REPORT NON-PUBLIC

December 19, 1963

To the Securities and Exchange Commission:

Upon the Commission's release of the Wharton School's Study of Mutual Funds in August of 1962 we were directed by the Commission to conduct a comprehensive study of the structure of the investment company industry. This study was undertaken to permit an evaluation, from the regulatory point of view, of the Wharton School report, and of the comments made therein which, as stated in the Commission's letter transmitting the report to the Congress, raised "questions of broad policy whether some of the practices and patterns which originated in an earlier time and under different conditions and which have become conventional within the broad tolerances of the [1940] Act should be reconsidered."

We have been engaged in conducting that study, and are now pleased to submit the first part of the report of our conclusions and recommendations. This part focuses on management structure. We expect to be able to submit the second part, which will focus on the underwriting and sales structure and on portfolio transactions and the allocation of brokerage, around the first of January. Shortly thereafter we expect to submit our views on the compliance report and inspection program.

This report, which is intended for Commission and staff use only, should serve as a basis for discussion and consideration of the proposed recommendations. As part of its review of this report the

Commission will want to consider the procedures to be followed in presenting the recommendations finally determined upon to the Congress and the public, and the procedures to be followed in implementing such recommendations. In this connection, our suggestion would be that following Commission consideration of our report and discussion of the recommendations, exploratory discussions be held with representatives of the industry and of the bar.

The present report does not set forth in textual form the basic facts upon which the conclusions and recommendations are based. Such facts, however, have already been submitted to the Commission in the reports of the Wharton School and the Special Study of Securities Markets, and in the reports of our own case studies.

I. Management Structure

The Wharton School report drew attention to the management and fee structure in the investment company industry. The report pointed out that while the cost of managing investment companies fails to increase directly with the growth in asset size of companies, the savings from such increase in size have not generally been passed on to or shared with shareholders in the form of reduced fees, and that the fees charged investment companies are typically at a higher rate than those charged other clients for investment services. It questioned generally whether management fees were being arrived at through arm's length bargaining, and the effectiveness of the "unaffiliated" director as a means of protecting shareholder interests in this area.

The spate of shareholder derivative suits involving open-end investment companies in recent years has also focused attention on the fee area.

During the course of our study we have examined fee structures and costs of operation and have interrogated a number of "unaffiliated" as well as "affiliated" directors of investment companies. We have concluded on the basis of our study that in the investment company industry there is an absence of competitive or other institutional or economic pressures which are effective in keeping management fees at reasonable or arm's length levels. As a result many of these fees are higher than appears reasonable in the light of the costs involved or than are paid by sophisticated individual or institutional investors for similar investment management.

Basically, the reason for the lack of price competition in the investment company industry is that the investment adviser and principal underwriter of an investment company have traditionally been considered to have some kind of proprietary interest in the investment company. This attitude has been buttressed by the presence of key executives of both the adviser and underwriter on the board of directors and among the officers of the investment company. These "affiliated" directors and officers of the investment company also typically constitute its full-time employees and dominate its operations and policies. As a consequence, investment companies have not asked themselves the question a prudent individual investor would -- under all the circumstances, has the investment company secured the best adviser available at the best price possible? The competition which exists in the investment company industry is between investment companies for customers. And, although there are some exceptions, this competition has not been based on the relative costs of the service sold.

The fee structure which has predominated in the investment company industry has, as outlined in the Wharton Report, been based on a fixed percentage of net assets and has, at least until very recently, clustered around 1/2 of 1 percent of net asset value annually. This fee structure and rate derives from an earlier time when individual fund complexes were considerably smaller than they are today. In spite of the great growth of the investment company industry and particularly the emergence of huge investment company complexes, the fee structure has not changed and rates have changed inadequately.

Although the problem of reasonable fees was not one with which the framers of the Investment Company Act of 1940 were particularly concerned, there are a number of tools in the Investment Company Act which have a bearing on it. One of these is disclosure. A basic thesis of the securities laws has been that if persons are forced to disclose the amount of money they are paid by a publicly held enterprise, they will be restrained by the threat of unfavorable publicity from seeking more compensation than is reasonable. Thus, in the normal corporate situation where a conflict of interest typically exists in determining the compensation of officer-directors, disclosure of the amount paid by the corporation and its subsidiaries to any such officer-director who receives over $30,000 a year and to all directors and officers as a group is required in the prospectus and in proxies subject to the Commission's proxy rules.

The patterns of disclosure utilized in the usual corporate situation have been applied to the investment company industry. However, the methods of doing business in the investment company industry including the mode of compensating persons in it are quite different from those found in the usual corporate situation. The result has been that disclosure has been relatively ineffective as a tool for keeping fees reasonable.

The typical investment company operation involves a relatively unique and complex corporate structure, whereby most if not all of the management and investment advisory functions of the investment company are delegated to a separate advisory firm, which may also be affiliated with the principal underwriter or a portfolio broker for the company, and which usually controls or is represented on the board of directors of the investment company. A feature of this unique and complex corporate structure is that only rarely does the investment company itself pay its officers or directors any substantial amount of compensation. The primary sources of compensation are the affiliated advisory firm, principal underwriter and portfolio broker. As a consequence, the disclosure requirement mentioned above that an issuer must disclose in the prospectus or proxy statement the aggregate direct remuneration of each of its officer-directors who receive from it or its subsidiaries in excess of $30,000 a year does not yield very significant information.

In addition, these disclosure rules focus on remuneration received from only one investment company and its subsidiaries. However, in the investment company industry the significant relationship is not one of parent-child but of brother-sister. It is not unusual to find that one individual serves a complex of brother-sister funds, each of which is a separate company. The complex is, in substance if not form, one basic business entity.

It may be helpful to describe the consequences of applying the present disclosure rules in terms of a concrete illustration. Henry T. Vance serves in an executive capacity with seven investment companies and three service organizations associated with them. In 1962 he was paid a substantial salary by two of the investment companies: $224,530 by Massachusetts Investors Growth Stock Fund, Inc. of which he is a director and chairman of the executive committee, and $30,580 by Century Shares Trust of which he is a trustee. He also received a substantial partnership distribution, $230,249, from Boston Management and Research Company which is the investment adviser to two investment companies of which he is either president or chairman of the board, and which provides investment information to the managers of three other investment companies including two swap funds of which he is chairman of the board. In addition, he was paid a substantial salary, $28,750, and received a substantial amount of dividends, $42,876, from Vance, Sanders & Co., Inc., which is the manager of the two swap funds, and the wholesale distributor of the five other investment companies which he serves and of Massachusetts Investors Trust. In addition his share of Vance Sanders' 1962 retained earnings was $13,615. However, under the present rules there is no single prospectus, annual report or proxy statement which discloses that Henry Vance made $570,600 from all his investment company activities. Nor is the reader of the prospectus, annual report or proxy statement of one of the investment companies clearly informed that Mr. Vance spends a very substantial part of his time and receives a very substantial part of his income from other investment company activities.

To be sure, present rules do require the disclosure of the gross amount of the advisory fee going to the management firm, and the gross amount of underwriting or portfolio brokerage commissions going to any affiliated underwriter or broker-dealer. This information permits the investor, among other things, to determine the per share cost of the investment advisory contract. He is also specifically informed how much money per share is spent to cover the total expenses of the investment company. However, in light of the small per share value typical in the investment company industry, the per share cost seems negligible. In terms of the total amount of shares typically held by individual shareholders, cost figures do not create a significant impact.

Even in those rare instances where shareholders may be concerned about costs, there is very little opportunity for them effectively to express that concern. As in most corporations, existing management (which in the investment company industry typically means those directors of the investment company who are affiliated with its investment adviser or principal underwriter or principal broker or any combination of these) has control over the proxy machinery. However, unlike the usual corporate situation, it is hard to conceive of any case in which it would be worth the while of any investment company shareholder to go to the expense of waging a proxy battle solely to obtain a lowering of the fee.

The shareholder does not even usually have an opportunity effectively to express his displeasure with, say, the advisory contract by means of his vote. The advisory contract need not be submitted to shareholders unless it is a new contract. Thus, the old contract may be continued in effect without shareholder approval even though the conditions in which the contract operates have radically changed. If the advisory contract is submitted to shareholders, the proposition on which they vote amounts, in effect, to whether the investment company will operate with an investment adviser or without an investment adviser. In most cases, this gives the shareholder no meaningful choice, since it would be an unacceptable alternative for the investment company to operate without an investment adviser. The directors of the investment company are not (and do not pretend to be) equipped for the task of managing the investment company's assets.

The only way in which a shareholder can effectively express his dissatisfaction with existing advisory arrangements is through the medium of a law suit. Although many law suits have been commenced for the ostensible purpose of recovering excessive fees, except for the unusual situation presented in the Managed Funds case, not one plaintiff has won his case on this point. A substantial number of the cases have been settled. These settlements reflect the fact that even token settlements from the point of view of the investment company involved can result in liberal compensation for plaintiffs' attorneys, thus diminishing their incentive to press the long, expensive and difficult litigation which would be required.

The framers of the Investment Company Act appear to have realized that the shareholders in an investment company would not be in a position to look after their interests by themselves and also to have realized that some of the directors might be diverted from protecting the interests of the shareholders by their own interests in an adviser, underwriter or broker-dealer serving the investment company. Consequently, they provided for unaffiliated directors who would act as a kind of watchdog over the interests of the shareholders. These unaffiliated directors were assigned a particularly critical role in approving the arrangements made for providing investment advice to the investment company. However, the unaffiliated directors have not adequately fulfilled the role assigned to them.

There are a number of reasons for this inadequacy. Primarily, it can be explained by the way in which unaffiliated directors are chosen and in the way in which they view their function. The affiliated directors normally choose the unaffiliated directors. Since the affiliated directors generally are the full-time operating personnel of the investment company, they educate the unaffiliated directors in the philosophy of the investment company industry and in the business operations of the particular company. The unaffiliated directors, whose contact with the investment company industry and the investment company is typically very much part time, tend to rely on the affiliated directors and identify with them rather than with the shareholders. Under the circumstances, the watchdog has become a pet.

Growing out of and along with this structure has been the feeling among many persons in the investment company industry that an investment company belongs to the adviser or underwriter who founded the company, and the fact that the industry operated (at least until recently) under the umbrella of a fairly uniform fee scale. Consequently, most unaffiliated directors have been unaware of what was expected of them in the area of fee negotiation.

Even in those situations where an unaffiliated director may have been moved to question the desirability of retaining a particular adviser or the appropriateness of a particular fee, he could legitimately conclude that he had little chance of forcing any changes. If, for example, the adviser kept the investment company books or sold its shares or both, the ability of the unaffiliated directors to bring competitive pressure on the adviser was severely limited.

It is significant that in those cases where fee scales have been reduced, the initiative for such reduction generally appears to have come from management itself rather than from the unaffiliated directors. In some cases the reductions appear to have resulted from simple self-restraint or calculated business judgment; in other cases, they appear to have been prompted by external pressures such as the extension of the Wharton School Study into the fee area or a desire to settle a derivative suit.

Another method of applying pressure to insure reasonable fees is direct governmental action. However, the Commission has been loath to intrude itself into that area. The only regulation of this sort has taken the form of maximum limitations imposed by certain states on the ratio which total fund expenses may bear to the net assets of the investment company. Such limitations are, however, by their nature rough and are effective only to protect the investor in the small rather than the large investment company.

The present situation is, in our judgment, particularly in view of the recent vast growth in investment company size, an unhealthy one. It is detrimental to present shareholders. It can only serve to impair confidence in the investment company industry. Its existence and the consequent harm to shareholders indicate that to this extent the Investment Company Act of 1940 has failed to fulfill its purpose of insuring that investment companies are managed in the interests of shareholders rather than their managers.

There are a number of possible remedies for the problem. Among them are the following:

> All investment companies, or perhaps only those over a certain size, might be prohibited from delegating any part of the advisory or management function to a separate entity (unless it is owned by the investment company or complex which it serves), thus requiring an internalized management for the company or for the complex of which it is a part. Such internalization might take differing forms. It might involve a system under which the persons providing investment management to the investment company or complex would be prohibited from working at the same time for outside advisory organizations serving other clients, or for brokerage or underwriting organizations serving the investment company or complex or other clients. Or it might involve a system under which the persons providing investment

management to the investment company or complex would be permitted to have some or all of these outside interests.

Each member of the board of directors as well as some or all of the principal officers might be required to be unaffiliated with the investment adviser, principal underwriter or portfolio broker.

Direct governmental regulation of the fee structure might be imposed, perhaps by imposing maximum expense ratios for investment companies, varying with the size of the company or the complex of which it is a part.

Each of these approaches would cause significant changes in the structure and operation of the investment company business as it now exists. Each in our judgment poses serious problems.

Complete internalization of investment management, under a system which would prevent the advisory personnel from having outside advisory, underwriting or brokerage interests, would require the most drastic re-arrangement in structure and business conduct for the great proponderance of investment companies. For all investment companies it would eliminate the opportunity of utilizing the services of investment advisory organizations which also serve non-investment company clients. For the smaller investment companies, it could result in an overall increase in expenditures. The investment company would have to supply whatever capital is necessary to support the management operation. And the advisory personnel who may presently serve other advisory clients or share in underwriting or brokerage profits would have to obtain their sole support from the management function. Even in some medium or large-sized companies, these factors might also result in increased expenditures, at least initially. In states like California which impose an upper limit on expense ratios, some companies, but particularly the smaller ones, would be required to abandon their sales efforts because there might be no employee or outside organization which was willing to subsidize the company's activities for a period of time. Another difficulty arises because in many situations the only person who would be willing to serve as the investment company's underwriter is a person connected with its investment adviser. Neither the smaller nor even many of the larger investment companies may be willing or able to make the expenditure of capital or time that might be necessary to support their own underwriting effort. Further, the imposition of a framework under which compensation is limited to a salary from the investment company may in some cases make it difficult to attract able personnel and may also discourage the investment of time and money required for building a new investment company. Finally, in those cases in which shares in the investment adviser are widely held, difficult (although not necessarily insuperable) problems concerning the interests of these public shareholders would be raised.

Internalization of a kind could also be achieved without prohibiting the persons performing the investment advisory services for investment companies from serving outside advisory, underwriting, or brokerage interests. To the extent that the person served the investment company he would be paid a salary which would reflect the amount of time spent. Although problems would exist in properly allocating personnel time and use of capital between the internalized and non-internalized functions, such problems are no more difficult than those which arise today in the proper evaluation of the fairness of the investment advisory fee. While it is possible and perhaps even likely that such a limited form of internalization might make the control of fees somewhat easier in practice than the present externalized structure, it would not eliminate the need for almost all the safeguards that are needed for an externalized structure. Disclosure of outside interests involving the investment company would still be necessary, as would the presence of unaffiliated directors to oversee allocation practices and the reasonableness of the salaries charged to the investment company. Moreover, a limited form of internalization would not resolve all the problems raised by complete internalization. For example, the limited form of internalization would not in every case dispose of the questions concerning the supplying of capital necessary to support an advisory operation, the attraction of able personnel and the making of satisfactory arrangements for the distribution of investment company shares which are raised by complete internalization. Nonetheless for many investment companies -- particularly the larger ones -- some form of internalization may be a very effective way to obtain competent investment advice at the most advantageous price. However, since this is not necessarily true for every investment company or even every investment company or complex over a certain size, we are reluctant to recommend its imposition as the required industry arrangement so long as a reasonable expectation exists of achieving a climate conducive to fair fee arrangements through more flexible means, which would permit each investment company to develop the management structure most suited to its needs.

Prohibiting affiliated persons from acting as investment company directors or officers would shift the balance in the corporate structure wholly in favor of the unaffiliated persons. Since it would no doubt mean that at least some of the unaffiliated persons would have to become full-time operating personnel, it would create what for at least some companies would probably be an additional item of expense. In addition, it goes beyond what presently appears essential for the investor's protection. Investors who purchase investment company shares often do so in reliance upon the reputation of the investment adviser and the affiliated persons on the investment company board. There is nothing improper or undesirable about this reliance. What the investor needs, however, is someone to be his alter ego, to play the role which a sophisticated investor would play in arranging and negotiating for the management of his securities and in carefully supervising the investment manager to insure that he performs his tasks properly and fairly -- a role which, by the very nature of the investment company vehicle and the smaller shareholder for which it is designed, the investment company shareholder cannot adequately perform for himself.

As for direct governmental control of the fee structure, a fundamental precept of our system is that government intervention should occur only where private forces prove either unable or unwilling to achieve an adequate solution. We believe that in the investment company industry these private forces have not been given the fullest opportunity to demonstrate their willingness or ability to provide solutions; on the other hand, we also believe that the possibility of government intervention in appropriate cases in this industry is a necessary device to insure that these private forces can operate in the most effective fashion.

We feel that the principal answers to the problems presented, however, lie in the areas of disclosure and the unaffiliated director. Adequate disclosure can help engender the self-restraint so necessary in any financial institution. In addition, we think that the unaffiliated directors, given the proper information and encouragement to act vigorously in behalf of the shareholders in arranging for and supervising the investment management, can supply a more adequate check than they so far have against the investment company's being run for the benefit of management. In the past, as has been pointed out above, this institution has not been particularly effective. But in our judgment this is so because the unaffiliated directors have not in the past been told clearly what their role ought to be and because many of the tools given them have been inappropriate to their task.

Reliance on the unaffiliated directors and their ability to arrive at solutions appropriate to the investment company they serve, rather than the imposition of some more rigid solution, has the virtue of permitting the development of a variety of solutions to fit the variety of fact situations which can exist in the investment company industry. For example, in some circumstances it may, as was discussed above, be desirable to have some form of internalization for the investment company. In others it may not. It is preferable that such judgments be made on the basis of the particular facts in the individual case by the persons closest to those facts. Our recommendations taken as a whole are intended to establish a climate which would permit the widest possible opportunity for making such judgments and which would be conducive to reasonable fee arrangements. They contemplate, however, a residual power in the Commission to act in any important individual case where for one reason or another the ability to make such arrangements is severely restricted.

The nature of our recommendations can be summarized as follows:

First, significant financial information not now readily available would have to be disclosed to both the unaffiliated directors and the shareholders.

Second, the Commission would take an active role in explaining to unaffiliated directors the nature of their duties.

Third, the statute would be amended to make even clearer to the unaffiliated directors that they have a special responsibility as the protectors of the investment company shareholders and to encourage them to play an independent role vis-a-vis the affiliated directors.

Fourth, the available sources of competent persons to act as unaffiliated directors of open-end investment companies would be expanded by removing the present restrictions applicable to directors and other personnel of banks which are members of the Federal Reserve System.

Fifth, the statute would be amended to make the renewal of the advisory contract a more meaningful event for both the unaffiliated directors and the shareholders.

Sixth, the Commission should be prepared, as a matter of policy, to act swiftly and directly to remedy those situations in which the process of bargaining about fees is so inhibited that fair management fees cannot be established by this process alone.

These recommendations would not effect major structural changes in the investment company industry. They would, however, give those forces which the framers of the Investment Company Act thought necessary to insure that investment companies were being operated in the interests of their shareholders an opportunity to be effective in the context of the investment company industry as it now exists and as it now is developing more than 20 years since the passage of the Act.

Our specific recommendations are these.

1. To fit disclosure requirements more meaningfully into the investment company context, we recommend that the Commission's requirements respecting disclosures in prospectuses and proxy statements be expanded in the manner indicated by the attached Schedule A.[1/] The thrust of the recommended changes is to require profit and loss data attributable to the investment company business, and balance sheets, for the investment adviser and its affiliates, the principal underwriter and its affiliates, and any affiliated broker-dealer who performs a substantial amount of portfolio business for the investment company or the complex of which it is a part. With respect to individuals who realize in excess of $30,000, the changes would expand disclosure to include amounts attributable to the investment company business whether or not paid by the issuer-investment company. For each of these individuals information would also have to be given regarding the proportion of his business time spent on investment company related matters. Only with disclosure of such information can the reasonableness of the fees paid by investment companies to these related service organizations and their personnel be properly assessed. And only if such disclosures are made to all the shareholders will the self-restraint which public disclosure fosters be encouraged.

1/ Schedule A also contains recommendations for expanded disclosures relating to the underwriting contract and portfolio transactions. Matters relating to underwriting and portfolio transactions will be discussed in the second part of this report.

2. To encourage independence of action on the part of the unaffiliated directors and to strengthen their role, we recommend that:

a. The Commission should issue a release which defines the nature of the position of the unaffiliated director in an investment company, outlines some of his major responsibilities and offers suggestions as to how these responsibilities might be met. A suggested draft of a release is attached to this memorandum. The release is written in the context of the present statute and can (and should) be issued before any of the statutory or rule changes suggested below are made. In addition to issuance of an initial release of this kind, we recommend that the Commission be alert to the task of providing guidance to unaffiliated directors by issuing releases in the future discussing those areas of responsibility in which there is shown to be confusion or uncertainty or where broad knowledge of the factual problems involved may not exist.

b. The Act should be amended to provide that director nominations for persons as unaffiliated directors can be made only by a vote of a majority of the unaffiliated directors. This provision is necessary to assure the unaffiliated director that his position (and consequently his loyalty) is not owed to the affiliated directors. Although this provision would not prevent the affiliated directors from making suggestions with respect to such nominations, it would require them to persuade a majority of the unaffiliated directors that any such nominee is a desirable choice. And it would help bring home to the unaffiliated director that he must approach his tasks in an independent manner.

c. The proxy rules and the rules governing the issuance of prospectuses should be amended to make clear that a majority of the unaffiliated directors have the right to include in any proxy statement or prospectus any proposal or material it deems desirable even though a majority of the board of directors opposes inclusion of any such proposal or material. These changes will enable the unaffiliated directors to speak directly to the shareholders in a meaningful way and will help place some limitations on the extent to which the affiliated directors can dominate the lines of communication to shareholders.

d. The Act should be amended to provide that the directors who are neither investment advisers, principal underwriters or regular brokers for the investment company nor affiliated with an investment adviser, principal underwriter or regular broker for the investment company shall, as a group, be known as the Shareholders' Committee; and that this Committee shall have the responsibility for negotiating the arrangements made to furnish the investment company with investment advice and to provide for the distribution of the investment company's shares. This amendment does not depart substantially from the concept embodied in Section 15 of the Act that a majority of the unaffiliated directors must approve the entering into or renewal of investment advisory and distribution contracts. Nor does this amendment contemplate relieving the affiliated directors of any of the fiduciary responsibilities, -- for example, the responsibility to disclose all information relevant to the negotiation to the unaffiliated directors and the responsibility not to propose or approve any unfair arrangement --, which they presently have toward the investment company and its shareholders. However, constituting the unaffiliated directors into a separate Shareholders' Committee and specifically giving that Committee the responsibility for negotiating the investment advisory and distribution contracts would help emphasize to the unaffiliated director his role as a special guardian of the shareholders' interests. The position of the affiliated director as a person with interests which may be adverse to those of the shareholders would also be emphasized.

e. At the same time that the above changes are made, the Act should be amended to eliminate the anomaly in Section 10(d) that permits investment companies which charge no sales load to have, under certain circumstances, only one unaffiliated director. This provision appears to have been placed in the Act in recognition of the fact that investment-counselor sponsored investment companies are purchased because of the reputation of the investment adviser and are "bought rather than sold." Of course, investment companies sold with a load may also be purchased because of the reputation of their investment advisers -- who sometimes are investment counselor firms. More important, even though no-load investment companies are not merchandised as aggressively as some other investment companies that fact does not necessarily make the conflicts of interests in the management fee area any less severe for them. In order to deal with these conflicts in the manner contemplated by our recommendations, reliance cannot be placed on one man standing alone. This does not mean that greater abuses in the fee area have occurred in no-load funds than in load funds. The point is that the problem here is essentially the same for load and no-load companies -- and the solutions should also be the same.

f. Action should be commenced by the Commission to eliminate the barrier which presently exists against allowing directors, officers or employees of Federal Reserve member banks from serving in similar capacities for open-end investment companies. This would eliminate an unnecessary limitation on the sources from which qualified persons may be drawn to serve as unaffiliated directors. The present barrier arises from rulings of the Federal Reserve Board construing Section 32 of the Banking Act of 1933 1/ which provides:

> "No officer, director, or employee of any corporation . . . primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments."

These rulings rest on the assumption that a primary (in the sense of substantial) part of the business of an open-end investment company is "the issue and distribution of its shares." 2/ These rulings do not generally apply to closed-end investment companies.

The rulings appear to misconceive the real nature of the investment company business. Investment companies exist to provide a vehicle by which investment management can be supplied on a commingled or pooled basis to persons who are unable to afford individual investment counseling. The shares which

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1/ 12 U.S.C. § 78.

2/ 27 Fed. Res. Bul. 399 (1941).

an investment company issues, in effect, evidence the purchase by the investor of this service. There seems no greater reason to prohibit a bank director from serving as a director of an open-end investment company than from serving as a director or executive of an investment counseling firm.

The continuous offering of shares by open-end investment companies does not squarely present the kind of problem which Section 32 of the Banking Act of 1933 sought to reach. The major evil which it sought to combat was, as stated by Justice Douglas, in Agnew v. Board of Governors of the Federal Reserve System, "that a bank director interested in the underwriting business may use his influence in the bank to involve it or its customers in securities which his underwriting house has in its portfolio or has committed itself to take."[1/] First, it should be noted that open-end investment companies, themselves, are not in the underwriting business with respect to their own shares in the sense meant by Justice Dougles. They do not hold the securities they issue at risk. They have little greater incentive to persuade a bank to purchase or recommend their shares than do other companies on whose boards member bank directors, officers and employees may serve. It is true that open-end investment companies are unique in that they issue their shares continuously; however, there does not seem to be a substantial difference in this respect between open-end investment companies and those companies, particularly public utility companies, which make public issues of securities at regular and frequent intervals and on whose boards member bank directors, officers and

1/ 329 U.S. 441, 447 (1947).

employees may serve. Indeed, the danger that a bank may purchase the shares of an open-end investment company for its fiduciary accounts is probably less than the danger that it will purchase the shares of an industrial company of which one of its directors is an officer or director. Although there is, of course, a possibility that the bank may influence its customers to purchase open-end investment company shares, a bank may also influence its customers to purchase the shares of an industrial company or a closed-end company of which one of its directors is an officer or director. No company is wholly uninterested in the market for its shares.

In addition, elimination of the present barrier would not in any meaningful sense increase the danger of banks' improperly purchasing or recommending the purchase of open-end investment company shares. Under present practices member bank directors and officers can serve on the advisory boards of open-end investment companies; and open-end investment company directors can serve on advisory committees (including trust committees) of member banks. Member banks can serve as investment advisers of open-end investment companies; and open-end investment companies can place deposits in member banks and build up corporate trust department relationships with member banks, which would dispose the banks to recommend the shares of the investment company to its customers. The present rule has not prevented the closest kind of ties between open-end investment companies and their managements and member banks and their managements. All it does is prevent bank personnel from serving the investment company shareholder in the role most meaningful to him -- that of unaffiliated director.

This situation can, in our judgment, be remedied by administrative action of the Federal Reserve Board without statutory amendment, either through a change by the Board in its interpretation of the meaning of Section 32, or through issuance of a general regulation as permitted by Section 32, where in the judgment of the Board officer-director ties with member banks would not "unduly influence the investment policies of such member bank or the advice it gives to customers regarding investments."

3. To supplement the above recommendations with respect to disclosure and the role of the unaffiliated director, we recommend that:

a. The Act should be amended so that investment advisory and underwriting agreements are permitted to continue in effect (subject to the present 60-day cancellation privilege) for a period not to exceed three years. The Act should also be amended so that at the end of the contract period the new agreement (whether or not its terms are the same as the old agreement) must be submitted to shareholders for approval. The Act places broad responsibilities on unaffiliated directors in the negotiation of investment advisory and underwriting agreements and it is difficult for them adequately to fulfill these responsibilities if they are called upon to review them within relatively short periods. In addition, the developments (such as the growth in size of the funds) which may require changes in the agreements can be better evaluated when their effects are viewed over a three-year period. A three-year contract period makes the function of negotiating investment advisory and underwriting agreements an event of significance. The submission of the agreements to shareholders at least every three years is important for at least two reasons: it permits shareholders to participate in the making of arrangements for investment advice and distribution of shares, and it causes vital information concerning such arrangements to be communicated to all the shareholders periodically.

b. The Commission should, as a matter of policy, be ready to intervene in those situations where disclosure and the bargaining process have not produced a fair fee by commencing an action which asks the court, in effect, to establish a fair fee. Commission willingness to intervene is necessary to make the bargaining process work. In some situations an investment company has become locked into a particular investment adviser and it is difficult for the unaffiliated directors (even if they wish to do so) to bargain effectively with respect to the investment advisory agreement. In cases where investment management is internalized and there are no "outside" directors, no bargaining is possible because there are no disinterested persons available to pass upon the compensation for those performing the investment management. Some mechanism is needed to redress the imbalance existing in these situations. Private litigation has not provided this mechanism. The only effective mechanism available is, in our judgment, Commission willingness to act.

The Commission already has some power to act under Section 36 of the Act albeit in a way which permits the Commission to raise the question of the fairness of the fee only in a context in which it must prove that one or more officers or directors of the investment company or the investment adviser was guilty of a "gross abuse of trust" or "gross misconduct" in the setting of the fee. If the Commission establishes its case, it may enjoin the offending person from continuing to act as an officer or director of the investment company or as the investment adviser, as the case may be; and the offending person appears to be subject to liability, at least in a private action, for any damages which the investment company has sustained. The difficulty with proceeding under Section 36 is that it seems to require a court to find that a person has, in effect, sinned -- a finding which a court is often reluctant to make. In addition, it may also expose the directors to personal liability -- an exposure which the court may be unwilling to countenance, particularly for those directors who are paid nominal compensation and who are required to spend only part-time on their directorial tasks.

These difficulties may perhaps be reduced if the Commission frames an action which names as defendants only the investment adviser and the investment company directors affiliated with it and asks only that each defendant be enjoined from continuing to act in its present capacity until a fair fee is charged and until the difference between the fee charged and what constitutes a fair fee is restored to the investment company. The Commission's theory would be that under the doctrine of cases such as Globe Woolen Co. v. Utica Gas & Electric Co., 224 N.Y. 483 (1918), affiliated directors and the investment adviser commit a gross abuse of trust when they propose or approve an investment advisory agreement containing a provision for an unfair fee. As Justice Cardozo said in Globe Woolen:

> "the constant duty rests on a trustee to seek no harsh advantage to the detriment of his trust, but rather to protest and renounce if through the blindness of those who treat with him he gains what is unfair."

By confining itself to a request for restitution from the adviser, the Commission would not make the court face the unpleasant task of imposing personal liability on the directors -- particularly a liability in excess of the benefit the directors personally derived from the payment of the unfair fee.

There are, we recognize, a number of very serious problems with respect to any proceeding under Section 36. Among these problems are: that the determination that the presence of an unfair fee can result in a finding of gross abuse of trust under Section 36 may result in imposition, in a later case, of personal liability against directors unaffiliated with the investment adviser;[1/] the uncertainties surrounding the possible res judicata effect of those cases in which settlements have been effected; the possible effect of shareholder ratification in changing the standard of proof so that the fee must be found to constitute waste or something approaching it; the difficulty in finding clear support in the legislative history for Commission use of Section 36 as a basis for establishing patterns pursuant to which fair fees can be more easily negotiated.

If the Commission feels that Section 36 does not provide an adequate basis for it to intervene where disclosure and the bargaining process have not produced a fair fee, we recommend that the Act should be amended to include a new Section 36A which would provide:

1/ But see SEC v. The Capital Gains Research Bureau, Inc. in which Justice Goldberg seems to indicate that the substantive standard for what constitutes fraud may vary depending upon the parties involved and the relief requested.

"This conclusion moreover, is not in derogation of the common law of fraud, as the District Court and the majority in the Court of Appeals suggested. To the contrary, it finds support in the process by which the courts have adapted the common law of fraud to the commercial transactions of our society. It is true that at common law intent and injury have been deemed essential elements in a damage suit between parties to an arms-length transaction. But this is not such an action. This is a suit for a preliminary injunction in which the relief sought is, as the dissenting judges below characterized it, the 'mild prophylactic,' 306 F.2d, at 613, of requiring a fiduciary to disclose to his clients, not all his security holdings, but only his dealings in recommended securities just before and after the issuance of his recommendations.

The content of common-law fraud has not remained static as the courts below seem to have assumed. It has varied, for example, with the nature of the relief sought, the relationship between the parties, and the merchandise in issue. It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages."

The Commission is authorized to bring an action in the proper district court of the United States or United States court of any Terriroty or other place subject to the jurisdiction of the United States, alleging that the fees or compensation, provided for under any agreement or arrangement pursuant to which investment advice or management services or both are being or are to be provided to one or more registered investment companies, are unfair to such company or companies. If the Commission's allegations of the unfairness of any such fees or compensation are established, the court shall require the person or persons receiving such fees or compensation to refund to the registered investment company or companies the difference, for the period commencing with the date the action was begun and ending with the date the agreement or arrangement expires, between the fees or compensation paid and what the court determines to be a fair fee or compensation. This section shall not be construed as providing a cause of action to any one other than the Commission; nor shall the failure of the Commission to commence an action pursuant to this section be used by any person in any proceeding, civil or criminal, to show that the fees or compensation paid by an investment company or companies for investment advice or management services or both are fair.

Proposed Section 36A would permit the fairness of the fee to be questioned directly. It would not impose personal liability on the directors. In addition, it would limit recovery of excessive fees to the period beginning with the date the action is instituted. It could be used only by the Commission and not by private litigants.

Neither enactment of Section 36A nor Commission willingness to act under Section 36 should give rise to the expectation that the Commission will use its power under the Act frequently, since the basic thrust of the Act and of our recommendations is for advisory fees to be set through the bargaining process. However, we feel that the willingness of the Commission to institute suit in the appropriate case is indispensable to setting the framework within which the bargaining process may take place.

Office of the Special Counsel
to the Commission on Investment
Company Act Matters

II. Portfolio Transactions

A. Allocation of Portfolio Brokerage

1. To help minimize the impact which each of the various problems in the portfolio brokerage area has on the investment company and on sales practices, we recommend that a high priority be given by the Commission and by the stock exchanges to a restructuring of the exchange commission rates, as was suggested in the Report of the Special Study of Securities Markets. A primary goal of such restructuring should be to bring brokerage costs for large investors like investment companies more in line with the actual cost of performing the basic brokerage and execution function for them, and to reduce or eliminate the present subterranean and indirect methods of obtaining what, in effect, is a form of rebate of the "mandatory" minimum commission through reciprocal business practices. For example, either the schedule should be changed from a minimum to a maximum one, or a meaningful volume discount should be adopted.

2. To assist the independent directors of investment companies in fulfilling their general responsibilities with respect to the various conflicts of interest which are involved in the handling of portfolio transactions and the allocation of brokerage, we recommend that the Commission issue a release drawing the attention of the directors to the types of problems involved and specifically recommending that the directors require the managers of the investment company to account to them with respect to these matters on a periodic basis.

3. To improve disclosures regarding portfolio turnover and brokerage

costs, we recommend that prospectuses and in certain cases proxy statements contain the issuer's total portfolio turnover and equity portfolio turnover ratios for its last three fiscal years, the dollar amount of the issuer's total transactions, and the dollar amount of its transactions which were executed on an agency basis and the dollar amount of the brokerage commissions which were incurred with respect to such transactions. This proposal has been included in the recommendations contained in Appendix A to the first part of our report.

4. To improve further the present mechanisms under the Federal securities acts for minimizing and controlling the particular conflict of interest which is involved when a portfolio broker is affiliated directly or indirectly with the investment company or its investment adviser or principal underwriter, we recommend that the Commission require disclosure of the profits which are realized by any such affiliated broker that receives substantial commissions attributable to the investment company. These profits can then be taken into account by the directors of the company in setting the amount of any other remuneration which is to be paid by the company to the broker and its affiliated persons. This proposal has been included in the recommendations contained in Appendix A to the first part of our report.

5. To assist further in controlling the specific problems which are involved in the area of sales reciprocity, we recommend that:

a. The Commission should work with the NASD in approving standards, the substance of which would be adopted both as NASD Rules of Fair Practice and as Commission rules applicable to investment companies and their investment advisers and principal underwriters under Section 36 of the Investment Company Act, which would:

(i) Incorporate a prohibition, similar in substance to the 1949 NASA resolution and later proposals by the NASD's Investment Companies Committee, making it improper for an investment company or its investment adviser or principal underwriter directly or indirectly to promise or agree to give, or arrange to have given, to any broker-dealer any specified amount of principal or agency business or brokerage commissions as an inducement to sell or as a reward for the sale of the shares of any investment company. In the NASD's rules of fair practice it should also be made improper for any broker-dealer to participate in such a scheme.

(ii) Incorporate the policy which was adopted by the NASA in 1952, of requiring all give-ups to be remitted to the dealer or broker designated by the investment company or its investment adviser or principal underwriter not later than the 25th day of the month following the month in which the transactions are completed by payment.

(iii) Incorporate the substance of the proposal which was made in 1961 by the NASD's Board of Governors that would prevent the allocation of brokerage commissions to any firm, as an inducement to sell or as a reward for the sale of the shares of any investment company, in an amount which is materially greater than or disproportionate to the amount which is generally directed to other firms in relation to their sales volume.

(iv) Incorporate the substance of the proposal which was adopted by the NASA in 1952, as supplemented by the proposals of the Special Study of Securities Markets, which would make it expressly clear that over-the-counter give-ups and interpositioning in all their forms are improper. The rules should also articulate the duty of investment company directors and managers to assure, as stated by the Special Study of Securities Markets, that: the best terms available for portfolio transactions from the point of view of investment company shareholders are obtained without regard to the reciprocal business aspects of the transactions, the investment company itself receives the maximum benefits available from any such reciprocal business; and the choice of market for portfolio transactions is made exclusively from the point of view of these obligations, and not on the basis of rewarding broker-dealers for their sale of fund shares or for other services.

(v) Incorporate the proposal which has been made by the NASD which would make it improper for the investment company or its investment adviser or principal underwriter to direct brokerage business, as an inducement to sell or as a reward for the sale of the shares of any investment company, to individual salesmen.

(vi) The NASD rules should also incorporate the proposal which has been made by the NASD that records of reciprocity practices be kept by underwriters and be submitted to the NASD.

b. The Commission should work with the NASD toward the adoption of additional rules designed to place sales reciprocity in proper perspective. The only role which sales reciprocity can properly be permitted to fulfill is as an inevitable by-product of fund business, not as an important competitive consideration in the determination of fund sales. Rules should accordingly be adopted which would make it an improper practice for broker-dealer firms to make reciprocal brokerage business a consideration in determining which funds to promote. Further, individual differences among funds in the reciprocity they are able to distribute should not be permitted to influence the choices of individual salesmen. Broker-dealer firms should therefore be required to neutralize these differences before passing any of the benefits of reciprocity directly or indirectly on to salesmen. This could be done, for example, by requiring the pooling of all reciprocal business received from all funds before any of it is allocated to salesmen, and then allocating the pooled amount in relation to the dollar volume of sales by the salesman of all mutual funds combined. It would of course be necessary to prevent the circumvention of such a rule by indirect means such as paying salesmen a greater fraction of the dealers' discount for some funds than for others.

c. The Commission should also improve the disclosures which are required to be made in prospectuses regarding sales reciprocals. This should be done in a way which will relate the sales compensation represented by reciprocal in a meaningful way to the sales load and the dealer discount. Specifically, the issuer should be required to state for the preceding fiscal year the percentage which the commissions allocated to NYSE member firms as sales reciprocal represented of the dollar value of their sales of the issuer's shares. A general statement should also be included concerning the differences in this respect between NYSE-member firms and other firms. This information should be included in the portion of the prospectus which describes the sales load and dealer discount.

B. Capital Gains Distributions

We believe the problems in this area are sufficiently important to warrant further action on the part of the Commission. At the very least, we believe the Commission should stimulate the NASD to adopt the substance of the rules regarding distributions which have been adopted by the NASA and the Investment Company Institute. Disclosures in prospectuses could also be improved perhaps by requiring that bold face type be used for the statement that capital gains distributions should not be considered to constitute a regular yield on the shareholder's investment but are in the nature of a partial return of his investment.

We feel, however, that even these measures are unlikely to end the confusion that appears to exist in the minds of shareholders and investors regarding capital gains distributions, or eliminate the improper management and sales practices which have resulted. We believe that stronger action is warranted. So long as confusion exists in the minds of a substantial number of investors, the practice of distributing capital gains is inherently misleading. Since the distribution of long-term capital gains is no longer necessary in order to obtain "pass-through" treatment for federal income tax purposes, there appears little justification for continuation of the practice. It cannot be expected, however, that individual companies will voluntarily abandon the practice, since such action would put them at a competitive disadvantage with companies that continue to make such distributions. In our judgment, therefore, it would be desirable to amend the Investment Company Act to prohibit the practice of distributing long-term capital gains. Such a prohibition would not work as much of a change for existing stockholders as might be imagined. It is estimated that about 65 percent of all capital gains distributions are presently being reinvested through automatic reinvestment plans. Those shareholders who have been depending on regular capital gains distributions could follow a practice of redeeming periodically a portion of their holdings. We believe that the benefits of such a change outweigh in importance its possible disruptive effects for shareholders.

Accordingly, we recommend that the Investment Company Act be amended to prohibit investment companies from making periodic distributions of long-term capital gains. We are not aware of any need at this time to prohibit the distribution of short-term capital gains, which are treated differently and are subjected to certain limitations under the Internal

Revenue Code.[1/] The Commission should be alert to detect any abuses which develop with respect to short-term capital gains, however, and to take whatever action is necessary to eliminate abuses. To give the Commission the necessary power to act if such abuses develop, the amendment to the Act should include a discretionary power in the Commission to control short-term capital gains.

1/ The Internal Revenue Code treats short-term capital gains in the same way as other ordinary income of the investment company. In contrast to the treatment of long-term capital gains, at least 90 percent of the company's net ordinary income must be distributed each year in order for the company and its shareholders to receive "pass-through" treatment. However, the Code requires that less than 30 percent of the company's gross income (meaning income before deduction of expenses or capital losses) be derived from the sale of securities held for less than three months: on the other hand, it does not limit the amount of income which can be derived from sales of securities held for more than three but less than six months. The Commission requires distributions of short-term, as well as long-term, capital gains to be stated separately from distributions of dividend or interest income.

III. The Underwriting Structure

In summary, we recommend that the Commission undertake a major rule-making effort and articulation of policy regarding the extent to which an open-end investment company may bear the cost of sales. The specific outlines for such a policy are indicated above. In view of the very important and fundamental nature of any such rule-making effort, we believe that public testimony should be encouraged with respect to any rule which is proposed and that any rule which is adopted by the Commission should be accompanied by a detailed and formal statement of the Commission, to be published in its permanent reports, articulating in full the reasons for adopting the rule -- its underlying purposes, its statutory base, and its intended scope and application in the more important fact situations to which it will apply.

We have several times pointed out above the close relationship between the level of management fees and problems in the present area. If management fees paid to adviser-underwriters are not kept to reasonable levels in the light of management services alone, it is difficult if not impossible to justify interfering with subsidization arrangements for unaffiliated underwriters or sponsors of the Hugh Long-First Investors variety. It also becomes difficult to justify preventing internally managed funds like Massachusetts Investors Trust from paying some of the extra costs of special plans like reinvestment and withdrawal plans, when their competitors are able to pay such extra costs out of management fees.

Thus, the more difficult questions in this area are created by the close affiliation that exists in the typical case between investment advisers and principal underwriters. These problems could be avoided by requiring investment advisers and principal underwriters to be separate and unaffiliated organizations. Such a requirement was in fact considered by the staff of the Commission's investment trust study in 1940 but was abandoned. Such a requirement would be particularly hard on the newer and smaller investment company. It would be very difficult for such a company to find an underwriter. And if affiliation is permitted for the early stages of funds and for small funds, it is not easy to impose segregation when the fund reaches a given size. Moreover, the segregation of the underwriting and advising function would impose standards for the investment company industry which do not apply to other industries and which runs counter in many respects to business realities. For these reasons, we do not recommend that such segregation be required. We do recommend that the difficult problems created by integration be faced, however, by a simultaneous effort to keep management fees reasonable and to control the extent to which open-end investment companies may be made to bear the cost of sales, promotional, and distribution expenses. Moreover, even if segregation were imposed, action with respect to the advisory fee would still be required.