MEMORANDUM

March 16, 1965

TO: The Commission

FROM: Philip A. Loomis, Jr.
General Counsel

RE: Commission's Report on Mutual Funds

In conformity with the Commission's request, we have prepared a summary or outline of the Report which is attached hereto.

This was prepared by Dick Phillips and Morgan Shipman, but conforms to the general understanding upon which we have agreed. I believe it is a reasonable approach, although there may be a few specific items concerning which I have doubts. For example, I question the usefulness and perhaps the desirability of the suggestion that unaffiliated directors can be nominated only by other unaffiliated directors rather than by the entire board.

Attachment

<u>MEMORANDUM</u>

March 15, 1965

To: Philip A. Loomis, Jr., General Counsel

From: Richard M. Phillips and Morgan Shipman

Re: Summary of the Commission's Report on Mutual Funds.

Set forth below are summaries of the proposed contents by chapters of Commission's Report on Mutual Funds. Chapters 1-3 were prepared by Dick Phillips and Chapters 4-6 by Morgan Shipman.

CHAPTER I - INTRODUCTION

Chapter I will discuss the origins, scope and purposes of the Report.

Part A will point out that the primary purpose of the Report is to examine and evaluate the adequacy of the regulatory pattern for the mutual fund industry in the light of certain of the principal findings and conclusions of the Wharton School's comprehensive study and those of Chapter XI of the Special Study Report which dealt with certain investment company problems. It will outline generally the broad areas that have been covered by these studies which were dictated by the tremendous growth of the mutual fund industry, explain the need for Commission evaluation of the principal questions raised by the studies and describe briefly the additional data gathered by the Commission's staff to test and supplement the findings and conclusions of the two studies.

Part B of Chapter I will outline the topics covered in each subsequent chapter and define the limited scope of the Report. It will discuss the reasons why the Report is generally limited to mutual funds and why the Special Study's findings as to mutual fund selling practices are not covered. It also will make clear that the Report is not intended to be an evaluation of mutual funds as personal investment medium and that it is not to be viewed as a balanced portrait of the mutual fund industry, since it mainly discusses the problem areas within the mutual fund industry and deals with significant aspects of the industry which raise no important regulatory problems in only a limited way.

CHAPTER II - BACKGROUND

Chapter II of the Report will serve several functions. It will describe the growth of the mutual fund industry, the typical structure of the industry, the regulatory pattern of the Investment Company Act, and the effectiveness of the Act in meeting the serious abuses which led to its enactment. It will further present the Commission's views as to those aspects of mutual fund size which were not found to involve significant problems and discuss certain questions relating to small investment companies.

1) Mutual Fund Growth -

The discussion of mutual fund growth will be presented in substantially the same form as it appears in the draft of Chapter II prepared by the Henderson-Mundheim group.

2) Mutual Fund Structure -

The section on structure of the mutual fund industry will describe the corporate and trust forms of organization, the duties of mutual fund directors and the investment advisory, underwriting and administrative services involved in the operation of mutual funds. This section will also analyze the Wharton School findings with respect to the control relationships among investment advisers, underwriters and the funds, examine the reasons for these relationships and identify the areas of conflict between the interests of the funds and their advisers and underwriters.

3. The Regulatory Pattern -

A third section will discuss the abuses which led to the enactment of the Investment Company Act, the provisions of the Act that are designed to cope with those abuses and the effectiveness of the regulatory pattern in dealing with these problems. It will conclude that the Act has been effective in eliminating or mitigating these abuses and that the problems that now arise with respect to mutual funds require attention but have not caused the extensive injuries to investors that the early abuses did.

4) Problems of Size Per Se -

The section on problems of size which do not raise the most important regulatory problems will deal with the Wharton School's findings on the impact of mutual fund growth on the stock market generally and on the stability of the market in individual stocks. It will also deal with the effect of size on control of portfolio companies and on concentration within the mutual fund industry. This section will point out that the findings of the Wharton School must be evaluated 1) in the light of the increase in mutual fund size since the time of the Wharton School study, 2) the increased market participation of other types of institutional investors which were not studied by the Wharton School and 3) the fact that the Wharton School study covered a period of generally rising stock prices and the validity of its findings have not been tested in the context of long-term declining markets. The Report will state that Although the Wharton School findings that size per se has not been shown to be a significant problem in 1958 are valid, its conclusions should be subject to continuing study. Of particular concern is the tendency of the larger funds to accumulate large portfolio holdings in individual securities which could create problems of market impact and fund performance in declining markets. While this problem calls for no legislative action at the present time, it does require continuing study. The section will also conclude that the tendency in recent years of mutual funds to play a more active stockholders' role in the affairs of portfolio companies could produce positive benefits to investors generally.

5) Small Investment Companies –

The section on small investment companies will discuss certain problems relative to investor protection in connection with these companies. It will conclude that the performance of these companies is as good as the larger ones but there are frequent changes in management and investment policy. There is no evidence that these changes have harmed investors except to the extent that their expectations are defeated. Disclosure of the special risks involved is suggested.

CHAPTER III - INVESTMENT ADVISORY FEES

Chapter III will discuss the validity of the Wharton School's findings that mutual funds pay more for investment advice than do other investors with comparable portfolios and that mutual fund advisers have failed to share with shareholders the economies of size made possible by the growth of fund assets. The purpose of the chapter is to analyze the validity of these findings in the light of industry growth and fee scaledowns subsequent to 1960, evaluate the regulatory significance of any higher investment advisory costs to mutual funds that may be found and present the justification for the Commission's proposals for more effective controls in the area of advisory fees insofar as they specifically relate to the advisory contract.

Chapter III will be divided into two parts. Part A, dealing with the level of advisory fees, will seek to determine the nature and extent of the problem. Part B, dealing with regulatory controls, will discuss the basis for regulatory concern over unfair fees, the possible regulatory alternatives and the nature of and reasons for the Commission's proposals.

The discussion in part A will center around the following points:

(1) The Wharton School's findings and conclusion that there are economies of size in the management of mutual fund assets is valid. This is shown by (1) the Wharton School's analysis of the financial statements of mutual fund advisers and historical financial and operating data for mutual fund advisers and (2) by industry recognition, as reflected in the statements of its leaders and in the scaled-down fee schedules for private clients of mutual fund advisers and for pension plans and other investment advisory accounts of banks as well as by the fees charged by advisers to several mutual funds operated as collective investment mediums for banks.

(2) The Wharton School's findings that advisory fee rates tend to cluster around .05% are no longer entirely true, since virtually all of the larger funds have adopted scaled-down fee schedules based on the size of the fund's net assets. The varying significance of these scaledowns will be discussed in the light of tables showing the fee rates as a percentage of net assets for the twenty-five largest funds under fee schedules prevailing in 1960, 1962, and 1964. The conclusion will be that there has been a trend in recent years toward lower fee rates for the larger funds.

3. The most significant difference between advisory fees charged mutual funds and those charged other clients is that mutual fund fees frequently cover various administrative services performed or paid for by the investment adviser. Since the extent of the non-advisory services covered by the advisory fee vary considerably from fund to fund, the cost of investment advice to the fund can be accurately determined and comparison with other funds and non-fund advisory clients can be effectively made only if the fees are adjusted for these factors by deducting the cost of such services to the adviser. A table setting forth the estimated adjusted advisory fees for 20 of the 25 largest funds will be presented for 1962 and 1964. In two-thirds of

the cases the estimates are based on 1962 figures supplied by funds; and in the remaining instances they are estimates of the staff made on a basis which resolves all questions in favor of the adviser.

4. A comparison of the adjusted fees charged the 20 large mutual funds with fees charged to private clients of mutual fund advisers, pension funds and private investment advisory accounts of banks and several mutual funds maintained as collective investment mediums for banks will tend to support the continued validity of the Wharton School's findings that the large funds pay more for investment advice than others, despite the recent scale-downs for these funds. Although in some cases the fee is low enough so that no serious question of unfairness can be raised and in other cases higher advisory costs may be justified on the basis of performance, investment policy or other factors, there are enough instances of substantially higher advisory fees, particularly if profits earned by affiliated brokers from the funds' portfolio business are considered, as to suggest the existence of a continuing question of fairness. While there are several differences between mutual fund and non-fund advisory costs, these differences appear to cut both ways and do not justify a pattern of higher costs to mutual funds.

The discussion in Part B will center around the following points:

1) <u>The Cause for Regulatory Concern</u> -

a) To some extent higher advisory fees for mutual funds are justified by the fact that mutual fund advisers have frequently incurred considerable expense and devoted considerable effort in the management of the funds during early years when profits were small or non-existent and that in so doing they have provided small and medium size investors with investment advice at a cost lower than would be charged such investors if they had attempted to obtain investment advice individually. Although these factors may be relevant considerations in a determination of fairness, they do not warrant a conclusion that there is no reason or need for mutual fund advisers to share with shareholders the economies of size.

b) First, a mutual fund portfolio, unlike a portfolio managed by a private adviser, is not tailored to the investment needs and objectives of the individual investor and, unlike other advisory clients, the mutual fund shareholder is locked into his advisory relationship by the sales load, the capital gains tax and, in some cases, a redemption fee.

c) Second, under basic concepts of corporate laws, the fiduciary duty of mutual fund officers, directors and persons affiliated with them requires that their transactions with the fund be governed by a standard of fairness. This standard is incorporated into the Investment Company Act by the general provisions of Section 1(b) and 36 and, with respect to advisory contracts specifically, by the provisions of Section 15(b) providing for annual review.

2) <u>Inadequacy of Present Controls</u> -

a) As the Wharton School recognized, the higher fees charged mutual funds for investment advice is due to the control relationships between investment advisers and the funds which have precluded arm's length bargaining in the setting of the advisory fees.

b) To the extent that mutual fund directors have evaluated the fairness of the fee, their inquiry frequently has been limited to comparisons with the fees paid by other mutual funds, which also are not negotiated at arms length.

c) Competition in the sale of mutual funds has not exerted significant pressures on investment advisers to reduce the fees. Since the advisory fee amounts to a relatively small percentage of the individual shareholder's interest in the fund, investors understandably have not considered advisory fees a significant factor in choosing a mutual fund.

d) The payment of a gross advisory fee expressed a small percentage of net assets tend to obscure profitability and avoids conventional limitations on individual salaries. This evidenced by the lower costs of investment advice to internally managed funds.

3. <u>The Regulatory Alternatives</u> -

a) <u>Background</u>

At the time the Investment Company Act was enacted, the growth enjoyed by mutual funds was simply not envisioned. In 1940 investment companies were relatively small and the advisory fees were correspondingly modest. To the extent that abuses existed, they were not considered important enough at the time to warrant regulatory controls that would drastically affect the structure of the industry. It was felt that the requirements of periodic approval by shareholders and independent directors, augmented by the forces of competition, would be sufficient to ensure fairness in the area of advisory fees.

b) <u>Competition</u>

Awarding the advisory contract on the basis of competitive negotiation or bidding is not generally feasible if the present adviser is performing adequately. Repeated switching of advisers would be highly disruptive to fund operations, particularly in the larger funds.

c) <u>Internalization</u> -

The extent of investor injury in the advisory area is not sufficient to justify this drastic alteration of the industry structure, and for smaller funds it would not be feasible.

d) <u>Statutory Fee Schedules</u> -

This alternative would introduce unwarranted rigidity into the fee structure. Since fair compensation for advisory services depends on a variety of factors, variance among mutual fund fees is proper. A statutory fee schedule would tend to become both the minimum and maximum fee rates, thereby legitimatizing unfairness in many instances.

e) Commission Fee Regulation -

While government rate regulation has often been enacted to control fees when competition is not feasible, a requirement of Commission approval of advisory contracts would impose a heavy regulatory burden on both the industry and the Commission. It merits serious consideration only if less onerous methods have proved unworkable. This argument does not preclude a provision for administrative proceedings, instituted at the Commission's discretion to determine whether a contract is fair.

e) Strengthening of Controls Within the Existing Industry Structure -

Since each of the above alternatives raises many problems and may have an undesirable effect on the mutual fund industry and its investors, the Commission recommends that they not be adopted at the present time. There is a need, however, for clear recognition of the duty of fairness in the setting of advisory fees on the part of both the affiliated and unaffiliated mutual fund directors and for better articulation of the standards of fairness by both the industry and the Commission. Although the duty of fairness is implicit in the Act, it should be underscored by a statutory amendment which affirmatively places a duty on the directors of a mutual fund to exercise reasonable care and diligence to ensure that the advisory contract is fair and reasonable. Since mutual fund directors and investment advisers have tended generally to limit their inquiry as to fairness to the fees charged other mutual funds, the statutory amendment should expressly require consideration of all relevant factors, including the fees charged non-mutual fund clients by banks and investment advisers.

4) The Role of Disclosure -

a) While disclosure is not an adequate substitute for recognition of the duties of the investment adviser and the mutual fund directors with respect to the fairness of the advisory contract, it is an essential prerequisite to an informed evaluation of such fairness and can serve as an effective additional control. As the Wharton School concluded with respect to internally managed funds, disclosure of individual compensation and other costs incident to the advisory function has contributed to lower investment advisory costs to these funds.

b) The Commission has adequate power under the Act to provide for such disclosure. As a result of its study of the mutual fund industry, it has made important improvements in the disclosures to be made available to the unaffiliated directors and to the fund shareholders in this area. While these changes will provide more adequate information to mutual fund directors and shareholders for the purpose of evaluating advisory fees, they do not affect the duty of the investment advisor and the affiliated directors to disclose to the unaffiliated directors and the shareholders any other information that may be relevant to an evaluation of the advisory contract.

5) The Effect of Ratification -

a) In decisions approving settlements of advisory fee litigation, state courts have held that, because of approval of the advisory contract by the fund shareholders, shareholders seeking to upset the contract must show that the fees are so unreasonable as to constitute a waste of corporate assets. These decisions have the effect of changing the standard of fairness to one of grossly or shockingly excessive fees.

b) In the context of the Investment Company Act this result is unwarranted. The requirement of fairness is a statutory mandate and many courts have held that shareholders cannot ratify a violation of a statutory duty. Moreover, since the determination of a fair advisory fee is necessarily a complex business judgment, shareholders must necessarily rely on the judgment of the directors. The ultimate test whether the directors have adequately performed their duty is whether in fact the advisory contract adheres to the standard of reasonableness. This standard cannot be effectively implemented if the courts judge the advisory contract in terms of the less rigorous standard of waste.

6) Conclusion

If these proposals and those contained in Chapter 6 are adopted, the Commission believes they are likely to deal effectively with the conflicts of interest between the investment adviser and mutual fund shareholders in the area of advisory fees. Until this alternative is tested, there is no justification for more drastic solutions which would drastically change the structure of the mutual fund industry or impose the heavy burden of traditional rate regulation on the industry.

CHAPTER IV - PORTFOLIO TRANSACTIONS

Chapter IV of the report to Congress would deal with problems concerning portfolio transactions. A memorandum on Chapter IV, dated November l3, 1964, has been prepared and circulated as an attachment to Philip Loomis' memorandum of December 1, 1964 to the Commission. That memorandum analyzes the problems in the area and contains recommendations. The problems can be divided into three broad areas--general problems; problems concerning portfolio allocation; and capital gains distributions. These are discussed below.

(a) General Problems

Most of the problems in the area result from the fixed commission rate structure in the exchange market, which does not allow for price negotiation and lower rates on volume purchases which mutual funds could obtain in a free market. Therefore, the threshold question must be whether the minimum commission rate structure should be abolished or modified (e.g. -- a meaningful volume discount provided so as to allow mutual funds to obtain the proper economic benefit from their large transactions). A related question is whether the Commission should affirmatively take action to alter the rules of the various exchanges to allow mutual funds, or subsidiaries thereof, to have seats on exchanges. The position that was taken in the memorandum is that these are, by and large, questions that go beyond the mutual fund field and that, for example, the volume discount problem mush be considered separately and in light of all considerations. The same is true about exchange memberships for mutual funds or mutual fund subsidiaries.

Give-ups, permitted by exchange rules and fostered by the inflexibility of exchange commission rates, have reached their zenith in the mutual fund industry. The whole give-up structure smacks of the unsavory and perhaps is not attractive to anyone--except, of course, those who receive give-ups. Nevertheless, it would appear undesirable to ban give-ups, unless corresponding action were taken (say, a meaningful volume discount) to give mutual funds a way to obtain cheaper portfolio executions. For example, if give-ups were banned and the existing exchange commission structure were retained, the result would appear to be a tremendous pressure to fragment orders among many brokers. In many cases, this might result in poor executions and harm the funds. Although the give-up problem--as opposed to the volume discount problem and the problem concerning seats by institutions on exchanges--is primarily a problem only in the mutual fund industry, it is closely tied in with the latter two problems, and any major action concerning the give-up problem should seemingly await resolution of the volume discount and institutional seat problems.

Similar considerations are applicable to the reciprocal business problem.

Another general question is whether more publicity might be given to turnover rates through increased disclosure in fund prospectuses and proxy statements. This would seem to be a desirable step.

(b) Allocation of Portfolio Business

This portion of the November 13, 1964 memorandum deals with a series of specific problems, all discussed below.

Brokerage Affiliation

Obviously, when a broker is affiliated with the fund or with its adviser, the temptations for unnecessary portfolio transactions increase. However, the Wharton School data seems to indicate that portfolio turnover in affiliated funds is in general not much higher than for funds with no brokerage affiliation. In addition, affiliation with a broker has often led to reduced advisory fees. For example, in the Broad Street group advice is provided at cost by the affiliated broker-adviser, since the broker obtains most of the funds' portfolio business. Also Lehman Brothers has reduced its advisory fee to One William Street Fund because it is now receiving most of that fund's portfolio business. Thus, a ban on brokerage affiliation is seemingly not warranted.

With respect to over-the-counter transactions, a more basic question a presented. Should a fund be required to internalize its brokerage operations, since a fund can deal directly with marketmakers on a basis as favorable as that of any broker-dealer, including an NASD member? This presents somewhat the same problem as whether a fund is to be forced to internalize its advisory operations. The answer may well depend upon the size of the fund and the nature of the business done by broker-dealer. If the fund is small and the broker-dealer does a general over-the-counter business, the payment of reasonable commissions to the broker-dealer may actually be cheaper than establishing and maintaining an internal trading department. At the other extreme, where, as in the ISI situation, the fund is large, most of the fund's portfolio consists of securities of unlisted companies, and the affiliated broker does not do a general securities business, there would seem to be no reason why the fund should not internalize its over-the-counter brokerage operations. In the latter situations, there should, at a minimum, be a requirement of an arm's length negotiated commission--that is, the standard New York Stock Exchange commission rate should not obtain where the amount of the trading activity is very large. Under the existing exchange rules and the existing commission rate structure of the exchanges, a fund whose affiliated broker is an exchange member gains nothing by internalizing.

Another basic question is whether a broker-adviser must reduce his advisory fee by brokerage profits or, alternatively, by a portion of those profits. It would seem that these profits should be given consideration in setting the advisory fee, though a stern requirement of a dollar for dollar reduction would seem inappropriate.

Use of Brokerage to Purchase Services
for the Investment Adviser

The Henderson draft generally concluded that there should be no objection to this practice, at least so long as it is consistent with best executions. This seems correct, especially if the services purchased for the investment adviser (which may in some cases be used in connection with advising other clients as well as in advising the fund) is given appropriate weight in setting the amount of the advisory fee. Indeed, the Commission should say that any such services should be taken into account in setting the amount of the advisory fee.

Allocation of Brokerage to Unaffiliated Brokers
as a Reward for Sales

The widespread existence of reciprocal business and give-ups in the mutual fund industry is a result of the intense desire of managers for sales of fund shares and of an exchange commission rate structure which contains a schedule of fixed prices but no volume discount and which permits give-ups. As discussed in an earlier section of this memorandum, a meaningful volume discount would go to the roots of the problem and a banning of give-ups without a meaningful volume discount would result in no substantial benefit to mutual funds and might simply create a host of new problems.

This section of this memorandum briefly outlines what might be done in the framework of the existing exchange and commission rate structure to deal with the problem. The most drastic change would be a statutory amendment to prohibit a broker from simultaneously receiving brokerage or give-ups and acting as a seller of fund shares. Another approach would be a statutory amendment providing that brokerage or give-ups received for sales would be treated as a substitute for an equivalent amount of the sales load. Both approaches seem undesirable, for they would entail legislation to accomplish what a meaningful volume discount would accomplish. In addition, the first approach would in no substantial way benefit the fund. Though the give-up practice smacks of the unsavory, creates problems of funds' bypassing best executions, and creates selling practice problems, if any fundamental steps are to be taken, it would appear that it should be the meaningful, basic one--the creation of meaningful volume discounts.

Some helpful steps can be taken within the present structure. The proposed revisions to section 26 of the NASD's Rules of Fair Practice (which would, inter alia, ban give-ups in over-the-counter transactions) will be helpful. Prospectuses might contain, in addition to the current general disclosure of the give-up and reciprocal practices, a statement of the amounts involved--stated as a percentage of the selling price of fund shares. Also, the Commission can remind funds, in strong terms, of their paramount duty to obtain best executions

Best Executions

The Commission should hammer home the thesis that a fund should always place its brokerage business so as to get the best possible execution, even if this means generating less reciprocals or give-ups to distribute to firms that have sold the fund's shares. This means, for example, using the third market when the best execution is available there.

When the fund has an affiliated broker which is an exchange member and the fund wishes to buy a listed stock, is the broker obligated to refuse the transaction if it can be executed at a substantially better price in the third market? The question becomes very difficult when brokerage is actually taken into account in reducing the advisory fee. It would appear that, generally speaking, the correct principle is that the affiliated broker is under a duty to forego the transaction and to direct the fund to the third market.

(c) Capital Gains Distributions

At present, most funds distribute their realized capital gains and they seem to manage to realize and distribute their capital gains in an amount about equal to the amount of their distribution of ordinary dividends. Capital gains distributions present two problems. First, there appears to be some confusion in the minds of shareholders as to exactly what capital gains distributions represent, although the disclosures in prospectuses are good. Though capital gains distributions are not always a return of capital, it is gross error for investors to think that a capital gains distribution is the equivalent of ordinary dividends on, say, directly-owned shares of General Motors stock and it is a fraudulent selling practice when salesmen represent, expressly or impliedly, that this is so.

Furthermore, if fund managements think that there is confusion in the minds of investors and that a high capital gains distribution therefore aids the sale of fund shares, they are tempted to improperly realize capital gains when a pure investment judgment would indicate otherwise. This is harmful in three respects. First, the shareholders are faced with an immediate tax that would otherwise be deferred. Secondly, appreciated securities are sold and are replaced with other securities which would not have been obtained if pure investment considerations were to prevail. Thirdly and lastly, the fund will refrain from selling depreciated securities which investment considerations would dictate should be sold.

It is sometimes said that fund shareholders “want” a steady stream of capital gains distributions. Actually, no investor who understands the situation would want, in light of the considerations mentioned above, capital gains distributions augmented by capital gains realized other than solely as an incident of sales motivated only by investment considerations.

Henderson recommended that the statute be amended to prohibit the distribution of capital gains. There would be no tax detriment; although a fund that retains capital gains must pay the tax, each shareholder is given a full credit on his individual return for the capital gains tax paid. The full credit is available even if the 25% rate exceeds the individuals' marginal or effective overall tax rate. Furthermore, at present about 65% of fund shareholders reinvest capital gains. In addition, those fund shareholders who need more cash than ordinary dividend distributions can produce could redeem a portion of their shares.

If distributions of capital gains were prohibited, there would be no problem of improper realization of capital gains, as there would be nothing to be gained thereby. Also, the problem raised by confusion in the minds of investors as to the nature of capital gains distributions would be eliminated, and fund sales would not be harmed by the change except to the extent that sales at present are aided by a lack of comprehension by investors of the true nature of capital gains distributions.

In the Managed Funds case and in one other instance, the Commission has found hard evidence directly showing management decisions to sell appreciated securities solely for the purpose of realizing capital gains to distribute to shareholders. However, if legislation to forbid the distribution of capital gains were to be recommended at this point, it would have to be recommended largely on the basis that there is an obvious temptation for improper realization of capital gains and for improper selling practices, and this is a step that would completely remove those conflicts without any harm to legitimate fund interests. A decision on whether legislation should be recommended might be affected by the other legislative recommendations made by the

Commission. This would seemingly not be appropriate for a <u>sole</u> Commission legislative recommendation, but might well be appropriate as a part of a legislative package.

<u>CHAPTER V - THE UNDERWRITING STRUCTURE</u>

Chapter V would deal with four problems: (1) the level of the sales load; (2) desirability of repeal or amendment of section 22(d); (3) the bearing of selling expenses by mutual funds; and (4) the front-end load.

A memorandum, dated February 25, 1965, has been prepared on the first three points. The memorandum compares the level of the sales load with the commissions or mark-ups charged in the over-the-counter and exchange trading markets. The trading markets are used as a base of comparison, as mutual fund sales are always riskless principal transactions and also unlike the situation in many conventional underwritings, mutual fund shares are not being injected into a market in competition with securities being actively traded in a trading market; thus, a comparison with trading market charges rather than conventional underwriting spreads was deemed proper. The memorandum concludes that, even after giving proper consideration to the larger sales effort employed in the sale of mutual fund shares, the generally high quality of those shares, and the fact that the Securities Act applies to all sales of such securities, the sales loads on larger regular account purchases of mutual fund shares--say, $5,000 and up--appears to be somewhat too high.

The memorandum recommends that section 22(d), a statutory price maintenance provision which presently requires <u>all</u> dealers to sell at the price stated in the prospectus, be amended to allow contract dealers, and only contract dealers, to sell at any price above their cost and below the price stated in the prospectus, which would become a suggested offering price. Such an amendment would allow price competition among dealers without allowing them to bypass principal underwriters. With this degree of flexibility, it is anticipated that the purchasers of larger amounts of shares might well negotiate lower loads; if this happened, the principal problem would disappear, without direct governmental regulation. If no improvement results, the Commission could use its section 22(c) powers. In discussing the general sales load problem, the memorandum notes that the available data is not sufficiently comprehensive on which to base a judgment whether the profits or earnings of underwriters, mutual fund firms, or mutual fund salesmen are too high. The memorandum, therefore, approaches the problem through comparisons with sales charges in the trading markets.

The memorandum recommends that the imposition of a sales load on reinvestment of ordinary dividends should be prohibited, but that an appropriate user charge should be permitted--or perhaps even required. Seemingly, this could be done under our existing section 22(c) rulemaking powers. The memorandum also notes the ISI repeating sales load, that that problem is presently under consideration by the Commission, and that it might be necessary or desirable to make only a brief mention of it in the report.

The memorandum analyzes the various forms in which the questions whether a mutual fund may bear selling expenses can arise. The three most important forms are (1) continuing fees to dealers; (2) costs of accumulation, withdrawal, and capital gains and dividend reinvestment plans; and (3) costs of compliance with securities laws and related expenses. The memorandum agrees with the general conclusion of the Henderson draft that mutual funds should not be allowed to bear selling expenses, although it notes that the problems are subtle and often difficult. For example, if a capital gains reinvestment plan is available to all shareholders, an argument can be made that the fund should be allowed to bear the incremental costs of operating the plan; it is concluded, however, that it is more desirable, and fairer to non-using shareholders, if an appropriate user charge is imposed to offset the incremental costs. The memorandum concludes that the Commission probably has sufficient power to deal with these problems under sections 12(b) and 22(a)-(c) and that if there is agreement within the Commission on this conclusion, the discussion in the report to Congress should be quite brief, as the problems are not as important as the other problems that are discussed.

A related question is whether there is automatically a violation of the statute where an underwriter-adviser uses advisory profits to subsidize underwriting or whether it only constitutes some evidence that the advisory fee is too high. The memorandum indicates that the latter position should be taken.

* * * * *

The front-end load brief is, of course, being prepared separately.

CHAPTER VI - RECOMMENDED STRUCTURAL CHANGES

The chapter would begin with a short recapitulation of the built-in conflicts of interest (especially those concerning advisory fees and brokerage), which inevitably raise the basic question whether drastic structural changes are needed.

The chapter would then discuss the possibility of a requirement that all directors of a fund be unaffiliated with the investment adviser, the principal underwriter, or any regular broker. It would point out that such a requirement would, in few short years, lead to a complete disruption of the existing structure, as the large funds, with completely independent managements, would undoubtedly internalize their advisory operations. The chapter would conclude that such a drastic rearrangement is not warranted by the evidence, in light of the fact that meaningful intermediate general structural reforms could be taken which would apparently be adequate to deal with the problems. The chapter would then state the recommended intermediate steps which the Commission decides upon; we would recommend the following, which have been discussed by the Commission:

(a) A requirement that 60% of the directors be unaffiliated with the adviser, the principal underwriter, or any regular broker;

(b) a requirement that the counsel for the fund be totally independent of the adviser, the principal underwriter, and any regular broker;

(c) the requirement that the right to nominate unaffiliated directors be lodged solely with the unaffiliated directors;

(d) the expansion of the definition of "affiliated person"; and

(e) the alteration of the definition of "control" in section 2(a)(9) to make it clear that an investment adviser will be deemed to control an investment company if the adviser or any affiliated persons thereof serve on the fund's board.

At this point, there should be a brief discussion of the duties of unaffiliated and affiliated directors. The fact that affiliated directors have duties to the fund, including a duty to keep the unaffiliated directors informed, should be pointed out. In addition, it should be stated that the affiliated directors have a duty to present a fair advisory contract to the company (indeed, this would be expressly provided by the legislative amendment to section 15) and also have a duty to ensure that other proposals coming from the persons with whom they are affiliated are fair and reasonable to the investment company.

The chapter would observe that the Commission has taken or is recommending a series of steps that should resolve, or materially aid the resolution of, the problems discussed in the report:

1. The publication of the report, along with the publication of the Special Study and the Wharton School Report, spotlight the problems, and the report to Congress will offer express Commission positions.

2. Form N-1R will make more continuous information available.

3. The suggested legislative structural changes will strengthen the position of the unaffiliated directors.

4. The recommended amendment to section 15 will provide a direct check on abuses concerning the advisory fee, which perhaps is the most important area of conflict of interest. (Any other pertinent legislative recommendations would also be mentioned here.)

5. The other steps which have been taken and are to be taken by the Commission and the NASD (such as any changes in the prospectus requirements and the proposed amendments to section 26 of the NASD's Rules of Fair Practice) would be referred to.

The report would conclude that the combination of these steps would appear to be adequate to deal with the problems, and if, and only if, these significant, but intermediate, steps do not work out, consideration should be given to the drastic and ultimate step of requiring a management, all of whose members are wholly independent of the adviser, the principal underwriter, or any regular broker.