

that of other publicly held enterprises, with the dispersion being greatest in larger funds.¹²⁸ Seldom does any individual or organized group of public shareholders own a significant portion of the outstanding shares of any of the larger funds. Should such large shareholders as there are become dissatisfied with a fund's management, they may redeem their shares at current net asset value.¹²⁹ On the other hand, large shareholders of other types of enterprises may find it difficult to liquidate their holdings at current market prices.

In mutual funds, as in other publicly held enterprises, shareholder voting can serve as an important method of communication with management. Indications of shareholder dissatisfaction expressed in this way may play a significant role in influencing the actions of fund managers on many matters of policy. But shareholder voting rights cannot be used effectively to obtain departures from traditional fees that inadequately reflect the economies of size in the management of investment companies or with respect, to other matters that affect so crucially the interests of the adviser and those who are affiliated with it.

4. *The role of the unaffiliated directors*

Mutual fund advisers generally are the organizers of the fund and, as such, select the fund's original board of directors. Although the fund later may grow to substantial size, because of the diffusion of share ownership and the absence of organized shareholder participation in fund affairs, the power to select the fund's directors remains with the original organizers or their successors. The adviser's discretion generally is limited only by those provisions of the Act, which require that specified percentages of the board members not be officers or employees of the fund or persons affiliated with the adviser, its principal underwriter, its regular broker, or any investment banker and their affiliates.¹³⁰

The unaffiliated directors are in a position to, and frequently do, perform a valuable service for the funds and their shareholders. They often bring broad perspectives from their diverse business and professional experience to the management of fund affairs, and in many instances they have sought to fulfill their responsibilities in a highly responsible and dedicated way. The Wharton Report suggested, however, that unaffiliated directors "may be of restricted value as an instrument for providing effective representation of mutual fund shareholders in dealings between the fund and its investment adviser."¹³¹ The unaffiliated directors usually have other occupations and necessarily cannot devote unlimited time to their directorial duties—duties for which they, like other corporate directors who are not part of full-time management, seldom receive more than minimal compensation. They also have no staff of officers and employees who work for and are compensated by the fund. In most cases, even the fund's counsel is the adviser's counsel as well. Hence

¹²⁸ Wharton Report 63-57. An exception to this is The Fund of Funds, Ltd., a foreign investment company not registered under the Act but organized to invest in U.S. investment companies and their advisory organizations, which in recent years has emerged as a major shareholder in a number of domestic funds. See pp. 311-324, *infra*.

¹²⁹ Should they wish to invest the proceeds in another load fund, they may do so at sales loads as low as 1 percent if the amount is large enough. See pp. 205-207, *infra*.

¹³⁰ The Act requires that, except for certain no load funds, at least 40 percent of the directors of a registered investment company must consist of persons who are neither officers or employees of the company nor affiliated with its investment adviser or their affiliates. A majority of the directors must be persons who are not principal underwriters or regular brokers to the company or investment bankers or affiliated persons of such underwriters or brokers or of investment bankers. Sec. 10.

¹³¹ Wharton Report 34.

the unaffiliated directors necessarily obtain most of their information about fund operations from persons who also owe allegiance to, and obtain the preponderance of their compensation from, the adviser-underwriters and who cannot be expected to look at such matters as advisory fees in a disinterested way.¹³²

It has been the Commission's experience in the administration of the Act that in general the unaffiliated directors have not been in a position to secure changes in the level of advisory fee rates in the mutual fund industry. In most instances the adviser serves as, or is closely affiliated with, the fund's principal underwriter which maintains a distributing organization for the fund's shares. The organization that has developed over a period of years to manage the fund's portfolio and to furnish it with some, and in certain cases virtually all, of the nonadvisory services necessary to its operation belongs to the adviser and not to the fund. Indeed, in some cases all of the fund's records are maintained by the fund's adviser. Although the unaffiliated directors under State law have an unqualified right of access to these records, the adviser, as a practical matter, is in a position to seriously hamper any employment of that right which might interfere with or threaten the adviser's operation of or control over the fund.

Thus, negotiations between the unaffiliated directors and fund advisers over advisory fees would lack an essential element of arm's-length bargaining—the freedom to terminate the negotiations and to bargain with other parties for the same services. In view of the fund's dependence on its existing adviser and the fact that many shareholders may have invested in the fund on the strength of the adviser's reputation, few unaffiliated directors would feel justified in replacing the adviser with a new and untested organization simply because of difficulty in obtaining a reduction in long-established fee rates which are customary in the industry.

Moreover, even if some of the unaffiliated directors were so inclined, they might not have the power to obtain another investment adviser for the fund. In some cases, the unaffiliated directors are only a minority; in many others they constitute only a bare majority of the board of directors and would need the support of all the unaffiliated directors for this drastic step. Even with such support it is unlikely that the action of the unaffiliated directors would be uncontested, since the interest of the existing advisory organization in continuing its relationship to the fund might induce the adviser to devote considerable resources to a proxy contest to retain control of that relationship.

The possibility of disrupting the fund's operations, the prospect of a bitter and expensive proxy contest, and the risk and uncertainty involved in replacing the entire fund management organization with a new and untested one, make termination of the existing advisory relationship a wholly unrealistic alternative in negotiations over advisory fees. Without such an alternative, advisory fees negotiated between advisers and the unaffiliated directors lack the essential element of arm's-length transactions and provide inadequate assurance that the fees bear a reasonable relationship to the price at which similar services could be obtained in a genuinely competitive market.

¹³² Cf. Wharton Report 67-68.

5. *The position of the investment adviser*

The absence of competitive pressures, the limitations of disclosure, the ineffectiveness of shareholder voting rights, and the obstacles to more effective action by the unaffiliated directors have meant that the determination whether and to what extent the economies of size realized from fund growth should be shared with the funds and their shareholders is left largely to the judgment of the adviser. As noted, some advisers voluntarily had reduced the fee rates for the funds under their management long before the publication of the Wharton Report and the institution of shareholder litigation attacking the fees as excessive. However, most advisers did not. Moreover, the ability of the managements of the publicly held fund advisory organizations to initiate reductions in advisory fee rates in the interest of fund shareholders is significantly affected by their responsibilities to the advisers' public investors.

Under these circumstances, for most funds only the pressures generated by the Wharton Report and the pendency of shareholder litigation have been sufficient to effect departures from the pattern of the flat 0.50 percent fee rate prevailing in the industry. The extent of these departures in many instances has not been substantial. The reasons for this lie in an understanding of the background and nature of the shareholder fee litigation and the circumstances under which most of the suits were terminated.

6. *The advisory fee in the courts*(a) *Background*

Although the absence of a sharing of the economies of size with the funds may not have elicited widespread concern among fund shareholders and directors in the context of the rising stock markets of the 1950's, it did lead to the institution of numerous lawsuits attacking the fees as excessive. Starting in 1959 over 50 suits were instituted against 18 mutual fund advisers. The suits involved mainly the advisory fees paid to the investment advisers of most of the larger externally managed funds and fund complexes.¹³³

In two cases, trustee's fees were attacked.¹³⁴ In each instance the litigation brought by fund shareholders was in the form of a derivative suit, a procedural device designed to permit minority shareholders to enforce a corporation's claim against its officers, directors, and controlling persons as well as against third persons when those in control of the corporation are reluctant to act.¹³⁵ The courts have

¹³³ None of these suits involved managerial compensation paid by internally managed investment companies. However, *Edtel v. Guilden*, 223 F. Supp. 129 (S.D. N.Y., 1963) was a derivative action on behalf of Atlas Corp., an internally managed closed-end investment company, to recover certain insurance brokerage commissions which Atlas directors were alleged to have received in violation of the Investment Company Act. Plaintiff's case was based on section 17(e) (1) of the Act, which makes it unlawful for any affiliated person of a registered investment company "acting, as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company, or any controlled company thereof, except in the course of such person's business as an underwriter or broker." The action was subsequently settled. *Neuwirth v. Allen*, 338 F. 2d 2 (C.A. 2, 1964). Atlas Corp. is no longer registered as an investment company under the Act.

¹³⁴ The trustee's fees were those paid to The Empire Trust Co. for administrative services furnished to the funds in the National Securities Series, and the investment management fees and the recurring fees paid to Keystone Custodian Funds, Inc., trustee for the funds belonging to the Keystone complex. See pp. 92-93, *supra*.

¹³⁵ The Supreme Court has noted with respect to such suits: "This remedy, born of stockholder helplessness, was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests. It is argued, and not without reason, that without it there would be little practical check on such abuses." *Cohn v. Beneficial Industrial Loan Corp.*, 337 U.S. 641, 648 (1949). See also, *Surowitz v. Hilton Hotels Corporation*, 383 U.S. 363 (1966).

held that mutual fund shareholders may institute derivative suits just as shareholders of other types of enterprises do.¹³⁶

The primary defendants in these suits were the investment advisers and the fund directors who are affiliated with them. Some of the complaints charged that the funds' advisory contracts had not been validly renewed. Some charged irregularities in the operation of the funds. But the focal point of all the complaints was the advisory fee. They alleged that the fees for various years in the late 1950's and early 1960's were unreasonable and excessive and that payment thereof constituted a waste of the funds' assets and a breach of fiduciary duty in violation of applicable State law and provisions of the Act.

(b) *The fully litigated cases*

The shareholder litigation against all but one of the advisers has now been terminated.¹³⁷ In most cases settlements were reached which provided for some reduction in advisory fees to be charged in future years. In only three cases did the termination result from a judgment on the merits based on an evidentiary record developed in an adversary proceeding. Each of the three fully litigated cases (*Meiselman v. Eberstadt*, decided in May of 1961,¹³⁸ *Saxe v. Brady*, decided in September of 1962,¹³⁹ and *Acampora v. Birkland*, decided in July of 1963)¹⁴⁰ held that the plaintiffs had failed to prove the fees legally excessive and resulted in a judgment for the defendants.¹⁴¹

The plaintiff in the *Meiselman* case was a shareholder of Chemical Fund, Inc. He contended that the fund's advisory agreement had resulted in the payment of excessive compensation to its investment adviser from 1956 to 1960. However, compared to the fees charged other externally managed funds, Chemical's advisory fees were relatively low. In 1956 at a time when most mutual funds were being charged a flat rate of 0.50 percent on all their assets, Chemical's advisory contract had been changed to provide for significant scale downs from the basic rate.¹⁴² Chemical had 1956 year end net assets of \$134.0 million. In that year its advisory fee amounted to 0.44 percent of average net assets. By year end 1960 Chemical's net assets increased to \$269.7 million, and its advisory fee rate dropped to 0.35 percent.

¹³⁶ In *Taussig v. Wellington Fund, Inc.*, 187 F. Supp. 179, 195-197 (D. Del., 1960) *aff'd.*, 313 F.2d 472 (C.A. 3), certiorari denied, 374 U.S. 806 (1963), the court rejected the contention that externally managed mutual funds are simply vehicles by which investment advisers furnish their services to large numbers of clients. Similarly, contentions that the shareholders of the Keystone Custodian Funds, which are organized as common law trusts, could not utilize the derivative suit on the ground that they were not shareholders but individual clients of the adviser who could terminate the advisory relationship simply by redeeming their shares were rejected by the court in *Saminsky v. Abbott*, 185 A.2d 765, 770-772 (Del. Ch., 1961), settlement approved, 194 A.2d 549 (Del. Ch., 1963), affirmed sub nom., *Kleinman v. Saminsky*, 200 A.2d 572 (Del. Sup. Ct.), certiorari denied, 379 U.S. 900 (1964).

¹³⁷ In the pending case a settlement has been proposed. For a discussion of the settlements see pp. 138-141, *infra*. For a tabular summary of the results of this litigation see table 111-11 at p. 154, *infra*.

¹³⁸ 39 Del. Ch. 563, 170 A.2d 720.

¹³⁹ 40 Del. Ch. 474, 184 A.2d 692.

¹⁴⁰ 220 F. Supp. 527 (D. Colo.).

¹⁴¹ Although the Commission participated *amicus curiae* on preliminary legal issues involved in several of the shareholdersuits, it did not participate on any of the factual issues involved in either the fully litigated cases or the settlements. William L. Cary, then Chairman of the Commission, pointed out that "the focus of these suits is in large part upon the question of the fee scale * * * the thrust of these suits goes to the structure and organization of mutual funds and the related responsibilities and duties of directors and other affiliated persons. These matters warrant and are receiving careful study by the Commission in a far more comprehensive way than would be possible to develop from the evidence in individual lawsuits." Hearings before a subcommittee of the House Committee on Foreign and Interstate Commerce on H.R. 11670, 87th Cong., 2d sess. (1962) 19-20.

¹⁴² The contract provided for the following annual rates:
One-half of 1 percent on the first \$75 million in assets;
Three-eighths of 1 percent on the next \$50 million in assets;
One-fourth of 1 percent on assets in excess of \$125 million.

Plaintiff's case was based on the theory that a mutual fund advisory fee was simply a specialized type of executive compensation and that the partners of F. Eberstadt & Co., Chemical's investment adviser, who also serve as Chemical's officers and directors, were entitled to be compensated only for the time that they spent on Chemical's affairs and only at rates comparable to the compensation received by salaried executives with analogous responsibilities.¹⁴³ Plaintiff contended that all net advisory income in excess of such a measure of compensation was unreasonable and should be refunded to Chemical.¹⁴⁴

The court rejected the view that the fairness of a mutual fund adviser's profits was to be judged on the same basis as executive salaries and held that under all the circumstances the advisory fees were not excessive.¹⁴⁵ In reaching its decision the court emphasized the approval of the advisory contract by the fund's shareholders and its directors, a majority of whom were unaffiliated with the adviser-underwriter. It further noted that Chemical's advisory fee rate was lower than "the average" in the mutual fund industry. The court stated:

Fiduciaries, of course, may not pay themselves excessive compensation, but here must be added the fact that the non-affiliated majority directors, whom plaintiff tacitly admitted he could not prove were dominated by defendants, approved the compensation arrangement yearly with knowledge of the company's audit. Moreover, the stockholders approved the basic compensation arrangement in 1956 and 1961, albeit they did not know the company's "net income" before taxes. Finally, as noted, it appears that the basic charges appearing in the management agreements for the pertinent years are lower than the average in the mutual fund field.¹⁴⁶

Meiselman was an atypical case in that it involved an advisory fee rate that had been voluntarily reduced to a level unusually low for the mutual fund industry then or, indeed, now.¹⁴⁷ The court's reasoning, however, foreshadowed to some extent its decision in *Saxe v. Brady*,¹⁴⁸ where it held a flat 0.50-percent fee on the assets of a very large fund legally permissible. In that case the plaintiffs were shareholders of Fundamental Investors, Inc., a fund with assets of about \$557 million at June 30, 1962.¹⁴⁹ They contended that the

¹⁴³ 170 A.2d at 722.

¹⁴⁴ Plaintiff made no claim based on Eberstadt's underwriting income. 170 A.2d at 721. * * * to say that the value of the services * * * rendered by the officers is to be automatically equated with the percentage of time formally devoted to the fund" and that the partners' other activities were of value to Chemical because they concerned investment matters and gave Chemical "sources of communication" helpful in "all phases of the problem of investment analysis." (170 A.2d at 722). This statement may have been based on the premise that mutual fund advisers are entitled to entrepreneurial profits over and above all costs, including appropriate salaries and allowances for managerial skill. Cf. *Krieger v. Anderson*, 40 Del. Ch. 363, 182 A.2d 907 (Del. Sup. Ct., 1962); *Saxe v. Brady*, 40 Del. Ch. 474, 184 A.2d 602, 615-616 (Del. Ch., 1962). While the experience and skill developed in other matters may affect the rate at which a professional is to be paid for the time he spends on a particular client's affairs, it is hardly customary to charge one client for time devoted to the affairs of other clients.

¹⁴⁵ 170 A.2d at 723.

¹⁴⁷ At midyear 1966 Chemical's net assets were approximately \$437 million. Its 1966 advisory fee amounted to 0.30 percent of net assets and was still among the lowest in the externally managed sector of the mutual fund industry. (See table III-3 at p. 93, supra.) However, it was more than double the management casts of the internally managed Massachusetts Investors Trust and the companies in the Broad Street complex. The plaintiff in the *Meiselman* case does not appear to have made any effort to compare the Eberstadt partners' charges to Chemical with the charges that they would have made to nonfund clients for comparable management services with respect to a \$500 million portfolio. (See pp. 114-121, supra.)

¹⁴⁸ 40 Del. Ch. 474, 184 A.2d 602 (1962).

¹⁴⁹ The \$557 million figure reflected the effect of the 1962 decline in stock prices. At the end of 1961 Fundamental's assets had been approximately \$732 million. Moreover, unlike Chemical, Fundamental is part of a larger fund complex. (See table 11-3 at p. 48, supra.)

0.50 percent rate that Fundamental was paying to its adviser, Investors Management Co., was "unreasonable, excessive, and an illegal waste and spoliation of the fund's assets."¹⁵⁰ The plaintiff's position was predicated on the fact that three other funds that they considered comparable to Fundamental were paying appreciably lower rates for investment management¹⁵¹ and on the further fact that Fundamental's investment adviser was earning a net profit of about \$2 million a year before taxes.¹⁵²

The court observed that "based on the 1959 and 1960 figures the profits are certainly approaching the point where they are outstripping any reasonable relationship to expenses and effort even in a legal sense."¹⁵³ The court apparently recognized that the defendants had a duty to deal fairly with the fund and that the burden of proving fairness normally would be on the defendants. It held, however, that because the fund's shareholders had ratified the advisory contract, the defendants were relieved of the burden of showing fairness and the plaintiff had to bear the burden of proving affirmatively that the fees were so excessive as to constitute a "waste" of corporate assets. As the court put it:

When the shareholders ratify a transaction, the interested parties are relieved of the burden of proving the fairness of the transaction. *The burden then falls on the objecting stockholders to convince the court that no person of ordinary, sound business judgment would be expected to entertain the view that the consideration was a fair exchange for the value which was given.*¹⁵⁴

¹⁵⁰ 182 A.2d at 604.

¹⁵¹ The three funds which plaintiffs compared with Fundamental were Massachusetts Investors Trust, Affiliated Fund, Inc., and Wellington Fund, Inc. Massachusetts Investors Trust is, of course, internally managed. Affiliated and Wellington, however, are managed by investment advisers. Plaintiffs pointed out that although Fundamental was still paying a flat 0.50 percent, Affiliated's rate had been reduced to (a) 0.50 percent annually on the first \$50 million, (b) 0.375 percent on the next \$50 million, and (c) 0.25 percent on the balance; and Wellington's rate to (a) 0.50 percent on the first \$70 million, (b) 0.375 percent on the next \$60 million, and (c) 0.25 percent on the balance (184 A.2d at 612).

¹⁵² Fundamental's investment adviser, Investors Management Co., Inc., was a wholly owned subsidiary of its principal underwriter, Hugh W. Long & Co., Inc. The \$2 million figure referred to in the text was based on plaintiff's reconstruction of the underwriter's accounts. In this reconstruction certain expenses that the Long organization had allocated to the adviser were reallocated to the principal underwriter on the ground that such expenses were part of the cost of selling new shares, not of the cost of supplying investment advice. The court found itself unable "on this record to overturn management's allocation." However, it went on to add: "But by refusing to overturn these allocations, the court does not thereby affirmatively approve them. The area of corporate affairs here involved is one in which an element of judgment is always present. In this case the difficulty is compounded by the reluctance of the court to interfere where the allocation was effected between a parent company and its wholly-owned subsidiary. In short, the inquiry is not as meticulous as one where liability is predicated solely upon the propriety of allocations between the companies * * *"¹⁵³ (184 A.2d at 609).

The parties did not raise and the court did not consider the propriety of justifying advisory fees on the basis of a management decision to subsidize sales of fund shares.

¹⁵³ 184 A. 2d at 616.

¹⁵⁴ 184 A. 2d at 610 [emphasis added].

Applying the ratification-waste tests that it deemed controlling under Delaware law,¹⁵⁵ the court was unable to attach much weight to the adviser's evident failure to share the economies attributable to the growth of the fund with the fund's shareholders. In this connection the court relied on the fact that other funds larger than Fundamental paid advisory fees at the same rate.¹⁵⁶ It also stated that "it is a matter of common knowledge that compensation in the mutual fund industry is paid on a percentage basis," and that "this provides an incentive for the manager to increase the size of the Fund." The court assumed that in the case of a fund as large as Fundamental such growth "benefits the stockholders" even in the absence of a scaled-down fee schedule.¹⁵⁷

The court observed, however, that growth of fund assets could at some point make the 0.50 percent fee rate legally excessive even under the "waste" test. The court stated:

Since the management contract must be re-evaluated by the board of the Fund at fixed periods, ideally a truly independent and active board would be expected to be alert to the factors I have mentioned. In other words, it is not to be assumed that an independent board would wait until the fees paid under the management contract warranted a finding of waste before attempting to negotiate a better deal.

[T]he business community might reasonably expect that at some point those representing the fund would see that the management fee was adjusted to reflect the diminution in the cost factor.¹⁵⁸

In the third and last of the fully litigated cases, *Acampora v. Birkland*,¹⁵⁹ plaintiff's attack on the propriety of a 0.50 percent fee was rejected on the authority of *Saxe v. Brady* and *Meiselman v.*

¹⁵⁵ Other courts have also held that a challenged payment or transaction which has been ratified by the shareholders can be set aside only if "wasteful." Absent ratification "unreasonableness" or "unfairness" would be sufficient to warrant judicial intervention. The classic case is *Rogers v. Hill*, 289 U.S. 582 (1953). Under those cases, however, the burden is still on the defendants to show that the transaction under attack was not "wasteful." The rule that relieves the defendants from the burden of justifying their conduct and obligates the complaining shareholders to demonstrate affirmatively that the transaction was wasteful seems to be a relatively recent Delaware innovation. Moreover, the present Delaware requirement that the plaintiff must demonstrate that "no reasonable businessman fully informed as to the respective values, and acting in good faith could be expected to consider the bargain attractive to the corporation" (see, e.g., *Goellieb v. Heyden Chemical Corp.*, 33 Del. Ch. 177, 91 A. 2d 57 (Del. Sup. Ct., 1952)) and that "what the corporation has received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid" (*Saxe v. Brady*, 184 A. 2d 602, 610 (1962)) goes far beyond anything said in *Rogers v. Hill* or in other cases. See note, *The Nonratification Rule and the Demand Requirement: The Case for Limited Judicial Review*, 63 Col. L. Rev. 1085, 1101-1102 (1963), describing the doctrine of the recent Delaware cases as one under which the "shareholders perform abdication by shackling a minority shareholder with an almost insurmountable burden of proof at trial."

The shareholder ratification test as so applied seems to produce much the same effect as an exculpatory clause. The application of this doctrine to investment companies seems inconsistent with the Congressional policy against exculpatory clauses for investment company insiders. Act, secs. 17 (h) and (j).

¹⁵⁶ The court rejected plaintiffs' contention that the dollar amounts paid (as distinguished from the fee rate) under the advisory contract were excessive. Although the court noted that during 1959 and 1960 Fundamental's advisory fee was about 60 percent higher than that of Affiliated and Wellington, it concluded that "it cannot be assumed that the fees of Affiliated or Wellington automatically establish the legitimate outer limit of payments for advisory services" that "a large degree of variation in the amounts paid is unexceptionable and that fees falling in the higher range are not necessarily excessive." 184 A. 2d at 612.

¹⁵⁷ 184 A. 2d at 612. But see Wharton Report 31-32 at pp. 262-263, *infra*.

¹⁵⁸ 184 A. 2d at 606-617. For discussion of the settlement of the *Saxe* case through adoption of a scaled-down fee schedule while an appeal from the trial court's decision was pending, see note 169 at p. 138.

¹⁵⁹ 220 F. Supp. 527 (D. Colo., 1963).

Eberstadt.¹⁶⁰ The plaintiff in *Acampora* was a shareholder of Financial Industrial Fund, Inc. ("FIF"), founded in 1935. At the end of 1955 its assets were about \$47 million. By mid-1961 they had risen to approximately \$243 million.¹⁶¹ Plaintiff's original contention was that the flat 0.50 percent advisory fee rate was in itself excessive. He abandoned that contention in view of the decision in *Saxe v. Brady* and based his claim on the theory that FIF's advisory fee was excessive because it was getting fewer services in return for the 0.50 percent fee paid its adviser than other funds were getting from their advisers.¹⁶² He contended that as a result of this disparity in the services provided, FIF was really paying more than the conventional 0.50 percent rate.¹⁶³

FIF's advisory fee seemed "high" to the court, but since it was not high enough to be "unconscionable" or "shocking," *Meiselman v. Eberstadt* and *Saxe v. Brady* precluded judicial intervention.¹⁶⁴ The court considered that shareholder approval of the advisory contract was controlling.¹⁶⁵ It stated:

As to whether the one-half of 1 percent formula in the instant case is excessive in view of the fact that Management fails to perform many routine functions which according to counsel other funds do furnish is inherently difficult, since the value of such services is a matter of judgment on the part of the persons who pay for them. * *

Judged by the tests set forth in *Saxe*, that is, unconscionable and shocking, it cannot be said from the evidence here presented that the amount paid was excessive because it is impossible to evaluate the service rendered. The fact that it seems high to this writer is not reliable."

On November 1, 1965, FIF adopted a new advisory contract under which previous provisions for a flat one-half of 1 percent fee for advisory services and for reimbursement of the cost of nonadvisory services were replaced by an arrangement under which FIF pays its adviser an advisory fee plus an "administrative service charge." Had the new agreement been effective during FIF's fiscal year ending August 31, 1965, it would have saved the fund \$12,600 out of its

¹⁶⁰ The *Acampora* case involved a number of additional issues. Among the more important of these were: (1) The contention that certain of the fund's allegedly unaffiliated directors were in fact affiliated with its adviser-underwriter and that the purportedly improper composition of the board rendered the advisory and the underwriting contracts void under the Investment Company Act so that the fund was entitled to recover all of the moneys that it had paid; and (2) the contention that even if the contracts were valid, the adviser-underwriter had breached them by shifting certain expenses that were to be borne by it under the contracts to the fund. Plaintiff's evidence with respect to the "unaffiliated" directors showed that some of those directors were personal friends of the adviser's president and, principal stockholder and that they had benefited financially from certain business dealings with the adviser. These circumstances, the court held, were insufficient to establish that the directors in question were "affiliated persons" of the adviser under section 2(a)(3) of the Act. For discussion of this problem, see chapter IX. Plaintiff's contention with respect to the allocation of expenses between the fund and the adviser-underwriter resulted in the fund's recovery of over \$300,000 from the adviser.

¹⁶¹ 220 F. Supp. at 535. By mid-1966 FIF's assets stood at about \$334 million.

¹⁶² 220 F. Supp. at 547-548.

¹⁶³ "Financial statements of numerous other mutual funds were offered in evidence * * * to show that the mutual funds generally get much more for their one-half of 1 percent than does the Fund in the instant case." (220 F. Supp. at 548.)

¹⁶⁴ 220 F. Supp. at 548-549.

¹⁶⁵ The advisory agreement had been approved by the shareholders in 1940. A 1941 amendment to the agreement was also approved by the shareholders. In 1960 the shareholders approved a new advisory agreement, which "in itself effected little change in the relationship between the parties" (220 F. Supp. at 534).

¹⁶⁶ 220 F. Supp. at 549.

total expenses of \$2,023,735.¹⁶⁷ The scaled-down fee schedules provided for in the new contract, however, would result in more substantial savings if the fund's assets were to increase substantially.

(c) *The settlements*

Although no court has ever held a mutual fund investment advisory fee legally excessive,¹⁶⁸ the efforts of the fund shareholders who challenged the propriety of the advisory fees that their funds were paying were not altogether fruitless. Most of the cases were settled, and most of the settlements resulted in new advisory contracts that were somewhat more favorable to the funds than the ones under attack had been. The results of the cases are summarized in tabular form in table III-11, at p. 154, infra.

Some of the settlements were arrived at prior to the decisions discussed in the preceding section. Others, however, were influenced by these decisions which created strong pressures for settlements on both sides. *Saxe v. Brady* was most influential in this connection. That case indicated that there was a point beyond which the flat fee rate—and perhaps even a slightly scaled-down fee schedule—would be deemed to result in “wasteful,” “shocking,” and “unconscionable” payments to investment advisers and that some advisory fee rates might be reduced by judicial decree.¹⁶⁹ Accordingly, many fund managers were willing to scale down their rates to some extent in order to dispose of the lawsuits in which they were involved.¹⁷⁰

¹⁶⁷ The fee rates are scaled-down according to the schedule below:

Net assets (millions)	Investment advisory fee (percent)	Administrative service charge (percent)	Total (percent)
Up to \$50	0.50	0.25	0.75
\$50 to \$300	.50	.15	.65
\$300 to \$600	.47	.14	.61
\$600 to \$900	.44	.13	.57
\$900 to \$1,200	.41	.12	.53
\$1,200 to \$1,500	.38	.11	.49
Excess of \$1,500	.35	.10	.45

¹⁶⁸ In addition to the three fully litigated cases previously discussed there were three other advisory fee cases in which the complaining shareholders consented to the dismissal of their complaints. In each of those cases (*Nadel v. Curtin*, New York Supreme Court, Kings County, County Clerk's Index No. 716/1964; *Levitt v. Long*, 63 Div. 1716 S.D.N.Y.; *Greene v. Shepard*, Delaware Court of Chancery, Newcastle County Civil Action No. 1732) plaintiffs' counsel capitulated because they were of the opinion that there was no chance of success under the doctrine of the decided cases. For the names of the funds and the advisers as well as the fee rate levels involved in these cases see the appendix table.

¹⁶⁹ The publication of the Wharton Report early in September of 1962 may have contributed to the defendants' desire to terminate these suits.

Indeed *Saxe* itself may have been such a case. The *Saxes* appealed to the Supreme Court of Delaware from the adverse judgment of the trial court. That appeal was later withdrawn pursuant to a settlement agreement by which the flat 0.50 percent advisory fee that Fundamental had been paying was replaced by the following scaled-down schedule:

- 0.485 percent on the first \$500 million;
- 0.40 percent on assets between \$500 and \$750 million;
- 0.35 percent on assets between \$750 million and \$1 billion;
- 0.30 percent on assets between \$1 billion and \$1.25 billion;
- 0.25 percent on assets between \$1.25 and \$1.50 billion;
- 0.20 percent on assets in excess of \$1.50 billion.

At the time of the settlement Fundamental's assets were about \$640 million. By June 30, 1966, they had increased to approximately \$1.2 billion.

The savings attributable to the reduced fee schedule were offset to some extent by the fact that under the new agreement Fundamental was obliged to pay the compensation of the unaffiliated directors (then about \$2,500 annually), an expense that the adviser had previously borne.

¹⁷⁰ The court in *Saxe* had stated that, “It is inherent in the ‘percentage of assets’ approach that at some point the relationship between admittedly reasonable expenses and net profits can become so disproportionate as to be shocking by any pertinent standard.” 184 A. 2d at 615. On the facts before him in that case the Chancellor said: “Based on the 1959 and 1960 figures the profits are certainly approaching the point where they are outstripping any reasonable relationship to expenses and effort even in a legal sense.” 184 A. 2d at 616.

Plaintiffs' counsel were not unmindful of the likelihood of an adverse judgment, since each fully litigated case had resulted in a judgment for the defendants. And under the courts' interpretation of applicable State law, obtaining a favorable result was no easy matter. The most modest of settlements seemed preferable to the risk of a trial which was likely to result in an adverse decision.¹⁷¹

When the settlements were submitted to the courts for their approval, certain shareholders urged that they be rejected as inadequate.¹⁷² Their contentions were uniformly rejected on the ground that they had failed to demonstrate enough of a probability that further prosecution of the case would be more advantageous to the fund than the proposed settlement so as to warrant rejection of a compromise recommended by the lawyers who had initiated the suit and who were presumably best able to evaluate the prospect of success.¹⁷³

As the courts saw it, the objectors were attacking the basic structure of the mutual fund business, an attack that they felt could not be sustained under existing law. Illustrative is *Kerner v. Crossman*,¹⁷⁴ where a settlement reducing the flat 0.75 percent advisory fee formerly paid by Axe-Houghton Fund B, Inc.¹⁷⁵ to somewhat lower levels¹⁷⁶ was approved on the ground that "the new scale of investment advisory fees is not out of line with similar fees charged by other open-end investment trusts of comparable size and importance."¹⁷⁷ Of one objector's position the court said:

He believes it to be wrong and contrary to the interests of the stockholders, to allow such a promising litigation to be terminated by a settlement of this nature. Mr. Hillman contends that the scale of investment advisory fees and distribution fees provided in the stipulation are excessive, and that it is no answer that they may be in line with similar

¹⁷¹ In most derivative actions the size of the plaintiff-shareholder's direct personal stake in the matter in issue is too small to warrant his paying a fee to the attorney who prosecutes the case. Lawyers undertake these cases in the hope that their services will prove to be of benefit to the corporation and that fees commensurate with such benefit will be awarded them by the court. The courts have observed that there are many cases in which the possibility of recovering attorney's fees provides the sole stimulus for the enforcement of claims against corporate insiders. See, e.g., *Smolowe v. Delendo Corporation*, 136 F.2d 231, 241 (C.A. 2 certiorari denied, 320 U.S. 751 (1943)); *Murphy v. North American Light & Power Co.*, 33 F.Supp. 566 570-571 (S.D.N.Y., 1940).

These considerations are even more significant in the cases brought by mutual fund shareholders than they are in derivative actions generally. As was pointed out in *Chabot v. Empire Trust Company*, 301 F.2d 458, 461 (C.A. 2, 1962): "It is a well known fact that investors in mutual funds are primarily small shareholders. Very few of them have a sufficiently large financial interest in the management of the fund to risk any considerable sum on the outcome of litigation." And even in the case where the plaintiff has invested a large sum in the fund, his proportionate share of the advisory fee will seldom amount to enough to induce him to disburse or to expose himself to the possibility of having to disburse — considerable amount of money in connection with remedial litigation.

¹⁷² To guard against the danger of collusive or fraudulent settlements in which derivative actions are discontinued in exchange for benefits to the plaintiffs and their attorneys rather than benefits to the corporation, many jurisdictions require that proposed settlements of such actions be judicially approved. See, e.g., Rule 23(c) of the Federal Rules of Civil Procedure, which has also been adopted in a number of States, and sec. 626(d) of the New York Business Corporation Law, both of which require that all shareholders be notified of the application for approval. And even where judicial approval of the settlements is not required as a matter of law, defendants' counsel will usually insist on it so as to foreclose future suits by shareholders who are not parties to the pending case and who would otherwise be free to relitigate the very issues presented by the pending case and to seek a greater recovery for the corporation than the one called for by the settlement.

¹⁷³ One judge has said of these cases: "Once a settlement is agreed the attorneys for the plaintiff stockholders link arms with their former adversaries to defend the joint handiwork. (Friendly, J dissenting in *Allegheny Corporation v. Kirby*, 333 F.2d 327, 347 (C.A. 2, 1964), affirmed en banc, 340 F.2d 311, certiorari dismissed as improvidently granted, 384 U.S. 28 (1966).

¹⁷⁴ 211 F. Supp. 397 (S.D. N.Y., 1962).

¹⁷⁵ This consisted of: (1) a 0.55 percent investment management fee paid to E. W. Axe & Co., Inc., the fund's investment adviser; and (2) a 0.20 percent "continuing fee" paid to Axe Securities Corp., its principal underwriter.

¹⁷⁶ See table III-11 at p. 154, infra.

¹⁷⁷ 211 F. Supp. at 402.

fees charged by other open end investment funds because in Mr. Hillman's opinion, the whole scale of such fees is outrageous.

Mr. Hillman's attack would appear to go far beyond the merits of this particular settlement. His attack is on the industry as a whole and the way it conducts its business.

A $\frac{1}{2}$ of 1% rate has sometimes been referred to as the classic fee in the industry, and there was a showing that some 18% of the funds are charged in excess of this rate.¹⁷⁸

Similar in tenor was *Saminsky v. Abbott*,¹⁷⁹ where the trial court noted that the benefits to be derived by the fund under the settlement which it was approving "were not too great in view of the realities,"¹⁸⁰ but found no merit in the objectors' contentions because:

The objectors * * * assert that the * * * charges as proposed in the settlement are excessive and unreasonable.

Thus, they say, the Trustee's return on net worth ranged from 45% in 1960 to 212% in 1962. It is said that by applying the proposed fee schedule to 1962, the Trustee's return would still be 190%. The objectors and their expert witness both contend that such "returns" were and are excessive. They say moreover that they have resulted from lack of competitive forces in the industry in general (because of the management company's built-in control) and a continuing breach of fiduciary duty in this case by a self-dealing trustee.

* * * I can only say that the legal format involved is not illegal and if there is to be "regulation" of this so-called "built-in" control, it must come from the legislative branch unless it results in the violation of some positive principle of law, such as that applicable to a waste of assets. These observations are equally applicable to the contention that the allegedly excessive profits flow from a breach of duty by a self-dealing trustee.¹⁸¹

And in *Glicker v. Bradford*¹⁸² the court in approving the settlement commented that "it is quite conceivable that a Court or a jury would find that what plaintiffs were really challenging was the Fund System as a whole of which defendants were but a part rather than any wrongdoing on the part of defendants."

Shareholder approval undermined the position of the intervenors who sought to block the settlements. Its effect was double edged. First, that the challenged agreements had been approved by the

¹⁷⁸ 211 F. Supp. at 401, 403.

¹⁷⁹ 194 A. 2d 549 (Del. Ch., 1963), affirmed sub nom. *Kleinman v. Saminsky*, 200 A. 2d 572 (Del. Sup. Ct., 1964), certiorari denied, 379 U.S. 600.

¹⁸⁰ 194 A. 2d at 552.

¹⁸¹ 194 A. 2d at 551-552.

In affirming, the Supreme Court of Delaware approved the trial court's analysis of the issues and observed: "Appellant * * * argues that a comparison with the fees paid by other investment companies is meaningless because none of the fees has been established competitively. It seems to us, however, that generally speaking the fact that all such fees show a pattern of uniformity suggests strongly that they have been established by forces which, in a sense, are the equivalent of competition. Furthermore, appellants do not suggest any means of using competition to establish fees, nor can we think of one. The economic facts preclude it." *Kleinman v. Saminsky*, 200 A. 2d 572, 577, certiorari denied, 379 U.S. 900 (1964).

¹⁸² 35 F.R.D. 144, 159 (S.D.N.Y., 1964).

shareholders cast so serious a doubt on the possibility of recovery that the courts were disposed to view any sort of a settlement as being of sufficient benefit to the fund to warrant the termination of the litigation. Second, where shareholders subsequently ratified all of the actions under attack, such ratification was viewed as indicative of the reasonableness of the settlement.¹⁸³

(d) *Summary*

Thus far shareholder resort to the courts in connection with advisory fees has been relatively ineffective in dealing with the divergent interests of the externally managed mutual funds and their investment advisers. Of course, no appellate court has ever passed on the merits of any advisory fee case.¹⁸⁴ Nor has any court—trial or appellate—fully explored the impact of the present provisions of the Act on the legally permissible level of advisory fees. Whatever their latent possibilities, existing legal controls suffer from a number of defects which make their effectiveness highly uncertain.

These defects stem from the nature of the two strands from which the present regulatory pattern is woven. The first strand consists of a body of State law generally applicable to business associations. That body of law was never intended to deal with and takes no special cognizance of the unusual problems of investor protection stemming from the position of the externally managed funds and their shareholders vis-a-vis the investment advisers. The second strand consists of the Federal securities laws, mainly the Investment Company Act. That statute was the product of congressional concern over the adverse effect on the national public interest and the interests of investors of malpractices endemic to the investment company industry of that day, a far smaller industry than the investment company industry of today.

Among the most important of these abuses were many forms of self-dealing between investment companies and their insiders. Thus with respect to transactions between investment companies and their principal underwriters, promoters, and affiliates which involve the lending of money or the purchase or sale of securities or other property, the regulatory controls provided by the Act are thoroughgoing.¹⁸⁵ Similarly, the Act contains comprehensive regulatory controls in the one area of management compensation—management fees and charges other than sales loads paid by contractual plan holders—where serious abuses were found to exist prior to 1940.¹⁸⁶ However, in the relatively

¹⁸³ See, e.g., *Kleinman v. Suminsky*, 200 A. 2d 572, 577 (Del. Sup. Ct., 1964): "At the very least such ratification demonstrates that reasonable businessmen might differ upon the propriety of the settlement in which event the duty of the court is to approve the settlement."

In *Rome v. Archer*, 197 A. 2d 49, 55 (Del. Sup. Ct., 1964) the suggestion that a claim of excessiveness founded on the Investment Company Act might be unaffected by ratification was dismissed on the ground that "since the Federal Act sets no maximum fee schedule, the same considerations found relevant in *Saxe* would probably also be relevant in litigation considering the Investment Company Act of 1940."

¹⁸⁴ Of the three advisory fee cases that have gone to the appellate courts, one (*Brown v. Bullock*, 294 F. 2d 415 (C. A. 2, 1961)) involved preliminary issues as to the legal sufficiency of the allegations in the complaint, and the other two (*Rome v. Archer*, 197 A. 2d 49 (1964); and *Kleinman v. Suminsky*, 200 A. 2d 572, certiorari denied, 379 U.S. 900 (1964)) involved the fairness of settlements that had been approved by the courts below.

¹⁸⁵ The Act prohibits such transactions unless the Commission first finds that "the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned." Secs. 17 (a) and (b).

¹⁸⁶ The Act specifically authorizes the Commission to prescribe reasonable management fees and charges only where a management company issues a periodic payment plan certificate. Sec. 27 (g) (5). In fact, such certificates are very seldom issued by management companies. They are commonly issued by unit investment trusts and sec. 27 (a) (6) prohibits the sponsor or underwriter of such a trust (or persons affiliated with the trust's sponsor or underwriter) from receiving compensation from a management company in excess of such amount as the Commission may prescribe.

small investment company industry of 1940 advisory fees generally were not an area of primary concern.¹⁸⁷ Thus, Congress determined to sanction the continuance of external management in the investment company industry subject to a "few elementary safeguards," which it was believed would operate as effective restraints on such fees.¹⁸⁸

The interaction with State law of the disclosure requirements of the Federal securities laws and the Acts' safeguards with respect to advisory contracts has been disappointing. These federally created shareholder protections under State law have been construed as precluding judicial inquiry into the "reasonableness" or "fairness" of advisory fees. The courts have considered themselves powerless to intervene—except in cases where the fee is "wasteful," "unconscionable," or "shocking."

The courts considered themselves bound to reach this result despite evidence of their concern over the reasonableness of the advisory fees. In *Acampora v. Birkland*, *supra*, the court stated:

Certainly, the one-half of one percent approach leaves a great deal to be desired (even though counsel does not now challenge the propriety of this). Such a guaranteed fee fails to take into account success or failure of the advisory effort. Still another bad feature is that its probable increase is disproportionate to the value of the services rendered.¹⁸⁹

The courts viewed the level of the advisory fee as a consequence of the industry structure sanctioned by the Act. The court in *Saxe v. Brady*, *supra*, 184 A. 2d at 616, stated:

If the fund management company format is to be legally questioned, such inquiry must come from some other place.¹⁹⁰

If the law continues to develop in the direction indicated by the cases discussed above, the Act will not protect adequately those who invest in investment companies. Such a result was not intended by the Congress in 1940 when it sanctioned the continuance of the external management structure in the investment company industry. The Court of Appeals for the First Circuit has noted that section 1(b), the preamble to the Act,¹⁹¹ "in effect codifies the fiduciary obligations placed upon officers and directors of investment companies."¹⁹² In the Commission's view, the duty of investment company managers to deal fairly with companies they serve is a basic fiduciary obligation.

The Act, however, does not explicitly implement this obligation with respect to management compensation. Generally it places no

¹⁸⁷ See ch. II at pp. 71-72.
¹⁸⁸ Senate Hearings 21-22.

¹⁸⁹ 220 F. Supp. at 547-548.

¹⁹⁰ See also *Saminsky v. Abbott*, 194 A. 2d 549 552 (Del. Ch., 1963); *Taussig v. Wellington Fund, Inc.*, 187 F. Supp. 179, 197 (D. Del., 1960), *affirmed*, 313 F. 2d 972, *certiorari denied*, 374 U.S. 806 (1963); "The Court is mindful that seemingly many practices prevail in this industry that in other areas are legally and economically intolerable * * *."

¹⁹¹ Subsec. (b)(2) of sec. 1 states that "the national public interest and the interest of investors are adversely affected—(2) when investment companies are organized, operated, managed * * * in the interest of directors, officers, investment advisers * * * or other affiliated persons thereof * * * rather than in the interest of all classes of such companies' security holders."

¹⁹² *Aldred Investment Trust v. S.E.C.*, 151 F. 2d 254, 260 (C.A. 1, 1945), *certiorari denied*, 326 U.S. 795 (1946). The court there found that the controlling persons of an investment company caused it to invest 30 percent of its assets in a race track, a business about which they knew nothing, and then proceeded to install themselves as officers of the race track at "handsome" salaries. The court agreed with the Commission that these activities along with other abuses, constituted "gross misconduct" and "gross abuse of trust." within the meaning of sec. 36 of the act, enjoined the defendants from continuing to serve as officers and directors of the investment company, and appointed a receiver for the company.

express limits on the amount of such compensation¹⁹³ and, in contrast to the regulatory controls imposed on most other types of dealings between investment companies and their affiliated persons,¹⁹⁴ it gives no express recognition to the duty of fairness in connection with advisory fees.

Absent express recognition of the duty to charge reasonable fees in the area of management compensation, the means provided in the Act for the enforcement of that duty in this area are unclear and inappropriate. For example, section 36 of the Act authorizes the Commission to seek injunctions against principal underwriters, investment advisers and certain other persons affiliated with investment companies who are "guilty" of "gross misconduct" or "gross abuse of trust" from serving in such capacities permanently or for such time as the court deems appropriate. In the Commission's view, section 36 should be broadly construed so as to effectuate the remedial purposes of the Act. But regardless of whether it can fairly be construed to affect current levels of advisory fees, the very harshness of the sanction provided for in that section impairs its usefulness in modifying advisory fee rates commonly charged in the industry. The failure of a mutual fund adviser to share the economies of size with the fund it serves does not suggest that it has not otherwise discharged its obligations faithfully. Pending consideration by the Commission and Congress of more appropriate means for achieving more adequate controls over investment company management compensation, the Commission has been reluctant to stigmatize advisers with charges of "gross abuse of trust" solely because they have adhered to the traditional pattern of fee rates in the industry.

Because the Act fails to articulate clearly the standard by which the propriety of managerial compensation should be measured, it makes for uncertainty and impairs rather than strengthens the fiduciary obligation of investment company managers to refrain from compensating themselves unfairly. If the Act is to be an effective force for fairness and equity in this area, the "few elementary safe guards," deemed adequate for the industry of 1940 must now be supplemented.

7. *The Commission's recommendations*

(a) *A statutory standard of reasonableness*

The analysis of the shareholder fee litigation not only underscores the need for changes in existing statutory provisions relating to management compensation in the investment company industry but points to the direction which these changes should take. It makes clear the need to incorporate into the Act a clearly expressed and readily enforceable standard that would measure the fairness of compensation paid by investment companies for services furnished by those who occupy a fiduciary relationship to such companies. The Act now contains an express standard of reasonableness which operates effectively as to transactions involving the lending of money or the purchase or sale of securities or other property between on the one hand investment companies and their controlled companies and on the

¹⁹³ Only in one very limited situation does the Act impose an express restriction on advisory fees. That restriction, which is of little practical importance today, appears in sec. 10(d), which permits no load funds to have boards of directors "all of the members of which, except one, are affiliated persons of the investment adviser of such company, or are officers or employees of such company, if * * * such investment adviser does not receive a management fee exceeding 1 per centum per annum of the value of such company's net assets averaged over the year or taken as of a definite date or dates within the year" and if certain other conditions are met.

¹⁹⁴ See p. 141, *supra*.