that security. The extent of the effect depends upon such factors as the size of the position sought, the speed with which the desired securities are accumulated, and the normal trading volume in the security. A decision by a fund to liquidate its holdings in a particular security will similarly influence the price of that security. Often such decisions are made by fund managers who control the portfolio of a number of different funds and intend to take similar action with respect to some or all of them.<sup>104</sup>

Obviously, one privy to such significant decisions could, prior to their execution, utilize his advance knowledge to benefit his personal portfolio. Since such a person may not technically be a corporate insider with respect to the issuer of any securities in which the fund deals, his action may not be affected by the restrictions imposed by section 10(b) of the Securities Exchange Act of 1934<sup>105</sup> and rule 10b-5 as presently interpreted.<sup>106</sup> However, from a regulatory point of view, such "profiteering" takes unfair advantage of the public investor and

<sup>102</sup> As of December 1971, the mutual fund industry had total net assets of approximately \$55 billion. Investment Company Institute, 1972 Mutual Fund Fact Book 3, 7. At that date these assets represented 7.42% of the total market value of all shares listed on the New York Stock Exchange. *Id.* at 12.

<sup>103</sup> As of December 1971 108 funds had assets in excess of \$100 million each and 13 funds had assets of more than \$1 billion each. *Id.* at 9.

<sup>104</sup> As of December 1970, the ten leading management companies had assets under management amounting to \$26.1 billion, or close to 55% of total industry assets. Estimate based on management information for all major management firms as contained in Moody's Investors Services, 1971 Bank and Finance Manual.

<sup>105</sup> 15 U.S.C. § 78j(b) (1970).

<sup>106</sup> 17 C.F.R. § 240.10b-5 (1972). Although under rule 10b-5 the duty of disclosure has been imposed on persons other than corporate insiders, such imposition has required the existence of a special relationship which made such a person privy to the internal affairs of the corporation. *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961). The imposition of liability on a "tippee" has required a finding that the information received originated with an inside corporate source in violation of his fiduciary duty to the corporation concerned. *Investors Management Co.*, SEC Securities Exchange Act Release No. 9267 (July 29, 1971), reprinted in [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163, at 80,523-24 (concurring opinion of Commissioner Smith).



hence is undesirable. SEC studies in 1963 and 1966 noted that trading by officers, directors and employees of investment companies and their investment advisers in the portfolio securities of their funds often placed such persons in a conflict-of-interest position. The SEC studies therefore called for the development of adequate restraints.<sup>107</sup> The SEC 1966 Public Policy Report recommended that each registered investment company be required to adopt a written policy covering insider trading, and make provisions for its implementation, including reporting of violations, satisfactory to the Commission. The report proposed that the minimum acceptable standards for such a policy should provide for: (1) coverage of all officers, directors, substantial shareholders and advisory employees of the investment company, its investment adviser and principal underwriter, but with appropriate recognition of the problems of independent, unaffiliated directors; (2) prohibition of purchases or sales of securities, directly or indirectly, by any person covered by the policy within thirty days prior to or following the date of a portfolio transaction in the same security issue, subject to reasonable exceptions, as in the case of hardship or with respect to such types of securities as the Commission might exempt from the application of such policy; (3) a requirement that persons covered by the policy report to the investment company any personal transactions in issues in its portfolio, such reports not to be made public but to be available for inspection by the Commission; and (4) appropriate provision for sanctions in the event of violations of the policy.<sup>108</sup>

The response of the 1970 Amendments to this problem and these recommendations is contained in new section 17(j) of the Act,<sup>109</sup> which prohibits an affiliated person of a fund, its investment adviser or principal underwriter and their affiliates from engaging directly or indirectly in any transaction involving a security held or to be acquired by the fund, in contravention of such rules and regulations as the Commission may adopt for the purpose of preventing fraudulent, deceptive or manipulative practices. The section further provides that such rules may include requirements for the adoption of codes of

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<sup>107</sup> Securities and Exchange Commission, Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 195-200 (1966) [hereinafter cited as SEC 1966 Public Policy Report]. Securities and Exchange Commission, Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4, at 241 (1963) [hereinafter cited as SEC 1963 Special Study] indicated that as many as 14.4% of all persons affiliated with funds and investment advisers included in the SEC Study had traded in portfolio securities of the fund with which they were associated during the same period as the fund, and 8% had traded within 15 days prior to the fund's trades. Trading following fund transactions was reported by 20.7% of affiliated persons.

<sup>108</sup> SEC 1966 Public Policy Report, *supra* note 107, at 196-200, citing SEC 1963 Special Study, *supra* note 107, pt. 4, at 225.

<sup>109</sup> 15 U.S.C. § 80a-17(j) (1970), amending 15 U.S.C. § 80a-17 (1964).

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ethics by registered investment companies embodying such standards as the SEC finds expedient for carrying out the purpose of the section.<sup>110</sup>

In December 1972, the SEC issued a release setting forth a detailed proposed rule 17j-1, regulating trading by fund "insiders," and requiring adoption of a code of ethics by each fund, investment adviser and principal underwriter.<sup>111</sup> Proposed rule 17j-1 contains an anti-fraud proscription against direct or indirect trading in portfolio securities by "access persons"—officers, directors, and advisory employees of funds, investment advisers, and principal underwriters and their affiliates. The proposed rule would prohibit any "access person" from purchasing or selling, directly or indirectly, any security in which such person has, or by reason of such transaction acquires, any direct or indirect beneficial interest or ownership and which such person knows: (1) is currently being purchased or sold by a registered fund; (2) is being considered for purchase or sale by the fund; or (3) is being recommended or is about to be recommended by any advisory employee of the fund or investment adviser for purchase or sale by the fund. In its release, the SEC indicated that transactions by fund "insiders" in the portfolio securities of a fund often placed such persons in a position of conflict of interest, and, further, that the policies adopted by the industry to deal with this problem revealed considerable disagreement as to the nature and extent of the obligations of "insiders" in this area.

The proposed rule is in some ways similar to a proposed voluntary code submitted to the SEC in November of 1971 by the Investment Company Institute, acting on behalf of a major part of the mutual fund industry.<sup>112</sup> However, the proposed SEC rule goes beyond the Investment Company Institute's proposal insofar as it incorporates a requirement that "access persons" file with the SEC reports on their personal securities transactions within ten days of the end of each quarter, such reports to be patterned after the reporting requirements of rule 204-2(a)(12) promulgated under the Investment Advisers Act.<sup>113</sup> Proposed rule 17j-1 would require funds to adopt codes of ethics which may provide for an optional "prior written clearance" procedure under which advance clearance could be obtained for particular transactions if the security in question is not being considered by the investment company or investment adviser for purchase or sale. The pro-

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<sup>110</sup> *Id.*

<sup>111</sup> SEC Investment Company Act Release No. 7581 (Dec. 26, 1972), reprinted in [Current] CCH Fed. Sec. L. Rep. ¶ 79,157 (1972).

<sup>112</sup> Letter from President of Investment Company Institute to Chairman, Securities and Exchange Commission, dated November 16, 1971, with draft rules and model code of ethics attached, reprinted in 2 CCH Mutual Funds Guide ¶ 9316 (1971).

<sup>113</sup> 17 C.F.R. § 275.204-2(a)(12) (1971).

posed rule would also provide for appeals from refusals to grant clearance.

Comments on the proposed rule were to be furnished to the SEC by March 14, 1973, and it is likely that the rule will be adopted in the proposed form. It is submitted that the new rule, although needed to tighten and clarify restrictions on insider trading practices, may prove difficult to administer on a practical day-to-day level. For example, fund "access persons," particularly "disinterested directors" as defined by the Act, may be trading in securities which they are not aware "are being considered" for purchase or sale by the fund adviser. Also, clearance obtained from a co-director or fund officer (elected by the board) may not be sufficiently difficult to obtain. It appears that SEC monitoring of insider transactions will be required to insure that the codes of ethics adopted by the funds are complied with on a day-to-day basis. It appears certain that fund legal compliance officers will be busy reviewing existing and potential problems under section 17(j) of the Act and counseling "access persons" on the relationship of their personal securities transactions and present and proposed portfolio transactions of the fund.

## II. DISTRIBUTION PROBLEMS

### A. *Retroactive Registration of Shares*

A mutual fund, like all issuers engaged in public offerings, must register its securities under the provisions of section 5 of the Securities Act of 1933.<sup>114</sup> Most issuers, however, attempt to offer their securities publicly within a limited time period. Mutual funds are engaged in a continuous offering of their shares through a continuous underwriting process, and stand ready to issue as many shares as are necessary to meet the public demand. In the course of its business, a fund may inadvertently offer and sell more shares than are covered by an effective 1933 Act registration statement, *and* may also fail to file a post-effective amendment to its original registration to ensure that all shares offered are registered. Although these excess sales are not likely to cause harm to an investor as long as each potential purchaser receives a current prospectus, such sales would violate the section 5 registration requirement<sup>115</sup> as well as various state securities acts.<sup>116</sup> Thus, any investor who can show that his shares were not actually registered

<sup>114</sup> 15 U.S.C. § 77e (1970). For a general discussion of the retroactive registration of mutual fund shares, see SEC Investment Company Act Release No. 6660 (Aug. 6, 1971), reprinted in [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,185.

<sup>115</sup> 15 U.S.C. § 77e (1970).

<sup>116</sup> See, e.g., N.Y. Gen. Bus. Law § 359-e (McKinney 1968), Cal. Corp. Code § 25110 (West 1968), Pa. Stat. Ann. tit. 70, § 43 (Purdon 1965), Ill. Ann. Stat. ch. 121½, § 137.5 (Smith-Hurd 1953), and Tex. Ann. Stat. § 851-7 (Vernon 1964).

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at the time of the sale might be entitled to rescind his purchase under section 12 of the 1933 Act.<sup>117</sup>

To enable funds to remedy systematically and legally any failure to register a sufficient number of shares, new section 24(f) of the Investment Company Act<sup>118</sup> provides for the retroactive registration of shares. Under this section, a delinquent fund may elect to have the registration of such shares deemed effective as of the time of their sale, if the fund acts within six months after the sale of the unregistered securities and pays a fee of three times the otherwise applicable registration fee.<sup>119</sup> To protect the interests of investors and the public, the SEC is given the authority to adopt rules and regulations regarding this procedure for retroactive registration. Rule 24f-1 requires (1) that the issuing fund file a statement confirming that the shares for which retroactive registration is sought were sold in accordance with the issuer's usual method of distributing its registered shares, including delivery of prospectuses as required by section 5(b) of the 1933 Act, and (2) that at the time of the sale of the securities, there was a registration statement in effect for shares of the same class or series.<sup>120</sup>

The passage of the section 24(f) amendment was not attended by any apparent controversy. Its sole purpose was to eliminate the potential liability of funds to shareholders whose injuries, if any, were connected to a technical and frequently inadvertent violation of the securities laws.

*B. Sales Loads*

Historically, one of the most serious problems in the mutual fund industry has been the excessive sales loads imposed on the purchasers of redeemable fund shares. The "sales load" represents the difference between the current net asset value per share received by the fund and the public offering price paid by the investor.<sup>121</sup> Through the sales load,

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<sup>117</sup> 15 U.S.C. § 77i (1970).

<sup>118</sup> 15 U.S.C. § 80a-24(f) (1970), amending 15 U.S.C. § 80a-24 (1964).

<sup>119</sup> 15 U.S.C. § 80a-24(f) (1970).

<sup>120</sup> 17 C.F.R. § 240.24f-1 (1971).

<sup>121</sup> Under § 22(d) of the Investment Company Act, 15 U.S.C. § 80a-22(d) (1970), the current offering price for a fund's shares must be stated in the fund's prospectus. Thus, if the fund intends to impose a sales charge on purchasers, it must describe the sales load in the prospectus as a percent of the offering price or of the amount invested. See SEC no-action letter, Investment Company of America (Sept. 28, 1972), 2 CCH Mutual Funds Guide ¶ 9557 (1972). The sales charge expressed as a percent of the net amount invested is always higher than the sales load expressed as a percent of the public offering price, and the SEC has advised funds to use the former mode of expression. SEC Guidelines for Preparation of Form S-5, SEC Investment Company Act Release No. 7219 (June 9, 1972), reprinted in 2 CCH Mutual Funds Guide ¶ 9476 (1972). See also Comment, The Mutual Fund Industry: A Legal Survey, 44 Notre Dame Lawyer 732, 836 n.648 (1969) [hereinafter cited as Mutual Fund Survey].

the purchaser is forced to assume a major part of the costs and expenses of distributing mutual fund shares to the public.<sup>122</sup>

The distribution process typically begins with an underwriter-distributor who may also be either the fund's adviser or a subsidiary of the advisory company. The mutual fund underwriter performs the usual underwriting function—purchasing the issuer's shares for resale, at wholesale prices, to independent broker-dealers who sell the shares at retail to the public. Unlike underwriters of other securities, however, fund underwriters are not fully subject to the usual risk of resale. According to the NASD Rules of Fair Practice, section 26(f)(2), the fund underwriters may not underwrite any shares unless a purchase order for such shares has already been received by a broker-dealer from a public customer.<sup>123</sup> When a purchase order has been received, the underwriter sells the shares at net asset value to the broker-dealer according to the terms of their sales agreement. The broker-dealer in turn sells the shares to his public customer at a public offering price consisting of the net asset value plus the sales load. Although the sales load may vary among funds, the prevailing rate at the time of the 1970 Amendments was 8.5 percent of the total offering price including the load, or, expressed differently, 9.3 percent of the amount actually invested.<sup>124</sup> The underwriter typically received 2 percent of the investor's payment, while the remaining 6.5 percent was split between the broker-dealer and the individual salesman.<sup>125</sup>

Except for contractual plans and face-amount certificates,<sup>126</sup> the original 1940 Act imposed no express statutory restriction on sales loads. In fact, sales loads were not considered a matter of primary concern during the hearings which led up to the initial passage of the Act.<sup>127</sup> It was believed at the time that sales loads were a "technical item which could be left to competition."<sup>128</sup> Unfortunately, the Act itself foreclosed one important avenue of competition: section 22(d) of the Act, establishing retail price maintenance, required that all

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<sup>122</sup> Mutual Fund Survey, *supra* note 121, at 752, 833. According to the SEC 1966 Public Policy Report, *supra* note 107, at 215, "[t]he sales load . . . is purely a payment for selling effort." Shares of some mutual funds may be purchased at a public offering price equal to the net asset value per share. There is no sales load because these funds maintain no dealer organization or staff of sales representatives. Investors are not personally solicited but must apply directly to the underwriter.

<sup>123</sup> National Association of Securities Dealers, Inc., Rules of Fair Practice, Art. III, § 26(f)(2), reprinted in CCH NASD Rules ¶ 2176 (1971).

<sup>124</sup> Mutual Fund Survey, *supra* note 121, at 816. See also Romanski, *The Role of Advertising in the Mutual Funds Industry*, 13 B.C. Ind. & Com. L. Rev. 959, 966 n.41 (1972).

<sup>125</sup> Mutual Fund Survey, *supra* note 121, at 816.

<sup>126</sup> 15 U.S.C. § 80a-27 (1970).

<sup>127</sup> Mutual Fund Survey, *supra* note 121, at 849.

<sup>128</sup> *Id.*

sales to the public be made at the offering price stated in the fund's prospectus.<sup>120</sup> Dealers were thereby prohibited from engaging in any form of price competition among themselves. All dealers were required to sell shares in a given fund at the same price and could not alter the sales charge fixed by the fund underwriter.<sup>180</sup> As an antidote to what appeared to be an antitrust exemption, section 22(b) provided 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>181</sup>

In the 1960's, the SEC became increasingly concerned over the lack of effective competition in the distribution of mutual fund shares and over the resulting high level of sales loads imposed on investors. The industry responded to the SEC's concern by maintaining that the prevailing sales loads were necessary to the continued existence of the funds and to the retention of effective sales forces.<sup>182</sup> Comparing the cost of investment in securities listed on the various stock exchanges with the cost of investment in the same securities through a mutual fund, the industry maintained that funds' sales loads merely represented a realistic price for all of the rights and benefits acquired by the mutual fund shareholder.<sup>183</sup> The purchaser acquires the right to future dividends and capital gains distributions, and in addition obtains the increased security of a diversified investment portfolio and professional investment management.

In its attempt to change the non-competitive sales load structure of the fund distribution system, the SEC had two possible courses of action open to it. First, competition could be restored by a repeal of section 22(d). Shares could then be sold at any price above net asset value, enabling retail dealers to attract customers by offering lower prices.<sup>184</sup> The SEC feared, however, that funds which maintained their

<sup>120</sup> See note 121 *supra*.

<sup>180</sup> Section 22(d), which effectively prevents any price competition among dealers selling the shares of a particular fund, was adopted in order to insure the orderly distribution of fund shares and to prevent discrimination among purchasers of such shares. Hodes, *Current Developments Under Section 22(d) of the Investment Company Act*, 13 B.C. Ind. & Com. L. Rev. 1061 (1972).

<sup>181</sup> 15 U.S.C. § 80a-22(b) (1964), as amended, 15 U.S.C. § 80a-22(b)(1) (1970).

<sup>182</sup> For a critical appraisal of both the SEC and industry positions, see *Mutual Fund Survey*, *supra* note 121, at 834-38.

<sup>183</sup> *Id.* at 840-42. In support of its argument, the industry relied heavily on a study report by a consulting firm, Arthur D. Little, Inc. The report indicated 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." A.D. Little, Inc., *Economic Studies of the Mutual Fund Industry I-3* (1967). See also Comment, *Valuation of Mutual Fund Shares for Federal Estate Tax Purposes*, 14 B.C. Ind. & Com. L. Rev. 134, 140 (1972).

<sup>184</sup> Report of the Staff of the Securities and Exchange Commission on the Potential

own sales organizations would then be able to maintain a higher sales charge for the benefit of their salesmen, but independent dealers would be forced by price competition to cut sales commissions in order to reduce prices and, as a result, would lose much of their sales forces. In 1967, the SEC, acting on the alternative theory that a more competitive price could be established by administrative or legislative pronouncement, chose not to recommend the abolition of section 22(d), but suggested instead the establishment of a five percent sales load.<sup>185</sup> This recommendation was incorporated into proposed legislation<sup>186</sup> that was subsequently altered to provide that the NASD could prohibit its members from selling securities at a price which included an "excessive" sales load.<sup>187</sup>

In 1969, Senator Thomas McIntyre introduced a bill which called for the complete repeal of section 22(d).<sup>188</sup> The Senate Banking and Currency Committee was hesitant to adopt such a proposal, noting in a subsequent report that impressive testimony had been presented to the Committee to the effect that no sufficient study of the consequences of such an amendment had been made.<sup>189</sup> The Committee expressed concern over the effects that such a repeal might have on both the investing public and the mutual fund industry.<sup>140</sup> Indeed, it was perhaps feared that a complete repeal of section 22(d) would represent an unwise attempt to protect the interests of investors at the expense of the industry's distribution system. The Committee recognized "the value of the services that the investment company industry has provided and can provide in the future to the many who wish to put their savings in broadly diversified and professionally managed portfolios."<sup>141</sup>

In reporting out S. 2224,<sup>142</sup> the bill finally passed by the Senate in 1969, the Senate Banking and Currency Committee concluded that partly because of section 22(d) and partly because of the way in which mutual fund shares are sold, competition has tended to operate

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Economic Impact of the Repeal of Section 22(d) of the Investment Company Act of 1940, pt. 2, reprinted in BNA Sec. Reg. & L. Rep. No. 177 (Nov. 15, 1972).

<sup>185</sup> Hearings on H.R. 9510 and H.R. 9511 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 90th Cong., 1st Sess. 176 (1967) (testimony of SEC Chairman Hamer Budge).

<sup>186</sup> S. 1659, 90th Cong., 1st Sess. (1967).

<sup>187</sup> S. 3724, 90th Cong., 2d Sess. (1948); Mutual Fund Survey, *supra* note 121, at 845 n.710.

<sup>188</sup> S. 296, 91st Cong., 1st Sess. (1969).

<sup>189</sup> S. Rep. No. 91-184, 91st Cong., 1st Sess. (1969), reprinted in U.S. Code Cong. & Ad. News 4897, beginning page # 4904 (1970) [hereinafter cited as 1969 Senate Report].

<sup>140</sup> *Id.* The Senate Committee asked the SEC to examine the probable consequences of a complete repeal of § 22(d) and to report its findings to the Committee as soon as practicable. *Id.*

<sup>141</sup> 1969 Senate Report, *supra* note 139, at 4900.

<sup>142</sup> S. 2224, 91st Cong., 1st Sess. (1969).

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in reverse—raising prices rather than lowering them.<sup>143</sup> Hence the approach taken in this bill was to rely not on free competition but on the existing self-regulatory machinery of the securities industry, as overseen by the SEC, to protect investors from excessively high sales loads. S. 2224 amended section 22(d) of the 1940 Act to allow the NASD to promulgate rules designed to prevent “excessive” sales charges, such rules being subject to SEC supervision and review under section 15A(k)(2) of the Securities Exchange Act.<sup>144</sup> The intention was to protect the interests of both sellers and investors, and the bill specifically provided that the rules published by the NASD should allow for “reasonable compensation for underwriters, dealers, and salesmen,” and for “reasonable sales loads to investors.”<sup>145</sup> The version of the bill passed by the House included substantially similar language.<sup>146</sup>

The Senate-House Conference Committee on the 1970 Amendments accepted the Senate language relating to the enactment of NASD rules on sales charges.<sup>147</sup> Thus the 1970 Amendments represented a rejection of both the argument for abolition of section 22(d) and for incorporation of a maximum retail sales price. The prohibition of the original 1940 Act against “unconscionable or grossly excessive” sales loads was replaced in the 1970 Amendments by a simplified prohibition upon “excessive” sales loads as determined initially by the NASD.<sup>148</sup> It is hoped that the result will provide reasonable compensation for persons involved in the distribution process, and allow no more than reasonable sales charges to investors.

Those authorities charged with enforcement of the 1970 standard do not lack specific legislative history to furnish them with practical guidance. According to the Senate Report on S. 2224, the “reasonable compensation” provision was not intended to preserve profits at current levels for mutual fund salesmen, but rather to assure that consideration “be given to the nature and quantity of services necessary to effect the proper distribution of fund shares to the public.”<sup>149</sup> The Senate Report also indicates that the requirement of “reasonable sales loads to investors” anticipates the imposition of higher sales loads in cases where comparatively greater selling effort or skill is needed.<sup>150</sup>

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<sup>143</sup> In order to attract competent salesmen, funds had to find a way to increase the compensation which they could receive. 1969 Senate Report, *supra* note 139, at 4912.

<sup>144</sup> *Id.* The section of the Securities Exchange Act referred to is found at 15 U.S.C. § 78o(3)(k)(2) (1970).

<sup>145</sup> S. 2224, 91st Cong., 1st Sess. (1969).

<sup>146</sup> Conf. Rep. No. 163, 91st Cong., 2d Sess. (1970), reprinted in U.S. Code Cong. & Ad. News, 4943, 4944-45 (1970) [hereinafter cited as Conference Report].

<sup>147</sup> *Id.* at 4945.

<sup>148</sup> 15 U.S.C. § 80a-22(b)(1) (1970), amending 15 U.S.C. § 80a-22(b) (1964).

<sup>149</sup> 1969 Senate Report, *supra* note 139, at 4912.



Conversely, it was contemplated that the reasonableness provision would allow more flexible treatment of sales loads in situations where comparatively little sales effort is required, as in the automatic re-investment of dividends.<sup>151</sup>

Also incorporated into new section 22 are the provisions of the House bill regarding the authority of the SEC to exercise supervision over, and to grant qualified exemptions from, the NASD sales load rules.<sup>152</sup> Qualified exemptions from the NASD rules may be granted by the SEC to smaller companies which show that they are subject to comparatively high operating costs and are therefore entitled to charge a relatively high sales load.<sup>153</sup> New section 22 allows the SEC to alter or supplement the NASD rules in order to effectuate the remedial purpose of the 1970 Amendments.<sup>154</sup> The SEC is given the additional authority to publish its own rules prohibiting the imposition of excessive sales loads by non-NASD members.<sup>155</sup> A non-member fund underwriter may, however, file with the SEC notice of its intention to comply with the NASD rather than the SEC rules in this area.<sup>156</sup>

At present, both the NASD and the SEC are studying the role of retail price maintenance in the distribution of mutual fund shares.<sup>157</sup> A November 1972 report by the SEC staff,<sup>158</sup> forwarded by former Chairman Casey to the House and Senate Committees,<sup>159</sup> lends new support to the movement to repeal section 22(d). The staff concluded that section 22(d) serves "no compelling public interest" and its repeal would lower acquisition costs for many mutual fund investors,

<sup>150</sup> *Id.*

<sup>151</sup> *Id.* at 4912-13.

<sup>152</sup> Conference Report, *supra* note 146, at 4945.

<sup>153</sup> 15 U.S.C. § 80a-22(b)(1) (1970), amending 15 U.S.C. § 80a-22(b) (1964).

<sup>154</sup> 15 U.S.C. §§ 80a-22(b)(2), (c) (1970), amending 15 U.S.C. §§ 80a-22(b), (c) (1964).

<sup>155</sup> 15 U.S.C. § 80a-22(c) (1970), amending 15 U.S.C. § 80a-22(c) (1964).

<sup>156</sup> 15 U.S.C. § 80a-22(b)(2) (1970), amending 15 U.S.C. § 80a-22(b) (1964).

<sup>157</sup> Securities and Exchange Commission Hearings on the Potential Impact of Repeal of Section 22(d), SEC Investment Company Act Release No. 7534 (Nov. 30, 1972), reprinted in BNA Sec. Reg. & L. Rep. No. 182, at A-16 (Dec. 26, 1972). See also Proposal to Amend Rule 22d-1 Regarding Quantity Discounts to Certain Bona Fide Groups, SEC Investment Company Act Release No. 7571 (Dec. 21, 1972), reprinted in [Current] CCH Fed. Sec. L. Rep. ¶ 79,148 (1972).

<sup>158</sup> Report of the Staff of the Securities and Exchange Commission on the Potential Impact of a Repeal of Section 22(d) of the Investment Company Act of 1940, pt. I (1972), reprinted in BNA Sec. Reg. & L. Rep. No. 177 (Nov. 15, 1972). The conclusions drawn by the report were opposed by the Investment Company Institute in its testimony before the SEC in February, 1973. The Institute President asserted that repeal of section 22(d) would severely harm the mutual fund industry by reducing incentives to sell fund shares and forcing fund salesmen out of business. Wall Street Journal, Feb. 13, 1973, at 7, cols. 1-2.

<sup>159</sup> Letter from SEC Chairman William J. Casey to Chairman, Senate Committee on Banking, Housing and Urban Affairs, BNA Sec. Reg. & L. Rep. No. 177, pt. 2 (Nov. 15, 1972).

although immediate benefits for investors of one thousand dollars or less were found to be "highly unlikely." The report indicated that the impact of the cost savings that would result from section 22(d)'s repeal would fall almost entirely on independent broker-dealer firms that sell mutual fund shares, but such repeal would have only a modest impact on the overall business of most retail sellers of fund shares. After reviewing this staff report, the SEC determined to hold public hearings on the desirability of repealing section 22(d) before formulating definitive legislative recommendations. The hearings, which commenced on February 12, 1973,<sup>160</sup> will also cover the SEC's mutual fund advertising rules, simplification of mutual fund prospectuses and the NASD's proposed rules on excessive sales loads, all of which the Commission felt had a bearing on the distribution of fund shares.

The proposed NASD rules were initially released for public comment on November 8, 1972. The proposed rules set the maximum sales charge on fund shares at six percent for funds which fail to offer three specific services—reinvestment of dividends at net asset value, rights of accumulation and quantity discounts on single purchases. The sales charge would be permitted to increase, based on the services or combinations of services a fund offered, up to a maximum of 8½ percent if all three services are provided. The NASD projected that if the proposed rules were to become effective, over two-thirds of the approximately six hundred and fifty U.S.-registered funds charging a sales load would have to offer additional services or adjust their sales charges. In addition, the twenty percent of the industry which now charges a sales load of more than 8½ percent would have to reduce such sales charge.

### C. *Periodic Payment Plans*

The investment company industry has traditionally maintained that investment in mutual funds offers benefits which the typical investor of modest means could not otherwise obtain.<sup>161</sup> In order to attract a maximum number of persons in this middle-income group, the funds developed a system of installment investment which allows a wage-earner to finance his investment out of current income. Under these periodic payment plans, the investor contracts with a fund to invest fixed amounts at given intervals over a period of years. A contractual plan investor does not purchase mutual fund shares directly, however. Instead, the investor purchases a security, known as a periodic payment plan certificate, issued by a unit investment trust company whose assets consist exclusively of shares in the underlying mu-

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<sup>160</sup> 2 CCH Mutual Funds Guide, Summary Report No. 105 (Dec. 15, 1972).

<sup>161</sup> See Mutual Fund Survey, *supra* note 121, at 851.

tual fund.<sup>162</sup> The investor acquires only a beneficial interest in the undivided assets of the periodic plan company which are held in trust for the planholder by a custodian bank.<sup>163</sup> When the investor redeems his certificates, he has the option of taking their cash value or obtaining the shares in the underlying fund represented by his interest in the assets of the plan company.<sup>164</sup> Despite the name "contractual plan," an investor is never under a binding obligation to continue his participation in the investment plan. He can present his certificates for redemption at any time.<sup>165</sup>

It has been a practice in the industry to deduct the major portion of the sales load from the payments made in the first years of the plan—hence their characterization as "front-end load" plans. The heavy, early application of the sales loads in these plans can work a hardship on any investor who wishes to discontinue his participation in a plan.<sup>166</sup> For example, because a large portion of payments made in the early years of the plan are allocated to the sales load, an investor who chooses to redeem his certificates during the early years of the plan can recover only a small part of his "investment."

Section 27 of the 1940 Act allowed up to fifty percent of the payments made during the first year to be deducted to cover the cost of the sales load.<sup>167</sup> The rest of the sales charge was then deducted from the investor's payments over the remaining years of the plan. Unlike the sales loads on regular purchases of mutual fund shares which were subject only to an "unconscionable or grossly excessive" test,<sup>168</sup> the sales loads on contractual plans were limited by section 27 to nine percent of the total amount to be invested under the plan.<sup>169</sup> Essentially, the nine percent maximum represented a .5 percent charge for installment purchasing, since the normal sales load was 8.5 percent of the total investment.

This restriction, however, provided inadequate protection for investors wishing to withdraw from a plan before its termination date. The SEC, believing that many planholders were forced to pay effective sales loads far above the nine percent maximum because of their early withdrawal,<sup>170</sup> became critical of "front-end loads." For its part, the

<sup>162</sup> *Id.* at 756, 852.

<sup>163</sup> *Id.* at 756.

<sup>164</sup> *Id.* at 757.

<sup>165</sup> *Id.*

<sup>166</sup> For a general discussion of the predicament of an investor wishing to cancel, see *id.* at 757, 858-60.

<sup>167</sup> 15 U.S.C. § 80a-27 (1964), as amended, 15 U.S.C. § 80a-27 (1970).

<sup>168</sup> See text at note 131 *supra*.

<sup>169</sup> 15 U.S.C. § 80a-27 (1964), as amended, 15 U.S.C. § 80a-27 (1970).

<sup>170</sup> Securities and Exchange Commission, Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. IV, at 191 (1963).

industry contended that the front-end loads were necessary to provide adequate and prompt compensation to the salesmen who were essential to the success of the fund's distribution system.<sup>171</sup>

In its report accompanying Senate bill S. 2224, which contained the 1970 Amendments, the Senate Committee recommended two alternatives for limiting the hardships caused by the disproportionate "front-end" sales loads.<sup>172</sup> The first alternative would have permitted the sellers of such plans to continue to charge approximately the same amount of sales loads over the first four years as they had been able to collect under the 1940 Act. The significant change, however, was that instead of collecting the greatest percentage in the first year, the seller would be required to spread the charges more evenly over the first four-year period. No more than twenty percent of any one year's payments could be deducted for sales loads, and the total deduction allowable during the first four years would be limited to sixty-four percent. It was expected that this change would correct the pattern established under the 1940 Act whereby the salesmen received most of their commissions during the first year of the plan and therefore had little incentive to seek to reactivate plans that had become delinquent.<sup>173</sup> By decreasing the sales charges on payments made in the first year, S. 2224 would have enabled planholders to have a larger portion of their payments actually invested for their benefit. Also under this alternative, the sales loads on all payments after the forty-eight monthly payment would have to be uniform.<sup>174</sup> This requirement was designed to discourage overly complex sales loads which would be difficult for an investor to comprehend.<sup>175</sup>

The other alternative considered by the Senate Report continued the fifty percent maximum first-year load allowed under the 1940 Act but substantially enhanced an investor's refund rights following payment of a front-end load. If for any reason an investor were to redeem his underlying shares for cash during the first three years of the plan, he would be entitled to receive the value of his account as well as a re-

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<sup>171</sup> Id. at 861-62.

<sup>172</sup> Two measures regarding sales loads were introduced in Congress in 1969. One of these, S. 296, called for a more significant revision than the other: it would have abolished the front-end load entirely by prohibiting any plan where "the amount of sales load deducted from any one payment exceeds proportionately the amount deducted from any other payment . . ." S. 296, 91st Cong., 1st Sess. (1969). The other bill, S. 34, was more of a compromise measure, allowing 64% of the total sales load to be deducted in the first four years of the plan, provided however that no more than twenty percent of any year's payments were deducted for the sales load and that each monthly payment within any one of the first four years was the same. S. 34, 91st Cong., 1st Sess. (1969).

<sup>173</sup> 1969 Senate Report, *supra* note 139, at 4906.

<sup>174</sup> Id. at 4913-14.

<sup>175</sup> Id.

fund of any sales charges paid which exceeded fifteen percent of the total payments made under the plan.<sup>176</sup> Within sixty days of the issuance of the plan certificate, the custodian bank would be required to mail to every planholder a statement of sales charges to be deducted from future payments and a notification of his refund rights.<sup>177</sup> The planholder would then have sixty days from the date of the mailing of the notice to cancel his participation in the plan and recover the value of his account and *any* sales load already paid.<sup>178</sup> Although the House bill relating to this alternative, H.R. 17333, was similar to the Senate bill, there were some technical differences which made the House version less favorable to investors. If the 1940 Act front-end load allowances were continued, the House bill would have afforded the planholder a refund right only during the first year, as opposed to the first three years, of the plan.<sup>179</sup> Furthermore the planholder would only be permitted to recover from the underwriter any sales charges paid in excess of twenty, rather than fifteen, percent of the total payments made under the plan.<sup>180</sup> Finally, the planholder was given only thirty, rather than sixty, days from the mailing of notification in which to cancel the plan and recover the same amounts as those allowed under S. 2224.<sup>181</sup>

As enacted in the 1970 Amendments, new sections 27(d)-(h) represent a compromise between the two versions. Two alternatives are offered for determining sales loads for periodic payment plans.<sup>182</sup> One alternative is that which was included in S. 2224, limiting the deduction for sales loads so as to spread them more evenly over the first four years.<sup>183</sup> The other alternative retains the allowance for a fifty percent maximum first year load formerly in effect under the 1940 Act, but also provides for an eighteen-month period after issuance of the certificate during which a planholder may recover in cash the value of his account and any sales load paid in excess of fifteen percent of the total payments made under the plan.<sup>184</sup> Under this alternative, a registered investment company issuing periodic payment plan certificates, or any depositor of or underwriter for such company, must give written notice

<sup>176</sup> *Id.* at 4914. It was anticipated that the refund privilege would discourage sales of contractual plans to persons who would probably be unable to fulfill the payment obligation under the plan. *Id.* at 4906.

<sup>177</sup> Conference Report, *supra* note 146, at 4945.

<sup>178</sup> *Id.*

<sup>179</sup> *Id.* at 4946.

<sup>180</sup> *Id.*

<sup>181</sup> *Id.*

<sup>182</sup> 15 U.S.C. §§ 80a-27(d)-(h) (1970), amending 15 U.S.C. § 80a-27 (1964).

<sup>183</sup> 15 U.S.C. § 80a-27(h) (1970), amending 15 U.S.C. § 80a-27 (1964).

<sup>184</sup> 15 U.S.C. § 80a-27(d) (1970).

to certificate holders of their right to redeem their underlying shares for cash.<sup>185</sup>

### III. THE SCOPE OF DISCLOSURE

#### A. Regulated Activities

##### 1. Registration of Investment Advisers

The 1970 Amendments amended the Investment Advisers Act of 1940 by repealing the exemption from registration provided by section 203(b)(2) of the Act for advisers whose only clients were investment companies.<sup>186</sup> The new amendment requires such advisers to register under the Advisers Act and makes them subject to the antifraud, book-keeping, reporting and inspection requirements of the Advisers Act, as well as to the restriction on fees set forth in amended section 205.<sup>187</sup> The new amendment does not affect the existing exemption from registration for two types of investment advisers: (1) those whose only clients are insurance companies, and (2) advisers (other than those who actually advise investment companies) who do not hold themselves out generally to the public as such and who have had less than fifteen clients during the most recent twelve month period.<sup>188</sup> The amendment increases substantially the number of investment advisers who are subject to, and required to register under, the Advisers Act.<sup>189</sup>

New proposed rule 202-1 under the Advisers Act<sup>190</sup> would imple-

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<sup>185</sup> As to any investor who has missed three payments or more, such notice must be given within thirty days following the expiration of fifteen months after the issuance of the certificate. 15 U.S.C. § 80a-27(e) (1970). If one or more payments have been missed after the fifteen month period but prior to the expiration of eighteen months after the issuance of the certificate, such notice is to be given at any time prior to the expiration of the eighteen-month period. *Id.* The written notice must inform the planholder of the value of his account as of the date of the notice and the amount to which he is entitled upon surrender of his certificate. *Id.* The custodian bank must also notify the investor of the sales charges to be deducted from future payments, and the planholder is given forty-five days from the mailing of this notice to cancel the plan and recover the specified amounts. 15 U.S.C. § 80b-3(b)(2) (1970).

<sup>186</sup> 15 U.S.C. § 80b-3(b)(2) (1970), amending 15 U.S.C. § 80b-3(b)(2) (1964).

<sup>187</sup> 15 U.S.C. § 80b-5 (1970), amending 15 U.S.C. § 80b-5 (1964). See also S. Rep. No. 91-184, 91st Cong., 1st Sess. 44-45 (1969), and H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 39-40 (1970).

<sup>188</sup> 15 U.S.C. § 80b-3(b)(3) (1970).

<sup>189</sup> At the time of enactment of the 1970 Amendments, 25 states provided for registration of investment advisers, 19 of which expressly exempted advisers whose only clients were investment companies. 1 CCH Mutual Funds Guide ¶ 2523 (1971). The impact, if any, of the new amendment to the exemption provisions of the Advisers Act upon state policy remains to be assessed at a later time. See also SEC Investment Company Act Release No. 6336 (Feb. 2, 1971), reprinted in [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,951.

<sup>190</sup> SEC Investment Advisers Act Release No. 353 (Dec. 18, 1972), reprinted in [Current] CCH Fed. Sec. L. Rep. ¶ 79,146 (1972).

ment the expanded coverage of the registration requirements of the Act. Under the proposed rule, which is expected to become effective without any change in principle, if an adviser is not autonomous under specified tests, the controlling persons of the adviser, and affiliates of such controlling persons, would be required to register with the SEC as investment advisers.<sup>191</sup> Persons or their affiliates who control a registered adviser may be required to register regardless of whether such controlling person derives a profit from the services it provides to the adviser.<sup>192</sup> Exemption from SEC registration would be available only where (1) a majority of the directors of the registered adviser is independent (as defined in the rule) of the person controlling the adviser and of any affiliate of such controlling person; (2) the registered adviser has, in the opinion of a majority of the independent directors, adequate capital independent of the controlling person or its affiliates to carry on its advisory business; (3) the officers, other than administrative officers, of the registered adviser are independent of the controlling person and any affiliate thereof; (4) the advisory representatives employed by the registered adviser are independent of the controlling person or affiliate, and make recommendations independent from such persons, and (5) research information conveyed to the registered adviser meets certain specified criteria.<sup>193</sup> Under the proposed rule, a wide range of officers, directors, stockholders holding five percent or more, and control persons of adviser affiliates would be compelled to register with the SEC and would become subject to certain record keeping, antifraud and other provisions of the Advisers Act. The effect on parents of advisers which are organized and operating from a jurisdiction outside the United States has not been officially determined.

In new section 206(a) of the Advisers Act,<sup>194</sup> the SEC was given general power, comparable to that granted by section 6(c) of the Investment Company Act,<sup>195</sup> to exempt individual persons or transactions from any provision of the Advisers Act or the rules promulgated pursuant to it. The SEC's disciplinary powers in section 203<sup>196</sup> over investment advisers and associated persons of such advisers were expanded to conform to those powers applicable to broker-dealers and other persons under the 1934 Act.<sup>197</sup> Similarly, new section 203(d) of the

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<sup>191</sup> The definition of control would be that of § 2(a)(9) of the 1940 Act. 15 U.S.C. § 80a-2(a)(9) (1970).

<sup>192</sup> SEC Investment Advisers Act Release No. 353 (Dec. 18, 1972), reprinted in [Current] Fed. Sec. L. Rep. ¶ 79,146 at 82,483 & n.3 (1972).

<sup>193</sup> *Id.* at 82,483.

<sup>194</sup> 15 U.S.C. § 80b-6(a) (1970), amending 15 U.S.C. § 80b-6 (1964).

<sup>195</sup> 15 U.S.C. § 80a-6(c) (1970).

<sup>196</sup> 15 U.S.C. § 80b-3(e) (1970), amending 15 U.S.C. § 80a-3(d) (1964).

<sup>197</sup> 15 U.S.C. § 78k (1970).

Advisers Act provides, as does section 15(b)(4) of the 1934 Act,<sup>198</sup> that registration under the Act eliminates the need for use of the mails or other jurisdictional means to establish a violation of the law.<sup>199</sup>

In October 1972, SEC Commissioner Hugh Owens indicated publicly that federal regulation of investment advisers must be substantially strengthened, particularly in the fields of registration, financial responsibility, bonding, and conflict of interest.<sup>200</sup> The recent appointment of a special SEC Advisory Committee on Investment Companies and Advisers to recommend reform in this area reflects a trend toward further federal regulation of investment advisers.<sup>201</sup> In addition, a number of recent no-action letters have broadly interpreted the performance of certain services to require registration as an investment adviser.<sup>202</sup> These interpretations have led to increased enforcement proceedings for failure to register or to terminate certain services and practices typically utilized by investment advisers.<sup>203</sup>

## 2. Fund Holding Companies

Another important development in the investment company industry has been the pyramiding of investment companies through the use of fund holding companies—companies whose portfolios consist entirely or largely of securities of other investment companies. Before 1940 there were several closed-end investment companies which invested in other closed-end companies. Section 12(d)(1) of the 1940 Act sought to deal with this situation by prohibiting (subject to certain

<sup>198</sup> 15 U.S.C. § 78o(b)(4) (1970).

<sup>199</sup> 15 U.S.C. § 80b-3(d) (1970), amending 15 U.S.C. § 80a-3 (1964).

<sup>200</sup> BNA Sec. Reg. & L. Rep. No. 173, at A-6 (Oct. 18, 1972). Commissioner Owens stated that additional disclosures by advisers are needed "to determine whether all accounts under management are fairly treated by an adviser relative to each other and compared with the adviser's own account." He then predicted an expanded program of enforcement inspections. *Id.*

<sup>201</sup> The Advisory Committee has already submitted its first report. SEC Advisory Committee Recommendations on Reporting Requirements for Investment Companies and Advisers, [Current] CCH Fed. Sec. L. Rep. ¶ 79,159 (1972). See also Speech by A. Mostoff, Dir. of SEC Div. of Inv. Co. Reg., BNA Sec. Reg. & L. Rep. No. 193 (March 14, 1973) at E-1.

<sup>202</sup> SEC no-action letters: Frank T. Hines, July 20, 1972, reprinted in 2 CCH Mutual Funds Guide ¶ 9530 (1972); Hardy & Co., July 6, 1972, *id.* at ¶ 9526; Fred Weiler, June 1, 1972, *id.* at ¶ 9501; William Wood Enterprises, May 31, 1972, *id.* at ¶ 9502; Loran K. Lantz, May 11, 1972, *id.* at ¶ 9520; Financial Research Corp., April 5, 1972, *id.* at ¶ 9468; George L. Bedford, April 5, 1972, *id.* at ¶ 9519; Schield Stock Service, Inc., Jan. 26, 1972, *id.* at ¶ 9398; and The Media General, July 16, 1971, *id.* at ¶ 9529 (1971).

<sup>203</sup> On November 5, 1972, the SEC charged the Wall Street Transcript, a weekly publication, with failure to register under the Investment Advisers Act of 1940. The SEC asserted that most of the publication is "devoted to analyses and reports concerning securities and advice as to the value of securities and as to the advisability of investing in, purchasing, and selling securities." BNA Sec. Reg. & L. Rep. No. 176, at A-9 to 10 (Nov. 8, 1972).



exceptions) a registered investment company from purchasing more than three percent of the outstanding voting stock of another investment company unless it already owned twenty-five percent or more of such stock.<sup>204</sup> This section, however, was not adequate to cope with all of the problems which have recently arisen in this area. For example, according to the SEC's 1966 Public Policy Report, the existence of fund holding companies resulted in the imposition of additional costs on investors in the form of greater administrative expenses, sales charges, and advisory fees.<sup>205</sup> The report also noted a danger that the transactions of the underlying fund would be controlled by the holding company.<sup>206</sup>

The 1970 Amendments to section 12(d)(1) of the 1940 Act confronted some of these problems by attempting to regulate the creation, operation, and growth of fund holding companies. Under the Act as amended, investment companies may acquire the securities of other investment companies only within specified limits and subject to detailed restrictions.<sup>207</sup> New subparagraph (A) of section 12(d)(1) prohibits a registered investment company and any company or companies controlled by it from purchasing or otherwise acquiring any security issued by another investment company if, as a result of such transaction, the acquiring company or companies controlled by it will own in the aggregate: (1) more than three percent of the total outstanding voting stock of the acquired investment company; (2) securities issued by the acquired company having a total value which exceeds five percent of the total assets of the acquiring investment company; or (3) securities issued by the acquired company and other investment companies (other than treasury stock of the acquiring investment company) whose aggregate value exceeds ten percent of the value of the total assets of the acquiring investment company.<sup>208</sup> For purposes of this section, the value of an investment company's total assets is to be computed as of the time of the purchase or acquisition or as close to that time as is reasonably possible.<sup>209</sup> Securities of investment companies

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<sup>204</sup> 15 U.S.C. § 80a-12(d)(1) (1964), as amended, 15 U.S.C. § 80a-12(d)(1) (1970).

<sup>205</sup> Securities and Exchange Commission, Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 318 (1966) [hereinafter cited as SEC 1966 Public Policy Report].

<sup>206</sup> *Id.* at 316.

<sup>207</sup> See H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 10 (1970), S. Rep. No. 91-184, 91st Cong., 1st Sess. 29-31 (1969), and SEC 1966 Public Policy Report, *supra* note 205, at 311-24.

<sup>208</sup> 15 U.S.C. §§ 80a-12(d)(1)(A)(i)-(iii) (1970). See also SEC Investment Company Act Release No. 6440 (April 6, 1971), reprinted in [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,022, and SEC Investment Company Act Release No. 6834 (Nov. 23, 1971), reprinted in [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,416.

<sup>209</sup> 15 U.S.C. § 80a-12(d)(1)(G) (1970).

not registered under the 1940 Act are not excluded in determining whether the ten percent limitation has been exceeded.<sup>210</sup>

Subparagraph (B) of section 12(d)(1) further restricts the sale of mutual fund shares to other investment companies.<sup>211</sup> It prohibits a registered open-end investment fund (the acquired company), its principal underwriter, or any broker-dealer registered under the Securities Exchange Act<sup>212</sup> from knowingly selling or otherwise disposing of a security issued by such acquired company to any other investment company (the acquiring company) or any company controlled by the acquiring company, if, immediately after such transaction, (1) more than three percent of the total outstanding voting stock of the registered mutual fund would be owned by the acquiring company and any company or companies controlled by it, or (2) more than ten percent of the total outstanding voting stock of the acquired fund is owned by the acquiring company, other investment companies, and companies controlled by them.<sup>213</sup> In order to comply with these provisions, it will be necessary for mutual funds to maintain accurate and up-to-date records on all shareholders that are known to be investment companies and companies controlled by investment companies. As a further check, such records and relevant information should be made available to a fund's principal underwriters and to dealers who sell its securities. Mutual funds and their underwriters and dealers should also adopt procedures to ascertain the identity of the ultimate purchaser when any order for an unusually large amount of shares is received.

New subparagraph (C) of section 12(d)(1) imposes limitations in addition to those contained in subparagraph (A) on purchases by registered and other investment companies of securities issued by registered closed-end investment companies.<sup>214</sup> Since the stock of closed-end companies is usually bought and sold in secondary trading markets rather than through the issuance of new shares as in the case of mutual funds, it would be difficult for a seller to know what portion of a closed-end company's stock is owned by investment companies. Therefore subparagraph (C) makes it unlawful for any investment company and the companies it controls to purchase or otherwise acquire any security issued by a registered closed-end investment company if, as a result of the transaction, the acquiring investment company, other investment companies having the same adviser, and companies controlled

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<sup>210</sup> 15 U.S.C. § 80a-12(d)(1)(E)(iii) (1970).

<sup>211</sup> 15 U.S.C. § 80a-12(d)(1)(B) (1970).

<sup>212</sup> 15 U.S.C. § 78(e) (1970).

<sup>213</sup> 15 U.S.C. § 80a-12(d)(1)(B) (1970).

<sup>214</sup> 15 U.S.C. § 80a-12(d)(1)(C) (1970), amending 15 U.S.C. § 80a-12(d)(1) (1964).

by such investment companies will own more than ten percent of the total outstanding voting stock of such closed-end company.<sup>215</sup>

Certain transfers of investment company securities are exempted from the section 12(d)(1) limitations. Under subparagraph (D), the above prohibitions do not apply if the acquiring company receives the securities as a dividend, as the result of an exchange offer approved under section 11 of the 1940 Act, or as the result of a reorganization plan other than one devised for the purpose of evading subparagraphs (A) through (C) of section 12(d)(1).<sup>216</sup> Under subparagraph (E), the acquisition of investment company securities by a registered unit investment trust is exempted from the section 12(d)(1) prohibitions against the transfer of investment company interests to other investment companies.<sup>217</sup> This exemption thus applies to contractual plan companies which acquire interests in a specific mutual fund. This subparagraph also exempts securities purchased or acquired by an investment company if two conditions are met. First, the depositor of, or principal underwriter for, the acquiring company must be a broker or dealer registered under the Securities Exchange Act of 1934, or be a person controlled by such a broker or dealer. Second, the investment portfolio of the acquiring company must consist solely of the security which is being acquired.<sup>218</sup>

Although new subparagraphs (A), (B) and (C) impose extensive restrictions on the creation and operation of fund holding companies,<sup>219</sup> new subparagraph (F) permits the continued creation and operation of registered fund holding companies subject to certain limitations.<sup>220</sup> These conditions are specified in guidelines promulgated by the SEC's former Division of Corporate Regulation (now under the administration of the Division of Investment Management Regulation):<sup>221</sup> First, a registered fund holding company may not offer or sell any security issued by it at a public offering price which includes a sales load of more than 1.5 percent. Second, a fund holding company, together with all of its affiliated persons, cannot purchase or acquire in the aggregate more than three percent of the total outstanding stock of any other investment company. Under prior law, a holding company could purchase five percent of the total outstanding stock of an investment company which had a policy of concentration, or three percent of the total outstanding stock of an investment company which did not have such

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<sup>215</sup> 15 U.S.C. § 80a-12(d)(1)(C) (1970).

<sup>216</sup> 15 U.S.C. § 80a-12(d)(1)(D) (1970).

<sup>217</sup> 15 U.S.C. § 80a-12(d)(1)(E) (1970).

<sup>218</sup> *Id.*

<sup>219</sup> 15 U.S.C. §§ 80a-12(d)(1)(A)-(C) (1970).

<sup>220</sup> 15 U.S.C. § 80a-12(d)(1)(F) (1970).

<sup>221</sup> SEC Investment Company Act Release No. 6440 (April 6, 1971), *supra* note 208.

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a policy.<sup>222</sup> Since a fund holding company's ability to purchase shares of an investment company is now dependent upon the action of the broad class of affiliated persons defined in section 2(a)(3) of the 1940 Act,<sup>223</sup> procedures should be instituted to assure that a fund will be able to determine, prior to making an investment, the eligibility of the particular security for the fund holding company's portfolio. Third, no investment company whose securities are owned by a fund holding company may be required to redeem more than one percent of its securities held by such holding company during any period of less than thirty days. Previously, a fund holding company was entitled to unlimited redemption within seven days after tender for that purpose, except during those emergency periods specified in section 22(e) of the 1940 Act.<sup>224</sup> The effect of this redemption limitation must be considered together with the obligation of the fund holding company itself to redeem its securities within seven days as specified in section 22(e).

### 3. *Factoring, Discounting and Real Estate Businesses*

Under the original provisions of the 1940 Act, companies primarily engaged in factoring, discounting or financing real estate were excluded from the definition of "investment company" unless they were engaged in the business of issuing face-amount certificates of the installment type or periodic plan certificates.<sup>225</sup> The latter category of company was not excluded in order to combat abuses that had arisen prior to 1940 in the sales of such securities on an installment basis, usually to relatively unsophisticated investors of limited means.<sup>226</sup> Section 3(c)(5), as altered by the 1970 Amendments, effectively limits the prior exclusion by including within the definition of an investment company all those companies which issue securities redeemable at the election of the holder.<sup>227</sup> The amendment has the effect of extending the regulatory provisions of the Act to a number of previously uncovered companies.

### 4. *Oil and Gas Funds*

The 1970 Amendments do not alter the present exemption from registration provided for oil and gas funds under section 3(c)(9) of the 1940 Act.<sup>228</sup> At the House hearings on the 1970 Amendments, the oil industry argued that the Investment Company Act recognized that syndicated drilling by oil fund companies is more like an operating

<sup>222</sup> 15 U.S.C. § 80a-12(d)(1) (1964), as amended, 15 U.S.C. § 80a-12(d)(1) (1970).

<sup>223</sup> 15 U.S.C. § 80a-2(a)(3) (1970).

<sup>224</sup> 15 U.S.C. § 80a-22(e) (1970).

<sup>225</sup> 15 U.S.C. § 80a-3(c)(6)(C) (1964).

<sup>226</sup> H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 17 (1970).

<sup>227</sup> 15 U.S.C. § 80a-3(c)(5) (1970), amending 15 U.S.C. § 80a-3(c)(5) (1964).

<sup>228</sup> 15 U.S.C. § 80a-3(C)(9) (1970).

company directly engaged in the drilling business than a passive investment company.<sup>229</sup> To insure direct tax benefits to an investor in a particular program, his participation is limited to certain activities and includes no overall interest in the operation of the sponsor company. Moreover, regulation by the Investment Company Act would cripple the ability of members of the industry to make immediate decisions free from outside influences.<sup>230</sup>

During early testimony on section 3(b)(5) of H.R. 11995 and S. 2224, SEC Chairman Budge stated that the SEC would not object to an amendment of that section that would continue the present exemption for oil and gas investment companies if certain requirements were added, the most important of which were (1) participants must pay \$10,000 or more during every consecutive twelve-month period, (2) participants are not afforded any cash surrender or redemption rights, and (3) no front-end load or other disproportionate charges would be made.<sup>231</sup>

In August 1972, legislation (S. 3884)<sup>232</sup> prepared by the Securities and Exchange Commission to regulate oil and gas drilling funds, entitled the "Oil and Gas Investment Act of 1972," was introduced in the Congress at the SEC's request.<sup>233</sup> The SEC bill would exempt from registration "oil programs" of companies which directly engage in actual oil drilling operations, but would extend to registered oil programs many of the provisions of the 1940 Act concerning self-dealing transactions. For transactions involving affiliates, which are regulated under section 17(d) and rule 17d-1 of the 1940 Act as discussed above, the requirement of prior SEC approval would not be imposed. No hearings were held on the bill, and the measure is expected to receive new consideration by the Ninety-Third Congress.

## B. *Specific Disclosure Provisions*

### 1. *Changes in Investment Policy*

The 1970 Amendments to the Investment Company Act also increased restrictions on management's discretionary power to change

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<sup>229</sup> Hearings on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 1st Sess. 149-50, 936-50 (1969).

<sup>230</sup> Id. See also BNA Sec. Reg. & L. Rep. No. 164, at A-14 to 15 (Aug. 8, 1972).

<sup>231</sup> Hearings, *supra* note 229, at 872-74 (testimony of SEC Chairman Hamer Budge).

<sup>232</sup> S. 3884, 92d Cong., 2d Sess. § 4 (1972).

<sup>233</sup> BNA Sec. Reg. & L. Rep. No. 164, at A-14 (Aug. 8, 1972). This legislation was introduced pursuant to the decision of the Senate-House Conference Committee on the 1970 Amendments to strike the provisions of the 1940 Act regulating oil and gas programs on the understanding that the SEC would submit new legislation on that subject within eighteen months after passage of the Amendments. Conf. Rep. No. 163, 91st Cong., 2d Sess. (1970), reprinted in U.S. Code Cong. & Ad. News 4943, 4944 (1970). See also S. 1050, 93d Cong., 1st Sess. (1973) (Sens. McIntyre and Williams).

a fund's investment policies. Before 1970, section 8 of the 1940 Act required funds to reveal in their registration statements policies regarding several specified activities<sup>234</sup> as well as policies which the fund elected to treat as "fundamental."<sup>235</sup> Section 13(a)(3) added strength to section 8 by providing that any deviation from a stated "fundamental" policy would be unlawful unless authorized by a majority of the fund's shareholders.<sup>236</sup> The two purposes of these sections were to provide investors with sufficient basic information to enable them to select a fund intelligently, and to assure investors that they might safely rely on the stated policy information furnished by a particular fund.

The protection afforded investors by these sections was not wholly adequate, however. As evidenced by the case of *Green v. Brown*,<sup>237</sup> a statutory loophole allowed funds to escape section 13 sanctions if the policy from which they deviated had not been labeled "fundamental" in the fund's registration statement. In *Green*, the trial court found that the fund in question had deviated from an investment policy which, according to the registration statement, could not be altered without shareholder approval. The shareholder's complaint was dismissed, however, on the ground that the policy in question had not been labeled "fundamental" in the fund's registration statement and therefore was not subject to the section 13(a) prohibitions.<sup>238</sup> Although the holding admittedly seemed illogical and contrary to the purpose of sections 8 and 13,<sup>239</sup> the court concluded that it was the responsibility of the Congress rather than the courts to correct the inconsistency.<sup>240</sup>

The 1970 Amendments were intended to eliminate that loophole. New section 8(b)(2) requires funds to reveal in their registration statement all investment policies, other than those relating to the certain activities specified in section 8(b)(1), which are changeable only with shareholder approval.<sup>241</sup> In addition, new section 8(b)(3) imposes a similar disclosure requirement for policies which the fund deems fundamental.<sup>242</sup> The sanctions for violation of the disclosure requirement were also expanded by the 1970 Amendments. Under new section 13(a)(3), shareholder approval is now required for any

<sup>234</sup> 15 U.S.C. § 80a-8(b)(1) (1964), as amended, 15 U.S.C. § 80a-8(b)(2) (1970).

<sup>235</sup> 15 U.S.C. § 80a-8(b)(2) (1964), as amended, 15 U.S.C. § 80a-8(b)(3) (1970).

<sup>236</sup> 15 U.S.C. § 80a-13(a)(3) (1964), as amended, 15 U.S.C. § 80a-13(a)(3) (1970).

<sup>237</sup> 276 F. Supp. 753 (S.D.N.Y. 1967).

<sup>238</sup> *Id.* at 756.

<sup>239</sup> *Id.*

<sup>240</sup> For a more extensive discussion of the subsequent history and significance of *Green*, see Comment, 13 B.C. Ind. & Com. L. Rev. 1113, 1123-24 & n.68 (1972).

<sup>241</sup> 15 U.S.C. § 80a-8(b)(2) (1970), amending 15 U.S.C. § 80a-8(b)(1) (1964).

<sup>242</sup> 15 U.S.C. § 80a-8(b)(3) (1970), amending 15 U.S.C. § 80a-8(b)(2) (1964).

changes in investment policies which are described in the registration statement as changeable only after shareholder approval or which are labeled as "fundamental" policies.<sup>243</sup>

Ostensibly these new provisions would allow an investor to rely safely on the information disclosed in a fund's registration statement. It has been suggested, however, that under new sections 8 and 13 funds may, through careful drafting of their registration statements, present certain policies designed to attract investors and yet retain sufficient flexibility to engage in a wide variety of investment practices without subjecting themselves to liability for deviating from stated policies.<sup>244</sup> If in the registration statement a policy is not labeled "fundamental" or is not described as being changeable only upon shareholder approval, the fund is free to deviate from that policy at will. In short, the provisions regarding disclosure of investment policies, even as amended, may still provide problems for the unsophisticated investor.

## 2. *Undisclosed Capital Gains Payments*

Prior to the Investment Company Act of 1940, the payment of dividends out of undifferentiated corporate income was a common practice in the mutual fund industry.<sup>245</sup> This lack of disclosure confused many fund shareholders who were unable to distinguish distributions of capital gains from dividends paid out of a fund's current investment income. This confusion was seriously detrimental to shareholders for several reasons. First, for income tax purposes, a capital gain dividend from an investment company is treated as a capital gain to the shareholder.<sup>246</sup> If an investor failed to recognize a capital gains dividend as such, he would lose the tax advantage of the preferential rates applied to capital gains. Second, the undisclosed distribution of capital gains was often connected with certain selling practices.<sup>247</sup> Sometimes the price paid for a security by an investor included an amount which would later be paid out to the investor as a dividend. Because a sales charge was paid on the total price of the security, it was argued by some that the shareholder was in effect paying a sales commission on his own dividend.<sup>248</sup> Third, in the minds of some shareholders, much of the measure of a fund's success is reflected in its current investment income. The inability of an investor to differentiate

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<sup>243</sup> 15 U.S.C. § 80a-13(a)(3) (1970), amending 15 U.S.C. § 80a-13(a)(3) (1964).

<sup>244</sup> Comment, *supra* note 240, at 1124-25.

<sup>245</sup> Comment, *The Mutual Fund Industry: A Legal Survey*, 44 *Notre Dame Lawyer* 732, 792 (1969) [hereinafter cited as *Mutual Fund Survey*].

<sup>246</sup> Int. Rev. Code of 1954, § 852(b)(3)(B).

<sup>247</sup> *Mutual Fund Survey*, *supra* note 245, at 792-93.

<sup>248</sup> *Id.* at 792.

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between capital gains dividends and regular investment income dividends prevented him from making a thorough appraisal of the fund's current performance.

Section 19 of the Investment Company Act of 1940<sup>249</sup> was designed to provide investors with adequate identification of capital gains dividends. That section made it unlawful for a fund to pay dividends out of capital unless the distribution was accompanied by a written statement adequately disclosing to the shareholder the source or sources of the payment.<sup>250</sup> This provision was not sufficient to dispel shareholder questions, however. The 1940 Act did not limit the frequency of capital gains distributions, and consequently a fund was able to make such payments whenever it chose. Adoption by a fund of an erratic distribution pattern inevitably resulted in shareholder confusion. Indeed, it was recognized in the Investment Company Institute's "Guide to Business Standards" that a distribution of capital gains at any time other than at the end of a fiscal year or shortly thereafter could cause investors to believe that the capital gains distributions were part of the fund's regular dividends paid out of investment income.<sup>251</sup>

New section 19 is intended to eliminate investor misunderstanding regarding capital gains distributions. The disclosure requirements of the 1940 Act were retained and are now incorporated in section 19(a).<sup>252</sup> Section 19(b), which was created by the 1970 Amendments, limits the frequency with which a fund may distribute its realized long-term capital gains. A fund may now make such a distribution only once every twelve months, except as the SEC may permit for the protection of investors and the public.<sup>253</sup> Such a limitation on distributions should relieve fund managers of the pressure to realize capital gains on a frequent and regular basis and would mitigate the improper sales practices related to the distribution of capital gains.<sup>254</sup> The frequency limitation should also reduce the administrative expenses involved with quarterly or semi-annual capital gains distributions.<sup>255</sup>

New rule 19b-1<sup>256</sup> limits a "regulated" investment company, as

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<sup>249</sup> 15 U.S.C. § 80a-19 (1964), as amended, 15 U.S.C. § 80a-19 (1970).

<sup>250</sup> 15 U.S.C. § 80a-19 (1964), as amended, 15 U.S.C. § 80a-19 (1970).

<sup>251</sup> S. Rep. No. 91-184, 91st Cong., 1st Sess. (1969), reprinted in U.S. Code Cong. & Ad. News 4897, 4924 (1970).

<sup>252</sup> 15 U.S.C. § 80a-19(a) (1970), amending 15 U.S.C. § 80a-19 (1964).

<sup>253</sup> 15 U.S.C. § 80a-19(b) (1970).

<sup>254</sup> SEC 1966 Public Policy Report, supra note 205, at 194-95.

<sup>255</sup> Id.

<sup>256</sup> SEC Investment Company Act Release No. 6834 (Nov. 23, 1971), reprinted in [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,416. The new rule is declared effective with respect to distribution made in taxable years beginning on or after January 1, 1972, other than distributions made pursuant to section 855 of the Code, of gains realized prior to that date. Id.



defined in the Internal Revenue Code,<sup>257</sup> to a single distribution of long-term capital gains realized by the fund during any one taxable year, except for a supplemental distribution under section 855 of the Code<sup>258</sup> which does not exceed ten percent of the fund's prior capital gains distribution. The one exception in the rule to the single-distribution requirement permits a regulated investment company to take advantage of the "spillover" provisions of the Code under which certain distributions made after the close of a taxable year are considered as made during that year. This enables investment companies to distribute such realized gains without making them taxable to the fund.

Rule 19b-1 limits a registered investment company which is *not* a "regulated investment company" to one distribution of long-term capital gains in any one taxable year. It also includes a clarifying provision which permits a unit investment trust to distribute capital gains dividends received from a "regulated investment company" within a reasonable time after receipt.<sup>259</sup>

The new rule allows a registered investment company, when faced with unforeseen circumstances, to request timely authorization to make a distribution which would not otherwise be permitted under the rule.<sup>260</sup> The SEC indicated that relief would be granted to a "regulated investment company" under this provision only where the initial distribution was made late in the taxable year and the likelihood of a "spillover" distribution exceeding ten percent of the initial distribution could not reasonably have been foreseen, and noted that under the Code a "regulated investment company" may avoid a "spillover" distribution by making a single distribution with respect to a taxable year after the close of such year.<sup>261</sup>

### 3. *Reporting Civil Litigation to the SEC*

In order to provide the SEC with more information concerning litigation in which funds or their affiliates are involved, section 33 of the original 1940 Act imposed certain disclosure responsibilities on a fund or any of its affiliated persons who were defendants in a derivative suit involving "an alleged breach of official duty."<sup>262</sup> The section also required a fund and its affiliated persons who were involved in such a suit to file with the SEC copies of the pleadings and the court

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<sup>257</sup> Int. Rev. Code of 1954, § 851(b)(4)(A)(ii).

<sup>258</sup> Int. Rev. Code of 1954, § 855.

<sup>259</sup> SEC Investment Company Act Release No. 6834 (Nov. 23, 1971), *supra* note 256.

<sup>260</sup> *Id.*

<sup>261</sup> *Id.*

<sup>262</sup> 15 U.S.C. § 80a-32 (1964), as amended, 15 U.S.C. § 80a-32 (1970).

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record after a final judgment on the merits had issued or after a settlement or compromise had been approved by a court of competent jurisdiction.<sup>263</sup>

These disclosure requirements in section 33, however, provided the SEC with only limited information regarding litigation involving mutual funds. A change was needed which "would permit the Commission to be kept informed of the progress of the litigation from its outset in the trial court, and would make it possible for the Commission to promptly take such action as may be appropriate."<sup>264</sup> In response to this need for greater disclosure, the 1970 Amendments expanded the filing requirements of section 33 to apply to copies of all pleadings, verdicts, or judgments filed with the court or served on a party as well as copies of any proposed settlement, compromise, or discontinuance in a derivative suit by a fund shareholder against an officer, director, adviser, trustee or depositor of a fund.<sup>265</sup> Also under new section 33, copies of motions, transcripts or other documents filed in, or issued by, the court or served on a party must be filed if requested by the SEC.<sup>266</sup> Any document delivered to the fund or to a party defendant must be transmitted to the SEC within ten days after receipt of the document.<sup>267</sup> Any document filed in court or delivered by the fund or party defendant must be filed within five days after the filing or delivery.<sup>268</sup>

A document need not be filed by any person if the same document has already been filed by another person.<sup>269</sup> In cases involving multiple defendants, in order to avoid duplicate filings, it is expected that the defendants will agree to designate one among them to file the necessary documents.

### CONCLUSION

The new law implements a large number of changes in the prior law which are of importance to the practical operation of the mutual fund industry, and expands significantly the regulatory role of the SEC and the NASD. Expanded, as well, is the scope of judicial review over internal investment company operations, including regulation and review of investment adviser compensation, sales loads, structure of contractual plans, composition of fund boards, procedures for approval

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<sup>263</sup> *Id.*

<sup>264</sup> S. Rep. No. 91-184, *supra* note 251, at 4937 (1970).

<sup>265</sup> 15 U.S.C. § 80a-32 (1970), amending 15 U.S.C. § 80a-32 (1964).

<sup>266</sup> 15 U.S.C. § 80a-32 (1970).

<sup>267</sup> 15 U.S.C. § 80a-32(A) (1970).

<sup>268</sup> 15 U.S.C. § 80a-32(B) (1970).

<sup>269</sup> SEC Investment Company Act Release No. 6506 (May 5, 1971), reprinted in [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,048.

of investment advisory and underwriting contracts, conduct of affiliated or "interested persons," selection of fund accountants, duties of fund directors, distribution of long-term capital gains, insider trading restrictions, retroactive registration of fund shares, and operation of fund holding companies. The registration and disciplinary powers of the SEC under the 1940 Act and the Investment Advisers Act have also been expanded. Philosophically, the new Act is disposed toward limiting the benefits obtainable from fund operations by managers and affiliated persons, reducing management compensation to "reasonable" levels, strengthening the watchdog role of fund disinterested directors, and providing more meaningful and precise standards with respect to disclosure of fund operations. Fund operations will not necessarily be made easier for management but, it is hoped, day-to-day operations will not prove to be so heavily regulated that the allocation of management energies to effecting proper investment performance on behalf of stockholders will be unnecessarily diluted. Additional time for observation of investment company operations under the 1970 Amendments, as implemented by the currently increasing number of SEC releases and staff interpretative and no-action letters, is necessary to determine whether the Amendments represent a meaningful and creative regulatory statute, justifying the twelve years of exhaustive study, congressional consideration, and SEC interpretation from which the Investment Company Amendments Act emerged.