CONFERENCE MEMORANDUM ON
<u>WHARTON SCHOOL SIZE STUDY</u>

DATE:	April 25, 1962		
TIME:	11:00 A.M. to 3:05 P.M.		
PLACE:	Wharton School of Finance and Commerce University of Pennsylvania Philadelphia, Pennsylvania		
PRESENT:	Wharton School	-	Professors Friend, Herman, Vickers, and Brown (the latter until 12:00 Noon)
	SEC staff	-	Messrs. Conwill and Pines

The purpose of this conference was to enable the SEC staff to obtain from the Wharton School people who had worked on the Investment Company Size Study their informal views as to how regulation of investment companies under the Investment Company Act could be improved.

Preliminarily, Professor Friend said that he would be able to send us only one or two conformed copies of the final manuscript of the Wharton School report, because the School has so few copies remaining of certain of the chapters. They definitely expect to be able to submit the conformed copies by May 31, 1962. If we can furnish them with extra copies of the existing chapters, they will undertake to conform them also. The Wharton School people will also make annotations in the Summary Chapter of the conformed copies only; they have no objection if the Government Printing Office, or the SEC staff, should undertake to annotate the Summary Chapter in the final printed version.

The Wharton School people will confer (probably through Professor Vickers) with the GPO regarding certain technical details involved in the printing. They will also visit our offices at the appropriate time to proofread and check the printed draft.

Prof. Friend also will write a preface or introduction to the report. He asked whether the SEC intends to write something similar. Mr. Conwill said that this matter, more particularly the kind of transmittal letter to send to the House and Senate, and also a public release on the report, are now under consideration by the Commission, but that Prof. Friend need not await the determination of those decisions before writing his preface. Prof. Friend will also furnish us with a suggested form of acknowledgments to be included in the report.

Mr. Conwill stated that he will give Prof. Vickers the name of a GPO staff member to contact concerning the printing details. Mr. Conwill also stated that he would speak to Andrew Stevenson, professional staff member of the House Committee on Interstate and Foreign Commerce, concerning the matter of printing the report.

The discussion then turned to the specific suggestions and recommendations which the Wharton School people gave us.

<u>Disclosure Recommendations</u>

1. Information as to the sales load and the investment advisory fee rate, which is now given in the prospectus and some of which is also included on the front page of the prospectus, perhaps ought to be presented in more prominent fashion. In addition, the investment advisory fee rate perhaps should be given on the front page of the prospectus and should also be stated in terms of a percent of income (preferably excluding capital gains, but possibly also including capital gains), and not merely as a percent of average net assets.

2. The disposition of brokerage business ad the basis for such disposition should be set forth fully in the prospectus and, to the extent possible, should also be given on the front page. Specific information should be given in the prospectus as to the identity of the affiliated broker. They also suggested that, since an existing stockholder of a fund does not receive a copy of the prospectus, such information ought also to appear in the annual report to stockholders.

3. Contractual Plans -- The prospectus should show the varying sales charge to planholders in relation to the different periods held. The front page should also give the cost to the planholders of drop-outs and the experience of the particular plan in drop-outs.

4. The fund's prospectus should indicate clearly the nature of the ultimate control and primary affiliation of the controlling interest, with particular reference to brokerage and selling costs. While this is now in the prospectus, it should be highlighted. For example, it should be made clear that ultimate control of Dreyfus Fund is held by a brokerage concern.

5. There should be more information supplied to the unaffiliated or independent directors and to prospective investors on the sales charge and the investment advisory fee rate. There should be comparisons of these charges and rates with those of other funds. The SEC itself might assist in this process by maintaining current public information on such items. It could prepare statistical frequency distributions of such items. The Wharton School people are not in agreement among themselves as to requiring the prospectus of a fund to show performance comparisons with other funds, since this involves a great deal of judgment factors.

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The discussion then turned to the following topics:

More Independent Directors

The definition of what constitutes an independent or unaffiliated director -- i.e., one who is not an affiliated person of the investment adviser, or an officer or employee of the investment company -- should be tightened, and the Investment Company Act should be amended to require that the independent directors should constitute a majority of the board rather than, as at present, not less than 40%. As one method of tighening the definition, the Wharton School people suggested that the SEC should be given veto power over the selection of the independent directors, somewhat along the lines of the veto power given the Federal Reserve Board in respect of Class C directors of the 12 member Reserve Banks.

The SEC should also issue a public release setting forth its views on the obligations or duties of directors of the funds, particularly with respect to the independent directors.

Again with reference to tightening the definition of independent director, the Wharton School people suggested that relatives of persons who are affiliated with the investment adviser, or relatives of officers or employees of the investment company, should perhaps not be regarded as independent. In addition, the definition might also provide that where a director serves on the boards of two or more funds which have a common adviser, such director cannot be regarded as being independent. They stated, however, that they have not yet thought out fully the way in which the definition of independent director should be tightened.

Limitations on Management Continuing the Present Organizational Structure

This discussion turned essentially to two points: (1) the loading charge and the investment advisory fee; and (2) other types of management activities, including the disposition of brokerage business. Their views on these two points are as follows:

1. The loading charge and the advisory fee -- Apart from the front-end load situation in contractual plans, the Wharton School people would not put any limitation on either item, although Prof. Herman stated that he thought it would be better to withhold judgment on the question of the loading charge until completion of the Wharton School study of selling practices, which has been undertaken for the Special Study of Securities Markets.

These views are dependent on continuation of the present structure of the industry. As to the front-end load companies, they agree that there probably should not be any front-end loading at all.

As to the investment advisory fee, they do not recommend regulating it because that would get into the area of price fixing in a free market. Front-end load, however, is, in their view, a deceptive mechanism the sole justification of which is getting the salesman rampantly to sell shares of a fund under a contractual plan because of the incentive of earning high commissions in the first year.

2. Other types of management activities

Brokerage -- The Wharton School people very strongly recommend action to permit mutual funds to own seats on the exchanges, particularly the New York Stock Exchange. Also, there ought to be a more flexible rate schedule on securities transactions on the exchanges. They recognize that the problem of rate schedules goes beyond the mutual fund industry. They further stated that perhaps there ought to be a prohibition of brokerage to affiliated brokers or to dealers for selling shares of the fund; or else the amount of brokerage given to affiliated brokers ought to be limited to, say, 10% of the brokerage business of the fund. These suggestions, however, would be unnecessary if the fund could have a seat on the exchange.

Churning -- If the fund has a seat on the exchange, or if brokerage to an affiliated broker is limited as discussed above, churning would not really be a problem. The Wharton School people, incidentally, referred to Preston Moss Fund and Oppenheimer Fund as examples of the investment advisory fee being based on or affected by brokerage transactions (or realized capital gains), although in the former fund there is a limitation on the amount of the fee in terms of a percent of net asset value.

Abolition of the Shell -- Two ways of eliminating the so-called fund "shell" were considered, namely, (1) integration of the investment adviser into the mutual fund, and (2) integration of the fund into the investment adviser. The Wharton School people recommend the No. 1 type of integration, but not with an easy conscience. This is so partly because the public has bought stock of investment advisers in good faith. With respect to the second type of integration, which they do not recommend, this would result in an investment counselor-fund type organization. The present fund shareholder would then own a participation certificate in what would amount to a common trust fund. Voting rights would not be required in such a situation.

They noted that the Investment Advisers Act prohibits an investment adviser who is subject to that Act from charging a fee based on capital gains. (See Section 205(1) of that Act.)

During lunch, the discussion continued with respect to the recommendation of integration of the adviser into the fund. Following lunch, there was a question period at which we explored various of the above suggestions, as well as other possibilities. For example, we asked whether they thought that officers of a fund ought not to be permitted to be affiliated with the investment adviser. The Wharton School people said they had not given consideration to this problem. Offhand, they thought such a requirement might add to the operating expense of the fund. We then raised the question of whether the president or chief executive officer of the fund should also be required to be one of the independent directors. They said this might be a good idea.

We also asked whether they thought it would be advisable, assuming the investment adviser is not integrated into the fund, that the adviser not be permitted to be affiliated with the principal underwriter. Profs. Vickers and Herman thought that this was not a particularly important problem, although Prof. Friend thought it might be a worthwhile prohibition.

We said that we would look into the legislative history of why the SEC has certain jurisdiction over fees charged by members of the stock exchanges. (See Section 19(b) of the Securities Exchange Act of 1934.) This might be relevant to the question of whether the Commission ought to be given jurisdiction over sales load on mutual fund shares.

Prof. Vickers said that his two basic objections to front-end load were (1) the cost to the planholder because of drop-out; and (2) the fact that, in terms of actuarial or present worth concepts, the total sales load is really more than an annual 9% sales load deduction, if consideration is given, as he contends it should, to the fact that in most contractual plans 50% of the first year's payments are deducted for sales load.

We said that we would examine the legislative history on the 9% maximum sales load figure permitted by Section 27(a)(1) for contractual plans, and also on the fee jurisdiction conferred on the Commission in Section 27(a)(5).

The Wharton School people, in answer to one of our questions, stated that they had no separate recommendations to make as to give-ups and reciprocals since their recommendations, discussed above, automatically took care of these two items.

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