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INVESTMENT COMPANY AMENDMENTS OF 1967

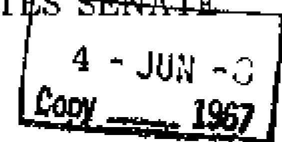
S. 1659

ANALYSIS OF S. 1659

COMPARATIVE PRINT SHOWING CHANGES IN EXISTING LAW

U.S. Congress. Senate

COMMITTEE ON BANKING AND CURRENCY
UNITED STATES SENATE



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STATEMENT OF THE CHAIRMAN

Remarks of Senator John Sparkman, on Introduction of the Bill (S. 1659), in the Senate, May 1, 1967

Mr. Sparkman. Mr. President, I introduce a bill proposed by the Securities and Exchange Commission to amend the Investment Company Act of 1940 and the Investment Advisors Act of 1940.

This legislation is the result of a series of detailed studies made by the Commission, its staff, and consultants. These studies were made pursuant to section 14(b) of the Investment Company Act of 1940, authorizing the Commission, if it finds that "any substantial further increase in the size of investment companies creates any problem involving the protection of investors or the public interest, to make a study and investigation" and to report the results to the Congress. Various aspects of the mutual fund industry have been studied by the Commission, its staff, and the academic community since 1958. The most recent of these, the Commission's report on the "Public Policy Implications of Investment Company Growth," was transmitted to the Congress on December 2, 1966.

Millions of Americans—many of them of modest means—have invested their savings in mutual funds and in other kinds of investment companies, and many more of our citizens will undoubtedly invest enormous additional sums in these companies in years to come. The amount already invested exceeds $46 billion.

This is a matter of long interest to the Committee on Banking and Currency which has jurisdiction over the securities laws of our country. Today this subject is of special importance in view of the rapid growth of the mutual fund industry. In 1940 when the Investment Company Act was enacted, mutual funds with their 300,000 shareholders and total assets of $450 million were on the periphery of the securities industry. Today mutual funds occupy a central position in our economy, having assets of over $40 billion and over 3½ million investors.

This bill, prepared by the Securities and Exchange Commission, will enable the Congress to take a fresh look at the laws which regulate our Nation's investment companies, and to determine whether existing law adequately serves the present needs of these investors and the national economy. It will, at the same time, provide us an opportunity to assure fairness and equity between these investors and those who manage their money.

The Banking and Currency Committee, of which I am chairman, in addition to considering the specific proposals encompassed in this bill, will seek suggestions and alternate courses of action for dealing with these problems. We shall welcome suggestions from investors and members of the mutual fund community as well as from the entire securities industry. Legislation will be recommended to the Senate only after the most careful consideration of all points of view and of the effect of such legislation on the national economy.

The bill is long and complicated, and the explanation of the bill prepared by the SEC is even longer. Together they add up to 124 pages. For this reason, I am not asking to have the bill and the explanation printed in the Record, as is my usual custom with a bill of this sort.

Instead, I am having the SEC's explanation of the bill printed as a committee print, together with a photographic reproduction of the bill, which will make it possible to refer to the bill's pages and lines. This will make a most useful document for the Senators and the industry representatives working on the bill. I expect that it will be available in 3 or 4 days, thanks to the outstanding work of the Government Printing Office.

So that all members of the committee will have an opportunity to hear and question the witnesses, hearings on this bill will be held before the full committee in room 5300, New Senate Office Building, beginning June 19, 1967. Those desiring to be heard may get in touch with Lewis G. Odom, Jr., staff director, telephone number 225-3921.

The PRESIDING OFFICER. The bill will be received and appropriately referred.

The bill (S. 1659) to amend the Investment Company Act of 1940 and the Investment Advisers Act of 1940 to define the equitable standards governing relationships between investment companies and their investment advisers and principal underwriters, and for other purposes, introduced by Mr. Sparkman, was received, read twice by its title, and referred to the Committee on Banking and Currency.

INVESTMENT COMPANY AMENDMENTS OF 1967

PRESS RELEASE FROM THE SECURITIES AND EXCHANGE COMMISSION REGARDING S. 1659

SEC SUBMITS LEGISLATION PROPOSALS TO CONGRESS ON INVESTMENT COMPANIES

The Securities and Exchange Commission announced today that it had submitted to Congress legislative proposals unanimously recommended by the Commission to amend the Investment Company Act of 1940 and the Investment Advisers Act of 1940. They would provide additional protection for mutual fund shareholders in areas where the tremendous growth of the industry since enactment of the Investment Company Act of 1940 has created needs which were either unanticipated or of secondary importance at that time. Between the end of 1940 and June 30, 1966, investment company assets increased from about $2.1 billion to $46.4 billion. Most of this growth was accounted for by mutual funds, whose net assets increased from $450 million at the end of 1940 to about $38.2 billion at June 30, 1966. By the end of 1965 there were more than 3,500,000 mutual fund investors as compared with less than 300,000 in 1940.

The Commission's proposals are the outgrowth of studies made by or for the Commission pursuant to Congressional direction, primarily that contained in Section 14(b) of the Investment Company Act of 1940 which authorizes the Commission if it finds "that any substantial further increase in the size of investment companies creates any problem involving the protection of investors or the public interest, to make a study and investigation" and to report the results to the Congress.

The first of these studies, which commenced in 1958 pursuant to Commission direction, was made by the Wharton School of Finance and Commerce of the University of Pennsylvania. The report submitted to the Congress in August of 1962 found that the more important current problems in the mutual fund industry involved potential conflicts of interest between the fund management and shareholders and the impact of fund growth and purchases on stock prices. The Wharton School Report was followed by the Report of the staff of the Commission's Special Study of the Securities Markets which, insofar as mutual funds were concerned, examined sales of mutual fund shares including sales practices and the special problems raised by the so-called front-end load in the sale of periodic payment plans for the accumulation of such shares.

Neither the Special Study nor the Wharton Report was a report by the Commission. Following publication of these reports the Commission undertook to evaluate the public policy questions that they raised as part of an extensive study of its own and to report its recommendations to the Congress. The results of that study are found in

the Commission's Report on the Public Policy Implications of Investment Company Growth which was transmitted to the Congress on December 2, 1966 and published as House Report No. 2337, 89th Cong., 2d sess. The legislative proposals transmitted herewith are designed to carry out the recommendations contained in that report.

Areas of primary concern in the report included the costs of management and sales charges. Mutual funds, although ordinarily organized either as corporations or as business trusts usually are managed and operated not by their own officers and employees but by separate entities which provide management and advisory services under contract with the fund. Traditionally these contracts have provided for compensation on the basis of a percentage of the assets of the fund. As the funds have grown in size the amounts of management fees have likewise grown and the Commission's report concluded that economies of scale in the cost of managing large pools of assets have seldom been shared equitably with investment company shareholders. The proposed legislation would expressly require that management fees be reasonable and make this standard enforceable in the courts. However, any person attacking the reasonableness of a management fee which had been approved by the fund's directors as required by the Investment Company Act would have the burden of proving that the fee was unreasonable. A requirement that the fee be reasonable would appear inherent in the fiduciary relationship between investment company shareholders and an investment advisory organization which is in effective control of the fund. The existing provisions of the Investment Company Act, however, provide no adequate means by which such a requirement may be enforced.

The proposed legislation would also place a 5% ceiling on charges for mutual fund sales, subject to a power in the Commission to grant exceptions where appropriate. This proposed maximum charge would still be substantially greater than the sales charges generally prevailing in the securities markets such as stock exchange commissions or over-the-counter markups for securities of comparable quality. As a result, in part, of the resale price maintenance scheme provided in Section 22(d) of the Investment Company Act, which the mutual fund industry regards as important for the preservation of the existing pattern of distribution of such shares, competition has not operated to reduce sales loads. Rather, the sales charges paid by the average or small investor have tended to increase as investment companies competed for the favor of dealers and their salesmen.

Of particular concern are the sales charges paid by those investors, generally small investors, who accumulate mutual fund shares by monthly payments over a period of years. Under the existing provisions of the statute, up to 50% of the first year's payments may be deducted for sales charges. The Commission's study as well as the Special Study showed that a substantial portion of such investors are unable or unwilling to complete their plans, with the result that up to half of the money that they pay in goes for sales costs. The proposed legislation would eliminate the front-end load feature and require that sales charges be spread equally over all payments, thus reducing the undue risk of loss suffered by those investors who do not complete their plans, as well as making sure that a greater proportion of the money paid by an investor is invested for his benefit.

The proposed legislation would also contain other provisions which are designed primarily to facilitate the administration and enforcement

of the Investment Company Act, to eliminate certain anomalous situations, and to update and correct certain provisions.

These legislative proposals recognize as did the Commission's report that on the whole the investment company industry reflects diligent management by competent persons, that the industry has provided a useful and desirable means for investors to obtain diversification of investment risks and professional investment management and that drastic changes in the Investment Company Act of 1940 are not required. The Commission believes, however, that enactment of these proposals would assure fairer treatment for the millions of Americans, including many of modest means, who have chosen to invest many billions of dollars in investment company securities.

The Bureau of the Budget advises that enactment of legislation along the lines of the Commission's proposals would be in accord with the program of the President.

The principal legislative proposals other than those relating to management fees, basic sales and front-end loads are as follows:

1. *Insider Trading in Portfolio Securities.* A new Section 17(j) would be added to the Act to empower the Commission specifically to adopt rules and regulations with respect to trading in securities held or being acquired by investment companies by persons affiliated with such companies. This proposal would fill the need for better definitions of standards and codes of ethics with respect to insider trading in investment company portfolio securities.

2. *Capital Gains Distributions.*—Section 19 of the Act would be amended generally to prohibit investment companies from distributing realized capital gains to shareholders more than once a year. This proposal would require all investment companies to conform to the practice now followed by the majority of investment companies.

3. *Disciplinary Proceedings.* Section 9 of the Act, which presently disqualifies from association with an investment company persons convicted or enjoined on the basis of specified acts of misconduct, would be amended to conform to the corresponding provisions of the Securities Exchange Act and the Investment Advisers Act by authorizing administrative proceedings before the Commission to determine whether or not any person connected with an investment company has willfully violated the federal securities laws and if so what sanctions, if any, should be imposed in the public interest.

4. *Breach of Fiduciary Duty.*—Section 36 of the Act, which presently permits the Commission to seek an injunction against investment company managers alleged to be guilty of gross misconduct or gross abuse of trust, would be amended to authorize action against such persons for breach of fiduciary duty to the investment company and to give the court greater flexibility in choosing remedies.

5. *Disinterested Directors.*—Sections 2(a), 10, 15 and 32(a) of the Act would be amended for the purpose of requiring that persons acting as so-called independent directors of investment companies be entirely independent of and disinterested in the management. This would exclude, among other things, persons having close family business or professional relationships with management from being classified as independent directors.

6. *Transfer of Investment Advisory Contracts.*—A new Section 15(g) would be added to the Act to prohibit the transfer of investment advisory or management contracts with investment companies on

terms which are burdensome or inequitable to the investment company.

7. *Fund Holding Companies.*- Section 12(d)(1) of the Act would be amended to prohibit the creation of new fund holding companies or the acquisition of additional securities of registered investment companies by existing fund holding companies. At present only one such organization, the Swiss-based Fund of Funds, Ltd., has attained substantial size.

There would be numerous other amendments to the Investment Company Act, most of which are designed to update its provisions to eliminate inconsistencies and to delete certain exemptions which have been found to have been unjustified.

AMENDMENTS TO THE INVESTMENT ADVISERS ACT

The Investment Advisers Act would be amended to conform its provisions for disciplinary action to the 1964 Amendments to the Securities Exchange Act of 1934 and to eliminate the exemptions from the Act for investment advisers serving investment companies.

Letter of Transmittal

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., May 1, 1967.

The PRESIDENT OF THE SENATE.
The SPEAKER OF THE HOUSE OF REPRESENTATIVES.

SIR: I have the honor to transmit legislative proposals unanimously recommended by the Securities and Exchange Commission with the hope that they will be introduced and enacted in this first session of the 90th Congress. They would provide additional protection for mutual fund shareholders in areas where the tremendous growth of the industry since enactment of the Investment Company Act of 1940 has created needs which were either unanticipated or of secondary importance at that time. Between the end of 1940 and June 30, 1966, investment company assets increased from about $2.1 billion to $46.4 billion. Most of this growth was accounted for by mutual funds whose net assets increased from $450 million at the end of 1940 to about $38.2 billion at June 30, 1966. By the end of 1965 there were more than 3,500,000 mutual fund investors as compared with less than 300,000 in 1940.

The Commission's proposals are the outgrowth of studies made by or for the Commission pursuant to congressional direction, primarily that contained in section 14(b) of the Investment Company Act of 1940 which authorizes the Commission if it finds "that any substantial further increase in the size of investment companies creates any problem involving the protection of investors or the public interest, to make a study and investigation" and to report the results to the Congress.

The first of these studies, which commenced in 1958 pursuant to Commission direction, was made by the Wharton School of Finance and Commerce of the University of Pennsylvania. That report submitted to the Congress in August 1962 found that the more important current problems in the mutual fund industry involved potential conflicts of interest between the fund management and shareholders and the impact of fund growth and purchases on stock prices. The Wharton Report was followed by the report of the staff of the Commission's Special Study of the Securities Markets, which, insofar as mutual funds were concerned, examined sales of mutual fund shares including sales practices and the special problems raised by the so-called front-end load in the sale of periodic payment plans for the accumulation of such shares.

Neither the Special Study nor the Wharton Report was a report by the Commission. Following publication of these reports the Commission undertook to evaluate the public policy questions that they raised as part of an extensive study of its own and to report its recommendations to the Congress. The results of that study are found in the Commission's Report on the Public Policy Implications of Investment Company Growth which was transmitted to the Congress

on December 2, 1966, and published as House Report No. 2337, 89th Congress, second session. The legislative proposals transmitted herewith are designed to carry out the recommendations contained in that report.

Areas of primary concern in the report included the costs of management and sales charges. Mutual funds, although ordinarily organized either as corporations or as business trusts, usually are managed and operated not by their own officers and employees but by separate entitites which provide management and advisory services under contract with the fund. Traditionally these contracts have provided for compensation on the basis of a percentage of the assets of the fund. As the funds have grown in size the amounts of management fees have likewise grown and the Commission's report concluded that economies of scale in the costs of managing large pools of assets have seldom been shared equitably with investment company shareholders. The proposed legislation would expressly require that management fees be reasonable and make this standard enforceable in the courts. However, any person attacking the reasonableness of a management fee which had been approved by the fund's directors, as required by the Investment Company Act, would have the burden of proving that the fee was unreasonable. A requirement that the fee be reasonable would appear inherent in the fiduciary relationship between investment company shareholders and an investment advisory organization which is in effective control of the fund. The existing provisions of the Investment Company Act, however, provide no adequate means by which such a requirement may be enforced.

The proposed legislation would also place a 5-percent ceiling on charges for mutual fund sales, subject to a power in the Commission to grant exceptions where appropriate. This proposed maximum charge would still be substantially greater than the sales charges generally prevailing in the securities markets such as stock exchange commissions or over-the-counter markups for securities of comparable quality. As a result, in part, of the resale price maintenance scheme provided in section 22(d) of the Investment Company Act, which the mutual fund industry regards as important for the preservation of the existing pattern of distribution of such shares, competition has not operated to reduce sales loads. Rather the sales charges paid by the average or small investor have tended to increase as investment companies competed for the favor of dealers and their salesmen.

Of particular concern are the sales charges paid by those investors, generally small investors, who accumulate mutual fund shares by monthly payments over a period of years. Under the existing provisions of the statute, up to 50 percent of the first year's payments may be deducted for sales charges. The Commission's study as well as the special study showed that a substantial portion of such investors are unable or unwilling to complete their plans, with the result that up to half of the money that they pay in goes for sales costs. The proposed legislation would eliminate the front-end load feature and require that sales charges be spread equally over all payments, thus reducing the undue risk of loss suffered by those investors who do not complete their plans, as well as making sure that a greater proportion of the money paid by an investor is invested for his benefit.

The proposed legislation would also contain other provisions which are designed primarily to facilitate the administration and enforcement

of the Investment Company Act, to eliminate certain anomalous situations, and to update and correct certain provisions.

These legislative proposals recognize as did the Commission's report that on the whole the investment company industry reflects diligent management by competent persons, that the industry has provided a useful and desirable means for investors to obtain diversification of investment risks and professional investment management and that drastic changes in the Investment Company Act of 1940 are not required. We believe, however, that enactment of these proposals would assure fairer treatment for the millions of Americans, including many of modest means, who have chosen to invest many billions of dollars in investment company securities.

The Bureau of the Budget advises that enactment of legislation along the lines of this bill would be in accord with the program of the President.

By direction of the Commission.

MANUEL F. COHEN,
Chairman.

ANALYSIS OF THE BILL (S. 1659) PREPARED BY THE SECURITIES AND EXCHANGE COMMISSION

Introduction

This statement explains the legislative proposals recommended by the Securities and Exchange Commission to amend the Investment Company Act of 1940 and the Investment Advisers Act of 1940. They would provide additional protection for investment company shareholders in areas where the tremendous growth of the industry since 1940 has created needs which were either unanticipated or of secondary importance in 1940.

The legislative proposals would implement the recommendations of the Commission in its report entitled "Public Policy Implications of Investment Company Growth," House report No. 2337, 89th Congress, second session. That report was the outgrowth of studies first commenced in 1958 made by or for the Commission pursuant to congressional direction, primarily that contained in section 14(b) of the Investment Company Act of 1940, which authorizes the Commission if it finds "that any substantial further increase in the size of investment companies creates any problem involving the protection of investors or the public interest, to make a study and investigation" and to report the results to Congress.

The areas of primary concern in the report included the cost of management and sales charges to mutual fund investors. Part A of this statement discusses proposed amendments to the Investment Company Act which would expressly require that management compensation be reasonable and provide for the enforcement of this standard in the courts. Part B of this legislation discusses the proposal to amend section 22 of the Investment Company Act to place a 5-percent maximum on sales charges for mutual fund shares, subject to a power in the Commission to grant exceptions where appropriate. Part B also explains the proposed amendments to sections 27 and 28 of the Investment Company Act which now permit the deduction for sales load purposes of up to 50 percent of the first year's payments made by investors who accumulate investment company securities by monthly payments over a period of years. The proposed legislation would eliminate this so-called "front-end load" and require that sales charges be spread equally over all payments.

The remaining parts of this statement explain various other proposed amendments which are designed primarily to facilitate administration and enforcement of the Investment Company Act and the Investment Advisers Act, to eliminate certain anomalous situations, and to update and correct certain provisions.

CROSS-REFERENCE TABLE I

Section-by-section guide to the Investment Company Act of 1940, the amendatory bill, this analysis of that bill prepared by the Securities and Exchange Commission, and the recommendations in the Commission's report of December 2, 1966, on "Public Policy Implications of Investment Company Growth" (H. Rept. 2337, 89th Cong., second sess.).

Section of the amendatory bill	Affected section of the Investment Company Act of 1940	Nature of change proposed in amendatory bill	Explanation in this analysis prepared by the Securities and Exchange Commission (references are to pages of this Committee Print)	Recommendations in "Public Policy Implications of Investment Company Growth" (references are to pages) [1]
1	None. But see xvii and xviii	Preamble and short title of amendatory bill.	None	None. But see 1-14.
2(1)	2(a)(5)	Change in reference to another statute which has been amended	32	341.
2(2)	2(a)(19) through 2(a)(42)	Renumbering of paragraphs	None	None.
2(3)	Would add new sec. 2(a)(19)	Definition of interested person	21-24	332-334.
2(4)	Existing sec. 2(a)(19), which would become redesignated sec. 2(a)(20).	Redefining the term "investment adviser" so as to include corporate trustees.	29	332.
3(a)	3(b)(2)	Addition of express requirement of good faith in applications for declarations that applicants are not investment companies.	26	327-328.
3(b)(1)	3(c)	Deletion of superfluous reference	32	341.
3(b)(2)	3(c)	Renumbering paragraphs to reflect repeal of 3(c)(4) in 1964 and proposed repeal of 3(c)(8).	None	None.
3(b)(3)	Existing sec. 3(c)(6) which would become redesignated sec. 3(c)(5).	Modification of exclusion for factoring, discounting, and real estate companies.	27	328-329.
3(b)(4)	Existing 3(c)(10) which would become redesignated 3(c)(8).	Clarification of exclusion for public utility holding companies	28	330.
3(b)(5)	Existing sec. 3(c)(11) which would become redesignated sec. 3(c)(9).	Modification of exclusion for companies holding oil, gas, or other mineral royalties.	28	329.
3(b)(6)	Existing sec. 3(c)(13) which would become sec. 3(c)(12).	Updating reference to Internal Revenue Code	33	342.
4	9	Changes in scope of Commission action against persons serving investment companies.	24-25	338-340.
5(a)	10(a)	Substitution of new term "interested person" for present term "affiliated person" in section relating to composition of investment company board of directors.	21-4	332-334.
5(b)	10(b)	do	do	332-334.
5(c)	10(c)	do. Will also correct inconsistency in statutory text	do [2]	332-334, [3]
5(d)	10(d)	do	do	332-334.
6	11(b)(2)	Deletion of sales charge in exchanges of series shares	17	331-332.
7	12(d)	Preventing the creation and operation of fund holding companies	19-21	322-324.
8(a) through 8(d)	15(a) through 15(c) plus new sec. 15(d)	Addition of express standard of reasonableness for managerial compensation in investment company industry and provisions for enforcement of such standard.	8-12	143-149.
8(e)	New sec. 15(g)	Prohibition of burdensome transfers of management relationships	12-13	152-153.

See footnotes at end of table, p. 6.

CROSS-REFERENCE TABLE I—Continued

Section of the amendatory bill	Affected section of the Investment Company Act of 1940	Nature of change proposed in amendatory bill	Explanation in this analysis prepared by the Securities and Exchange Commission (references are to pages of this Committee Print)	Recommendations in "Public Policy Implications of Investment Company Growth" (references are to pages) [1]
9(a)	17(f)	Provision for bank custody of investment company cash assets in certain cases	30	335-336.
9(b)	New sec. 17(j)	Rulemaking authority with respect to insider trading in investment company portfolio securities.	18-19	199-200.
10	18(f)(2)	Modification of definition of "senior security"	28-29	339-341.
11	New sec. 19(b)	Prohibiting distribution of long term capital gains more frequently than once a year.	19	193-195.
12(a) and 12(b)	Repeal of 22(b) as 22(b), and amendment of present 22(c) which would be redesignated 22(b).	Deletion of SEC and NASD rulemaking authority with respect to grossly excessive and unconscionable sales loads.	13-15	221-223
12(c)	New sec. 22(c)	5-percent limitation on sales loads coupled with discretionary authority in the Commission to exempt applicants from this limit and to prohibit or restrict charging of sales loads in circumstances where such charges would be inequitable to investors.	do	Do.
13	24(d)	Updating reference to Securities Act of 1933 to reflect 1954 amendments thereto	34	342
14	25(c)	Improved standard for judicial scrutiny of investment company reorganizations.	31	336-337.
15	26	Substitution of underlying securities of unit trusts	31	337.
16	27	Abolition of front-end load in sale of contractual plans	15-16	246-247.
17	28	Abolition of front-end load on, and application of, 5-percent sales charge ceiling to face amount certificates.	16-17	250.
18	32(a)	Attendance at directors' meetings; selection of independent accountants by investment company directors.	23, 29-30	332-335.
19	33	Transmission to the Commission of papers filed in shareholder actions.	32	338.
20	36	Deletion of the word "gross" from statutory provisions governing injunctions breach of fiduciary duty.	25-26	340-341
21	38(a)	Clarification of extent of Commission's authority to make rules under Investment Company Act.	34	343.
22 & 23	43(a) & 44	Updating statutory references	do	Do.

[1] This table has been cross-referenced only to the specific recommendations in "Public Policy Implications of Investment Company Growth", and not to the background discussion therein.
[2] See also 33.
[3] See also 342.

CROSS-REFERENCE TABLE II

Showing the effect of the amendatory bill on the Investment Advisers Act of 1940 with cross-references to the corresponding sections of the Securities Exchange Act of 1934, as amended by the Securities Acts Amendments of 1964, this analysis of the amendatory bill prepared by the Securities and Exchange Commission, and the Commission's Report of December 2, 1966, on the "Public Policy Implications of Investment Company Growth" (H. Rept. No. 2337, 89th Cong., 2d sess.).

Section of the amendatory bill	Affected section of the Investment Advisers Act of 1940	Nature of change proposed in amendatory bill	Corresponding section in Securities Exchange Act of 1934, as amended in 1964	Explanation in technical statement (references are to pages of this Committee Print)	Recommendations in "Public Policy Implications of Investment Company Growth" (references are to pages)
24	202(a)	Addition of new section 202(a)(17) defining term "person associated with an investment adviser."	3(a)(18)	37-38	343-344
25(a)	203(b)	Removal of exemption from Investment Advisers Act for investment advisers to investment companies.	None	35-36	344-345
25(b)	203(c)	Revision of provisions as to information to be furnished by applicants for registration under Investment Advisers Act.	15(b)(1)	37-38	343-344
25(c)	Insertion of subsec. 203(d) and appropriate redesignations	Changes in requirements of proof	15(b)(4)	38	346
25(d)	Existing subsec. 203(d) which would become 203(e).	Adding authority to censure to range of Commission disciplinary sanctions.	15(b)(5)	None	343-344
25(e)	Addition of new subsec. (f) and appropriate redesignations.	Grant of Commission authority to bar persons guilty of misconduct from association with investment advisers	15(b)(7)	37-38	343-344
26	205	Removal of exemption to advisers to investment companies	None	36	344-345
27	Insertion of new sec. 207 and redesignation of secs. 208 through 223.	Grant of discretionary exemptive authority to Commission to conform Investment Advisers Act to Investment Company Act	None. But see sec. 6(c) of the Investment Company Act of 1940.	38	[1] 345-346

[1] The last section of the amendatory bill, sec. 28, specifies the dates on which its various sections would become effective. See pp. 38-39 of the Commission's analysis.

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PART A: MANAGEMENT AND ITS COST

SECTION 8, AMENDING SECTION 15—STATUTORY STANDARD OF REASONABLENESS

Section 8 of the bill would amend section 15 of the Investment Company Act to apply to advisory fees and other forms of compensation received by investment company managers an express statutory standard of reasonableness. This section of the bill deals with problems that are deeply rooted in the unique structural characteristics of the investment company industry, characteristics that are especially marked in its mutual fund sector. Unlike most other American corporations and financial institutions, which employ their own staff to manage their affairs, mutual funds typically receive investment advice and management services from separate organizations which are owned and controlled by the organizers of the fund or their successors. A very small minority of existing funds are "internally" managed.

The separate "investment adviser" is compensated for its services by an advisory fee almost always based on a percentage of the fund's net assets. Traditionally, the fee has been set in the area of one-half of 1 percent of average net assets. Although the growth of the mutual funds has resulted in very substantial management economies, in many cases these economies of size have not been adequately shared with the funds and their stockholders.

The close relationships that traditionally exist between the funds and their advisers have precluded either effective competition for advisory contracts or meaningful arm's-length bargaining over fees. In a substantial number of instances, the percent fee rate has been reduced for net assets in excess of a designated amount, but the reductions are often insubstantial, even for the larger funds. The management and advisory costs of the externally managed funds are, as a general rule, appreciably higher than the corresponding costs of internally managed funds of comparable size. They substantially exceed the fees charged by investment advisers to other types of clients for portfolio management and advice.

Management compensation was not considered a major problem in the relatively small investment company industry of 1940. The act, therefore, included only a "few elementary safeguards," to quote the phrase used by the Commission's spokesman in the Senate hearings of 1940—mainly a requirement that advisory contracts be disclosed to, and approved by, shareholders and "unaffiliated" directors. These safeguards have not proved effective in providing fund shareholders with a meaningful share in the economies of size to which the growth of the funds has led. Moreover, some courts have held that shareholder approval limits judicial inquiry into the fairness of advisory fees and precludes a remedy in the absence of "waste."

The bill would incorporate the standard of reasonableness into the act by substituting a new section 15(d) for the existing section.

1. THE SCOPE OF THE STANDARD

Proposed section 15(d) would state expressly that compensation for services to a registered investment company received by any investment adviser, officer, director, and controlling person of or principal underwriter for such a company shall be reasonable. The main thrust of this section would be toward the fees that investment advisers receive for the advisory and other management and administrative services that they supply to externally managed investment companies. Fees of this type constitute the principal form of management compensation in the investment company industry. The standard of reasonableness would also apply to all forms of managerial compensation in the investment company industry, including salaries, commissions, fees, and payments received by officers and directors, including trustees, of the so-called internally managed companies.

The standard of reasonableness would apply to compensation for services provided to an investment company whether or not deducted on the books of the investment company from each security holder's account and would similarly apply to administrative fees and charges deducted from the accounts of users of withdrawal plans, reinvestment plans, and optional services offered to investment company shareholders.

The proposed section would apply to compensation for services to an investment company only when received by its investment advisers, principal underwriter, officers, directors, controlling persons, and persons affiliated with such persons. The standard would be inapplicable to compensation for services furnished to investment companies received by persons whose relationships with those companies are not inconsistent with genuine arm's-length bargaining between buyer and seller. Thus for example, dealings between an investment company and banks and printers would not be subject to the standard of reasonableness unless, by virtue of other relationships, such persons occupy the status of fiduciaries for the investment company.

The statutory standard of reasonableness would not interfere with the internal compensation arrangements of investment advisers to, or principal underwriters of, investment companies. Advisers and principal underwriters would be free to remunerate their officers, directors and employees in such fashion as they wished.

2. APPLICATION OF THE STANDARD

Section 8(c) of the bill seeks to facilitate well-informed directorial consideration of the matters relating to advisory fees. It places investment company directors under a duty to request and evaluate—and imposes a correlative duty on investment advisers to furnish the information reasonably necessary to determine the reasonableness of the compensation provided for in an advisory contract.

Reasonableness would, of course, have to be determined in the light of all factors relevant to that issue. A number of those factors are specified in proposed new section 15(d)(2).

Clause (A) would require consideration of the nature and extent of the services to be provided, based on separate evaluation of the compensation to be paid for investment advisory services and of the compensation to be paid for all other services. This evaluation would be facilitated by section 8(a) of the bill which would amend section 15(a) of the act to require that advisory contracts describe precisely and "separately" the compensation payable for the two types of services. This requirement would recognize the difficulties which are inherent in evaluating an advisory fee which (as is typically the case) calls for a

lump sum payment covering both professional services required for investment management and routine administrative services incident to the operation of investment companies as corporate or trust entities.

An illustration of the applicability of clause (A), which requires consideration of the nature and extent of services provided, is furnished by those situations in which an investment company has two investment advisers each providing a different service. It would, of course, be unreasonable to pay each of the two advisers at a rate which would constitute the maximum reasonable compensation to a single adviser who assumes complete management responsibility.

Under clause (B) the quality of the service provided would also be relevant to the reasonableness of an advisory fee. Thus superior investment performance in relation to a fund's objectives would be entitled to appropriate recognition.

Clause (C) states the principle that mutual fund shareholders are entitled to an equitable share of the economies attributable to the growth of their funds. It provides that a determination as to reasonableness shall include consideration of the extent to which the compensation of the adviser takes into account such economies of scale, including economies attributable to the operation of other investment companies managed by the same adviser. It also makes clear that consideration should be given to the reflection of economies of scale in the compensation received for investment advisory and other services rendered to internally managed investment companies, other clients of investment advisers and other financial institutions. As pointed out in chapter III of the Commission's report, the advisory fees charged to externally managed investment companies are generally substantially higher than the fees charged to other types of investment advisory clients, such as pension and profit-sharing plans and individual advisory accounts. Since charges to these clients (as contrasted to investment companies) often are influenced by strong competitive forces, they tend to reflect to a much greater extent the decreased cost per dollar managed of large accounts.

The management of investment company portfolios has many characteristics in common with the management of other types of large investment securities portfolios. Accordingly, the fees received by the managers of other types of portfolios can furnish meaningful guidelines for the application of the standard of reasonableness to investment company management compensation. As the Commission's report notes, however, there are a number of differences in the nature and extent of the investment management and administrative services provided various types of investment media and accounts. Clause (C), therefore, would provide expressly that due allowance be given to these differences when comparing the fees for management and administrative services by other financial institutions with the compensation received by investment company managers.

Clause (D) provides that the reasonableness of advisory fees received from an investment company would be evaluated in the light of all other benefits directly or indirectly received by the investment adviser by virtue of its relationship to the company.

Clause (E) would make clear that an evaluation of the reasonableness of advisory fees is not limited to the specific factors enumerated in section 15(d) but would include such other factors as are appropriate and material. Ordinarily, no single factor would be determinative of reasonableness. For example, an advisory fee paid by a no-load fund or a charge for execution of a portfolio transaction by an affiliated broker-dealer may, in light of other factors, be unreasonably high even though below the maximum charge expressly set forth in the act.

The standard of reasonableness would not, of course, prevent those affiliated with investment companies from realizing profits on the services they provide to such companies. Its effect would be to make clear that those who benefit from fiduciary relationships with investment companies should obtain no greater rewards for the services they furnish to such companies than they would expect to obtain from purchasers of their services with whom they deal at arms' length.

3. ENFORCEMENT OF THE STANDARD

The applicability of the standard of reasonableness provided in proposed section 15(d)(1) would be postponed under section 28 of the bill until 1 year following enactment. Thereafter, actions to enforce the standard would be governed by the provisions of section 15(d). Section 15(d)(3) would provide that the party attacking the reasonableness of managerial compensation received pursuant to an advisory contract or other arrangement approved or otherwise authorized in compliance with the procedures set forth in the act would have the burden of persuading a court by a preponderance of the evidence that such compensation was unreasonable. While recognizing that the primary responsibility for a determination as to the reasonableness of compensation lies with investment company directors this provision would eliminate the effect of certain State court decisions which have held that shareholder or directorial approval of advisory contracts operates to change the standard otherwise applicable to such transactions from fairness to "waste." Under the "waste" standard, the party seeking to overturn a contract must prove that the compensation which it provides is grossly and shockingly excessive.

Section 15(d)(5) would provide that the recipients of unreasonable compensation would be the only persons from whom recovery could be obtained. Under section 15(d) such persons would be liable only for the unreasonable portion of the challenged compensation actually received by them. Disinterested directors and others who received no part of the unreasonable compensation would have explicit statutory protection against personal liability.

Proposed section 15(d)(4) would provide a 2-year statute of limitations in section 15(d) cases. This limitation recognizes the need of investment company management organizations, many of which are publicly owned, for a measure of security with respect to the revenues and earnings they receive from the investment companies they serve. Absent a limitation on recoveries of compensation subsequently deemed to have been paid in violation of the statutory standard of reasonableness, the liabilities created by such a statutory requirement might operate with undue harshness on those obligated to comply. This is particularly so because a determination of unreasonableness depends on a variety of circumstances.

The limitations on the recovery of compensation paid in violation of the standard of reasonableness would apply only to suits based on proposed section 15(d). They would not derogate from such remedies

as are presently available under existing law for breach of duty by the managers of investment companies. If, under applicable State law standards or under the existing provisions of the act, a right of recovery exists, it would be unaffected by the Commission's proposed amendment. However, under no circumstances could there be double recoveries of the same sum.

Finally, section 15(d)(6) would provide that a finding that compensation is unreasonable would not be deemed a violation of the act for purposes of criminal prosecution or administrative disciplinary action under the Investment Company Act, the Securities Exchange Act or the Investment Advisers Act. Thus no person would be liable to criminal prosecution or disqualified from participation in the investment company or securities industry solely because his compensation has been found unreasonable under this section.

SECTION 8(e), ADDING NEW SECTION 15(g)—PROHIBITING BURDENSOME TRANSFERS OF MANAGEMENT RELATIONSHIPS

Section 8(e) of the bill would add a new subsection (g) to section 15 of the Investment Company Act to prohibit investment advisers and their affiliated persons from (1) selling the adviser's assets or its stock, or (2) obtaining other benefits in connection with transactions by which someone else either obtains control of the adviser or succeeds to the adviser's relationship to the investment company, whenever the transaction is accompanied by terms, conditions, or understandings, express or implied, that are likely to be inequitable to the investment company by imposing additional burdens on it, by limiting its freedom of action in the future, or otherwise.

The problem dealt with in this section of the bill arises from the fact that either the stock or the assets of the separate organizations that control the affairs of externally managed mutual funds can be bought and sold just as the stock and the assets of other types of corporations are bought and sold. The sale of a management organization is of great importance to a fund and its shareholders, since it often means that a new person or group of persons will be managing the fund. Since the management organization's control of the fund is usually its most valuable asset, the price paid for that organization's stock or its assets reflects the expectation that the buyer will be able to succeed to the advisory, brokerage, and underwriting revenues obtainable from this control relationship. It is in the interest of the selling manager to obtain for himself the highest price for this relationship. The interest of the fund and its shareholders, on the other hand, is to obtain the best available management at the lowest cost.

Although the act presently requires that any new advisory relationship be approved by a majority of the fund's shareholders, the Commission's experience raises a serious question as to the adequacy of this safeguard to protect shareholders from transfers of managerial relationships that are adverse to their interests. This is particularly true in light of the control exercised by the fund management over the solicitation of shareholder proxies. The proposed amendment would incorporate into the act the traditional obligation imposed on those who occupy a fiduciary relationship to a company to refrain from using that relationship for personal profit to the detriment of the company and its shareholders. It would not apply to sales of stock in

investment company management organizations by ordinary public investors whose only relationship to the investment adviser is that of security holder.

The scope of the proposed amendment is not limited to situations involving a sale of the assets or the stock of an advisory organization. It would reach all types of benefits to predecessors in succession situations. For example, if an affiliated person of an investment adviser assists another person in succeeding to the advisory relationship with the company and in return obtains a contract of employment from the investment company, the consideration received in connection with that employment contract would be subject to the proposed statutory standard. Another type of case to which the amendment would apply is one in which the successor-adviser agrees to direct the investment company's brokerage business to the predecessor-adviser or to an affiliate of the latter. Such an arrangement imposes a fresh burden on the investment company and also limits its freedom in choosing brokers for the future.

The proposed amendment would not authorize the Commission or the courts to determine whether owners of advisory organizations should dispose of their interests and allow other persons to undertake the responsibility of managing the funds they serve. Nor would the amendment empower the Commission or the courts to prescribe or limit the consideration that retiring advisers can obtain from their successors. Its sole purpose would be to protect investment company shareholders from harm resulting from transfers of the management relationship. It would prohibit such transfers only when it appears that the new relationship is likely to impose additional burdens on the investment company, limit its future freedom of action, or subject it to other inequities. The proposed amendment would be limited in its application to those cases in which the new advisory relationship is in view of all pertinent circumstances more burdensome to the fund than the old one was.

SECTION 23, AMENDING SECTION 44—STATUTORY RIGHT OF INTERVENTION

The standard of reasonableness of proposed section 15(d) and the proposed prohibition against burdensome transfers in new section 15(g) would be enforceable through injunctive suits instituted by the Commission in U.S. district courts. Under well-established judicial precedent Commission enforcement action could be supplemented by private actions instituted by an investment company or by a shareholder on its behalf. This provision of the bill would amend section 44 of the act to authorize the Commission to intervene as a party at any stage of any private action under sections 15(d) and 15(g).

Commission intervention in such private suits would assist the courts in an orderly development of the law governing the application of the standard of reasonableness.

PART B: SALES LOADS

SECTION 12, AMENDING SECTION 22—SALES LOAD LIMITATIONS

This section of the bill would provide for a maximum sales charge of 5 percent, subject to Commission authority to grant exemptions from this limitation where appropriate. The effect of the proposed

amendment would be to narrow somewhat the wide disparity that now exists between the 9.3 percent sales charge most commonly involved in the sale of mutual fund shares and the cost of acquiring other types of securities of comparable quality in the exchange and over-the-counter markets.

Subsection (d) of section 22 of the Investment Company Act of 1940 provides for retail price maintenance in the sale of mutual fund shares. Dealers are prohibited from selling to the public the redeemable securities of any investment company at other than a current public offering price determined by the principal underwriter. The absence of downward pressures that might otherwise have been exerted by price competition at the retail level has given rise to increased competition among principal underwriters for the favor of retail dealers. Such competition has had the effect of raising rather than lowering prices to investors.

Subsections (b) and (c) of section 22 give to a registered securities association—in practice the National Association of Securities Dealers, Inc.—and to the Commission rulemaking authority to prohibit principal underwriters and dealers from engaging in the primary distribution of redeemable investment company securities if their public offering price includes an "unconscionable or grossly excessive" sales load. The authority granted by these subsections is so limited as to apply only to exceptional situations and not to the basic problems associated with the sales load and discussed in the Commission's report.

Section 12 of the bill therefore amends the provisions of subsections (b) and (c) of section 22 of the act by deleting existing subsection (b), and that portion of subsection (c) which gives the Commission authority over "unconscionable or grossly excessive" sales loads. Existing subsection (c) would be redesignated as (b) and a new subsection (c) would be added. Paragraph (1) of new subsection (c) would prohibit a registered investment company from offering securities issued by it if their public offering price includes a sales load of more than 5 percent of that portion of the proceeds of the offering price received by the issuer for investment. This 5-percent limitation is expressed in a manner which reflects a change in the existing method of calculating mutual fund sales loads but which conforms to the prevailing practice in calculating commissions and markups for executions of transactions in the over-the-counter and exchange markets. At present mutual fund sales loads are typically presented as a percent of the offering price. Thus a sales load amounting to 9.3 percent of the net asset value of shares purchased is represented as an 8.5-percent sales load. The proposed amendment would express the maximum sales load as a percent of the portion of the amount paid by the investor which is actually received by the issuer for investment.

Any issuer offering or selling its securities through a principal underwriter or otherwise could establish a public offering price which would include a sales load lower than 5 percent. The proposed maximum under paragraph (1) would apply whether the securities are sold through a principal underwriter with or without the assistance of other dealers, or by the investment company without a principal underwriter.

Investment companies operating under the Small Business Investment Company Act of 1958 are excepted from the proposed maximum sales charge limitation. These companies, which are all of the closed-end type, invest in the relatively unmarketable securities of small business enterprises. Since the securities of these companies entail a considerably higher degree of risk than those of other investment companies, and since their successful distribution requires a selling effort analogous to that necessary in conventional underwritings of the speculative or promotional type, the imposition of a 5-percent ceiling in these cases might seriously hamper the issuers' ability to raise new capital.

Proposed paragraph (2) of subsection (c) of section 22 of the act would empower the Commission to exempt, conditionally or otherwise, any person, security, or transaction from the 5 percent maximum sales charge. The Commission could thus permit the maximum sales load to be increased when it found such action appropriate in the public interest and consistent with the protection of investors. For example, the Commission might determine that a higher maximum sales load is appropriate where closed-end investment companies wish to raise limited amounts of capital by noncontinuous offerings of new shares. The Commission would expect to give careful consideration to the appropriateness of an exercise of such exemptive power to permit somewhat higher sales loads for the investment of comparatively small sums in investment company shares. It could increase the maximum for the investment company industry as a whole if, in light of future developments, it found such change to be in the public interest and consistent with the protection of investors.

Paragraph (3) of subsection (c) of section 22 of the act would empower the Commission to prohibit or restrict sales loads in transactions where the imposition of such charges would be inequitable to investors. Under this provision the Commission would expect to consider adoption of a rule to restrict or prohibit the imposition of a sales load (as opposed to an appropriate charge to cover administrative expenses) where dividends distributed by investment companies are applied to the purchase of additional shares.

The proposed amendments of existing section 22(c) of the act would not affect the Commission's authority, similar to that given to a registered securities association under subsection (a) of section 22, where necessary to adopt rules designed to reduce or eliminate any dilution of the value of outstanding redeemable investment company securities or any other unfair result of the purchase, redemption, or sale of such securities.

Section 16, Amending Section 27—Contractual Plans

This section would amend section 27 of the Investment Company Act to eliminate the front-end load feature of so-called contractual plans, that is, periodic payment plans for the accumulation of mutual fund shares by monthly payments over a period such as 10 or 15 years. The proposed amendment would provide that sales charges on such plan should be spread evenly over all payments.

Many persons of modest means invest in mutual funds through contractual plans. Sellers of these plans are presently permitted under section 27 of the act to charge investors a maximum sales load of 9 percent of the total payments to be made on their plans. They may, however, deduct as sales load one-half of the first 12 monthly plan

payments or their equivalent (the "front-end load"). With few exceptions, contractual plan companies invest exclusively in the shares of another mutual fund (the underlying fund) the shares of which are available to the public at normal mutual fund sales loads without a front-end load deduction.

Experience has indicated that a majority of contractual planholders do not complete their investment programs in accordance with the agreed time schedule. Because of the front-end load deduction, such investors have paid effective sales loads, as of their scheduled plan completion dates, which are substantially higher than they would have paid if they had invested directly in shares of the underlying fund. Experience has also shown that a large minority (from a quarter to two-fifths) of contractual planholders are unable or unwilling to complete their scheduled payments. In consequence, the sales charges which they incur amount to from 20 to 50 percent of their total payments or, stated another way, the sales charges equal from 25 to 100 percent of amounts actually invested in their behalf. It is believed that charges of this magnitude subject small investors to an unacceptable risk of loss. Moreover, even if an investor completes his plan, up to 50 percent of his first year's payments are never invested for his benefit. Consequently, over the term of the plan, he has less money working for him than would be true if he had invested in a level-load periodic investment plan.

The proposed amendment would repeal existing paragraphs (1) and (2) of section 27(a) and would amend existing paragraph (3) to prohibit the issuance and sale of periodic payment plan certificates if the amount of sales load deducted from any one payment exceeds proportionately the amount deducted from any other payment. The maximum sales load that investors could be charged under such plans would be determined by the provisions of new section 22(c) of the Investment Company Act proposed in section 12 of this bill.

Section 16 of the bill also amends section 27(a) of the act by redesignating paragraphs (3) through (6) as paragraphs (1) through (4), respectively. It would delete present subsection (b) of section 27 and redesignate existing subsection (c) as (b). The provision to be deleted presently gives the Commission specific exemptive authority for small contractual plan companies having higher operating costs. Such a provision would be superfluous since the Commission could at any time use its exemptive powers under section 6(c) of the Investment Company Act, as well as the exemptive power proposed under section 12 of this bill, if it appeared appropriate to permit a sales load which exceeded the limitations of the act.

SECTION 17, AMENDING SECTION 28—MAXIMUM SALES CHARGES ON FACE-AMOUNT CERTIFICATES

This section of the bill would amend section 28 of the Investment Company Act to eliminate the charging of what, in effect, amounts to a front-end load on the sale of face-amount certificates and to provide a ceiling on sales charges comparable to the ceiling that would be applicable under the bill to other investment company securities.

Face-amount certificates are debt securities in which the company promises to pay to the investor a fixed sum of money upon the maturity of the certificate and certain lesser fixed sums if the certificate is

surrendered prior to maturity. Under section 28 a face-amount certificate company is required to establish certain minimum reserves and to make payments into the reserve fund which must at least amount to certain minimum percentages of the certificate holder's gross payment or payments. The sales load consists, in effect, of the difference between such gross payment or payments and the proportion of such payments which must be put into the reserve. Section 28(a)(2)(A) now limits the sales charge by providing that payments into the reserve for the first certificate year shall amount to at least 50 percent of the required gross annual payment by purchasers. It also provides for reserve payments in the second to fifth certificate years, inclusive, of at least 93 percent of the gross annual payment and for reserve payments of at least 96 percent of each subsequent year's gross annual payment. The aggregate of reserve payments must amount to at least 93 percent of aggregate payments to be made under the certificate.

The bill would amend section 28(a)(2)(A) by providing that payments into the reserve shall amount to at least 95.24 percent of the required gross payment during each certificate year. This would limit deductions for sales expense to 5 percent of the amounts paid into the reserve during any period prior to the maturity of a face-amount certificate of the installment type.

Clause (E) of section 28(a)(2), which deals with fully paid face-amount certificates, would be amended by adding a proviso to require that the reserve for such certificates shall amount to at least 95.24 percent of the single payments made by the purchasers thereof. This provision would apply to fully paid certificates the same sales charge limitation as would be applicable to face-amount certificates of the installment type.

In addition, the bill would delete various provisions of existing sections 28(a)(2)(A), 28(d)(1), and 28(d)(2) relating to reserve requirements and cash surrender values which would become superfluous with the elimination of front-end sales charges in the sale of face-amount certificates. Lastly, the bill would delete provisions in existing sections 28(d)(2) and 28(d)(4) of the act which presently permit the imposition of a surrender charge in an amount not exceeding 2 percent of the maturity amount of the certificate or 15 percent of the amount of the reserve, whichever is less, upon surrenders of face-amount certificates by their holders. Such surrender charges are unrelated to the economic cost of administering the surrenders of such certificates.

SECTION 6, ADDING NEW SECTION 11(b)(2)—DELETION OF SALES CHARGE IN EXCHANGE OF SERIES SHARES

Section 6 would delete from the Investment Company Act section 11(b)(2) which permits series companies or their principal underwriters to charge an additional sales load when shareholders in one series exchange their shares for shares in another series. Section 11(a) of the act specifically prevents the imposition of sales charges when shareholders were induced to exchange their certificates for new certificates in the same or another investment company. The proposed amendment merely would subject series companies to the same treatment as other open-end investment companies with respect to offers of exchange.

PART C: PORTFOLIO TRANSACTIONS

Section 9(b), Adding New Section 17(j)—Insider Trading in Investment Company Portfolio Securities

Section 9(b) of the bill would amend section 17 of the act by adding a new subsection (j) thereto which would provide the Commission with rulemaking power with respect to purchases and sales of investment company portfolio securities by persons associated with such companies. This proposal represents a response to the widely recognized need for the development of adequate restraint on the trading of investment company insiders in the companies' portfolio securities. Such trading carries a potential for harm to the interests of investment company shareholders and entails, as one court has said, an "ever present danger of a conflict of interests." Although persons affiliated with investment companies cannot be expected to refrain from engaging in securities transactions for their personal accounts, the shareholders they serve are entitled to assurance that such transactions will not conflict with their companies' investment programs.

This section would not be self-executing, but would require the adoption of rules or regulations by the Commission. Such rules or regulations could affect transactions involving securities of any issuer whose securities are owned by a registered investment company or of securities of any issuer which the investment company is contemplating purchasing, by any affiliated person of such registered investment company, any affiliated person of an investment adviser of such company, or any affiliated person of such underwriter. Section 2(a)(3) of the act defines an "affiliated person" to include, among others, any investment adviser of such investment company, member of an advisory board of such investment company, any officer, director, partner, copartner or employee of such other person, as well as any person, directly or indirectly owning, controlling, or holding with power to vote, 5 percent or more of the outstanding voting securities of such other person, any person 5 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person, and any person directly or indirectly controlled, controlled by, or under common control with such other person.

The section would permit the Commission to make rules affecting transactions by such insiders involving any securities of an issuer whose securities are owned by the investment company, or which the investment company contemplates purchasing. Thus the Commission's rules could apply to insider trading in the convertible securities, options and warrants of issuers whose underlying securities are owned by an investment company with which the insider is affiliated.

The ability to deal with such transactions by rule would permit the Commission to draw flexible guidelines to prohibit persons affiliated with investment companies, their advisers and principal underwriters, from engaging in securities transactions for their personal accounts when such transactions are likely to conflict with the investment programs of their investment companies. The section would also permit the Commission to make rules requiring investment companies to adopt their own codes of ethics meeting minimum standards specified by the Commission.

The section would not interfere with the Commission's present power to deal with problems of insider trading under the antifraud and antimanipulative provisions of sections 10(b) and 15(c) of the Exchange Act and of section 206 of the Investment Advisers Act or to deal with joint transactions under section 17(d) of the Investment Company Act. However, it would enable the Commission to deal with trading by insiders of investment companies in a more flexible manner than may be permitted by those provisions and to fashion guidelines suitable to many diverse circumstances.

Section 11, Adding New Section 19(b)—Distributions of Long-Term Capital Gains

Section 11 of the bill would amend section 19 of the Investment Company Act by adding a new subsection (b) thereto, which would prohibit registered investment companies from distributing realized long-term capital gains more frequently than once every 12 months except as the Commission may permit by rule, regulation or order in the public interest and for the protection of investors.

At present the Investment Company Act does not limit the frequency with which investment companies may distribute their realized long-term capital gains. Present section 19 of the act, which would be designated section 19(a), prohibits investment companies from making any distribution in the nature of a dividend payment other than from certain defined sources unless such payment is accompanied by a written statement which adequately discloses the source or sources of such payment. It also empowers the Commission to prescribe the form of such statement by rules and regulations in the public interest and for the protection of investors.

The proposed amendment would incorporate into the act views expressed in the Investment Company Institute's "Guide to Business Standards." The guide states that no member should make a distribution of "realized capital gains to shareholders in a manner that would indicate that capital gains distributions are part of regular dividends from investment income" and recognizes that "distributions of capital gains other than at fiscal yearends, or soon thereafter, could have such an effect." This amendment would minimize any confusion on the part of investors which might arise from their failure to differentiate regular distributions of capital gains from distributions of investment income. It would not interfere with the ability of registered investment companies to comply with present provisions of the Internal Revenue Code applicable to them. In addition, the Commission could by rule or regulation permit registered investment companies to take advantage of the "spillover" provisions of the Internal Revenue Code under which certain distributions made after the close of a taxable year are considered as made during such taxable year.

PART D: FUND HOLDING COMPANIES

Section 7, Amending Section 12(d)(1)—Preventing the Creation and Enlargement of Fund Holding Companies

Section 7 of the bill would amend section 12(b)(1) so as to prevent the creation and operation of new "fund holding companies" and the further enlargement of existing companies of this type. These com-

panies are investment companies whose portfolios consist either entirely or largely of the securities of other investment companies.

The renewed interest in the fund holding company device is a very recent phenomenon which carries implications detrimental to investors and to the long-range public interest. The existence of fund holding companies as large shareholders in other investment companies would create a potential for harm which would be especially marked when the portfolio of the fund holding company consists of mutual fund shares. The ability of the holding company's managers to demand redemption of such shares at any time could give them an undue influence over the managers of the underlying funds upon whom the great majority of stockholders of such funds rely for management of their capital. Moreover, the managers of underlying funds, confronted by the possibility that substantial portions of capital may be withdrawn suddenly at the behest of one or more holding company shareholders could be influenced to maintain excessive liquidity or otherwise to manage the fund in a manner inconsistent with the investment objective of the majority of the shareholders. Finally, fund holding companies necessarily involve duplication of administrative expenses and layering of management charges.

Before 1940 there were several closed-end investment companies that invested in other closed-end companies. Section 12(d)(1) of the act sought to deal with the regulatory problems they posed by prohibiting (subject to certain exceptions) a registered investment company from purchasing more than 3 percent of the outstanding voting stock of another investment company unless it already owned 25 percent or more of such stock. This section, however, does not cope with the problems that have recently arisen in this area and that may become more acute in the future. Section 12(d)(1) applies only to purchases by registered investment companies. Hence, under existing law, a fund holding company organized under the laws of a foreign country and not subject to registration under the act can buy unlimited quantities of the securities of registered investment companies.

This gap in the statutory scheme has led to the creation of several unregistered, foreign-based fund holding companies that invest primarily in the securities of American mutual funds. The largest of these unregistered foreign-based companies, The Fund of Funds, Ltd., was organized in 1960 and has stated its June 30, 1966, assets at more than $420 million. Its rapid growth has engendered interest in the formation of domestic registered fund holding companies that would be subject to the percentage restrictions of section 12(d)(1), and two such companies have recently registered under the act.

The bill would amend section 12(d)(1) of the act to prohibit all investments by a registered investment company in another investment company. It would also make it unlawful for an unregistered investment company (or any company or companies controlled by an investment company) to "purchase or otherwise acquire" any interest (whether in the form of a security or otherwise) in any registered investment company. Section 12(d)(1) would be further amended to prohibit registered investment companies themselves, their principal underwriters, and brokers and dealers in securities from knowingly selling an interest in any registered investment company to any other investment company—whether or not the purchasing investment company is registered under the act.

The proposed amendment would retain two existing exceptions from the prohibitions against the transfer of investment company interests to other investment companies. The first relates to securities received because of: (*a*) dividends; (*b*) exchange offers that have been approved by the Commission under section 11 of the act; and (*c*) plans of reorganization. None of the three items in this first exception involves a new commitment by an investment company. The first item, the exception for dividends, covers only those which the issuer declares in terms of stock and not in terms of money. Dividends and capital gain distributions declared in terms of money, which the recipient may elect to apply to the purchase of additional shares, are not within this exception.

The second exception relates to the acquisition of interests in investment companies by unit trusts. This exception covers contractual plan companies that invest in a specific mutual fund. There are no limitations now—and there will be none under the proposed amendment—on the extent to which a unit trust can invest in the securities of its underlying investment company. Under the amendment, however, the exception for the contractual plan type of unit trust, which now applies to all such trusts, would be confined to those trusts the depositor or principal underwriter of which has registered with the Commission as a broker-dealer under the Securities Exchange Act of 1934. This limitation is designed to forestall the use of foreign-based unit trusts by persons who are not subject to the regulatory surveillance that the Commission exercises over registered broker-dealers and their associated persons.

The amendment would not require any investment company to divest itself of any existing holding. Where existing holdings are significant (as in the case of the Fund of Funds, Ltd.), their sudden divestiture might have a harmful effect on the portfolio investment companies. Only in the case of an illegal acquisition resulting in new holdings or additions to preexisting holdings would the Commission have the power to direct divestiture. It will be able to do so under the proposed amendment in a flexible fashion that takes into account the varying circumstances of particular cases.

PART E: STRENGTHENING INDEPENDENT CHECKS ON INVESTMENT COMPANY MANAGEMENT

SECTIONS 2, 5, 8(c) AND 18, AMENDING SECTIONS 2(a), 10, 15(c) AND 32(a)—ADDING THE TERM "INTERESTED PERSON"

Section 10 of the act now provides that at least 40 percent of a registered investment company's directors must be persons who are neither officers nor employees of the company and who neither serve as, nor are "affiliated" with, its investment adviser. It also provides that if any officer, director, or employee of the investment company acts as, or is affiliated with, its principal underwriter or regular broker, a majority of the board must consist of persons other than those affiliated with such principal underwriter or regular broker. The function of these provisions with respect to unaffiliated directors is to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.

The definition of an "affiliated person" in section 2(a)(3) is inadequate for this purpose. That definition now permits a director who has strong ties with the company's managers to be classified as "unaffiliated." For example, a director is presently deemed "unaffiliated" even though he owns up to 4.99 percent of the adviser-underwriter's stock, has substantial business or professional relationships with the investment company or its adviser-underwriter, or is closely related by blood or marriage to the company's managers.

Section 2(3) of the bill seeks to remedy the act's deficiencies in this regard by adding a new section 2(a)(19) to the act which would define the term "interested person." Other sections of the bill would substitute that new term for the present term "affiliated person" in the following sections of the act: (1) section 10, relating to the composition of boards of directors; (2) section 15, relating to the approval of advisory and underwriting contracts; and (3) section 32(a), relating to the selection of independent public accountants. The new "interested person" concept will not widen the scope of sections 10(f) and 17 of the act, which prohibit transactions between investment companies, on the one hand, and the companies' affiliated persons as well as the affiliated person of such affiliated persons on the other, absent prior Commission approval. These sections will remain unchanged.

Clause A of proposed new section 2(a)(19) states that when the term "interested person" is used with respect to investment companies, it includes the companies' affiliated persons. In addition, the term "interested person" includes "any member of the immediate family of any natural person who is an affiliated person of such company." The phrase "member of the immediate family" is specifically defined in the last sentence of the proposed section to include "any parent, spouse of a parent, child, spouse of a child, spouse, brother or sister, brother-in-law, or sister-in-law," and extends to adoptive and step-relationships.

The definition also provides that an "interested" person of an investment company includes "any person who either has, or within the preceding 3 years has had, any direct or indirect material business or professional relationship with such investment company, its chief executive officer, or any of its controlling persons." This changes the existing law which permits persons who have close professional relationships or economic ties with investment companies, their chief executives and controlling persons to serve as "independent" directors of the companies. Those in such relationships may not be able to act as disinterested checks on investment company managers.

Finally, this portion of the definition provides that "any interested person of any investment adviser or principal underwriter" to an investment company is by reason of his interestedness in the adviser of the underwriter an interested person of the company itself. Although section 2(a)(3)(E) of the act now provides that those who are affiliated with an investment adviser also are deemed to be affiliated with the adviser's investment company client, there is no corresponding provision for those who are affiliated with the companies' principal underwriters. Thus, the president of a principal underwriter can in those cases where the underwriter is unaffiliated with the adviser serve as an unaffiliated director of the fund. Proposed section 2(a)(19) would end this anomaly.

The part of the definition of "interested person" which defines who is and who is not an interested person of an investment company would be implemented by the following sections of the bill: (1) section 5(a), which would amend section 10(a) of the act so as to provide that at least 40 percent of the directors of a registered investment company must be persons who are not interested persons of the company, except that for the purposes of section 10(a), a person would not be deemed interested solely because he is a director or security holder of the company; and (2) section 18, which would amend section 32(a) of the act so as to require that the independent public accountants of a registered investment company be selected by the vote of a majority of those members of the board of directors who are not interested persons of such registered company.

The second part of the definition of "interested person" deals with the meaning of that term when used with respect to an investment adviser, a principal underwriter, a regular broker, or an investment banker. Here, as in the first portion of the definition, the bill provides that affiliated persons as well as the members of their immediate families are interested persons.

In addition, clause (B)(iii) of proposed new section 2(a)(19) provides that "any person who has any direct or indirect beneficial interest in or who holds as trustee, executor, or guardian any legal interest in any security" issued either by an "investment adviser, principal underwriter, regular broker, or investment banker or by any controlling person of such investment adviser, principal underwriter, regular broker, or investment banker" is "interested" in the issuer of that security. This provision takes cognizance of situations in which the holding of some sort of a bare legal interest is devoid of substantive significance. Lawyers, brokers, and others may hold record title to securities simply as a convenience to their clients or customers. Such nominees and escrows have no special interest in the issuer of the security that has been placed in their custody. Since there is no reason to consider this type of a legal title-holder an interested person, the range of disqualifying legal interests is expressly limited to those held in the classic fiduciary capacities of trustee, executor, and guardian.

The last clause of the definition provides that those who have or within the preceding 3 years have had material business or professional relationships with investment advisers, principal underwriters, regular brokers, or investment bankers are interested persons of those advisers, underwriters, brokers, or bankers. This clause goes on to state that a material business or professional relationship with the chief executive officer or a controlling person of an adviser, principal underwriter, regular broker, or investment banker is as disqualifying as one with the adviser, underwriter, regular broker, or investment banker itself. The clause corresponds to the provision in the first part of the definition with respect to material business or professional relationships with the companies themselves. It would deal with situations where one who derives substantial economic benefits from significant economic relationships with an adviser, principal underwriter, a regular broker, or an investment banker is nevertheless treated at present for purposes of the act as though he were completely independent of the persons from whom he receives such benefits.

The second part of the definition, which deals with the meaning of "interested person" when that term is used with respect to an investment adviser, principal underwriter, regular broker, or investment banker, would be implemented by amendments to sections 10(b) and 10(d) relating to composition of boards of directors and section 15(c) relating to approval of advisory contracts. These amendments would substitute the term "interested" for the term "affiliated" wherever that term appears in these sections.

PART F: ADMINISTRATIVE AND OTHER PROCEEDINGS

Under the provisions of the Federal securities laws (other than the Investment Company Act) the Commission has authority to use flexible procedures and a variety of remedies to protect investors. The amendments suggested in part F would provide the Commission with comparable flexible procedures and remedies in administering the Investment Company Act.

SECTION 4, AMENDING SECTION 9—PROVIDING FOR ADMINISTRATIVE ACTION AGAINST CERTAIN PERSONS SERVING INVESTMENT COMPANIES

Section 9(a) of the act now prohibits any person from serving in certain capacities with a registered investment company if he has been convicted of any of the crimes set forth in section 9(a)(1) or, as set forth in section 9(a)(2), has been permanently or temporarily enjoined by a court from acting in certain capacities.

Section 4(b) of the bill would add a new subsection (b) to section 9 of the act so as to empower the Commission, after notice and opportunity for hearing, to bar an individual, either permanently or for such time as may be appropriate, from serving an investment company in the capacities now enumerated in section 9 or as an employee of an investment company or as an affiliated person of its investment adviser, depositor, or principal underwriter. The Commission could take such action only if it found (1) that the individual in question had willfully violated, or had willfully participated in a violation of any provision of the Securities Act, the Securities Exchange Act, the Investment Company Act or the Investment Advisers Act or any rule or regulation under those statutes; and (2) that the action was in the public interest.

The proposed amendment would supplement the existing provisions of section 9. It would provide grounds and procedures for disqualification from affiliation with an investment company of persons willfully violating the Federal securities laws. To some extent, the present section 9 is the counterpart to the provisions of section 203(d) of the Investment Advisers Act and section 15(b) of the Exchange Act which, among other things, empower the Commission to disqualify persons who have committed certain types of misconduct from serving as a registered investment adviser or broker-dealer or as an associated person of a broker-dealer, if such action is found to be in the public interest.

In several respects, section 9 as it presently stands affords investment company shareholders substantially less protection than that provided to clients of investment advisers by the Investment Advisers Act and to customers of broker-dealers by the Exchange Act. Under

these acts, willful violations of the Securities Act, Investment Advisers Act, Exchange Act, or any rule or regulation thereunder, are grounds for disqualifying a person from registration as an investment adviser or as a broker-dealer or as an associated person of a broker-dealer. The existing provisions of section 9 are much narrower and are not coordinated with the corresponding provisions of the Exchange Act and the Investment Advisers Act. Under the proposed amendment, if the Commission finds that an investment adviser or broker-dealer or an associated person thereof has violated the antifraud or other provisions of the Investment Advisers Act or the Exchange Act and has barred or suspended him from serving as an investment adviser or broker-dealer or from association with a broker-dealer, it can also prevent him from being associated with an investment company, its adviser or its principal underwriter.

Like the provisions of section 15(b) of the Exchange Act and section 203(d) of the Investment Advisers Act, the proposed amendment would provide for an administrative proceeding to determine whether persons have engaged in willful misconduct and whether the public interest requires that such persons be barred from serving an investment company.

Prior to 1960 the basis for disqualifying persons from association with an investment adviser were essentially the same as those presently provided in section 9 of the Investment Company Act. In 1960 Congress amended the Investment Advisers Act to substantially broaden these grounds and coordinate them with those provided in the Securities Exchange Act. A similar change in section 9 of the Investment Company Act is needed.

The proposed amendment will correct another deficiency of section 9 which bars a person convicted of certain crimes or enjoined on the basis of misconduct specified in that section from serving as an officer, director, or investment adviser of an investment company, but permits such a person to be an employee of an investment company.

Further, under the proposed amendment, in appropriate cases, the Commission could proceed against an individual affiliated with a company's investment adviser, principal underwriter, depositor, or sponsor without naming or joining the individual's employer as a party in such proceeding. Moreover, the Commission could, where appropriate, institute private proceedings which would not be made public unless and until the parties so request or adverse findings are made against the individual or company involved.

SECTION 20, AMENDING SECTION 36—ENJOINING BREACH OF FIDUCIARY DUTY

Section 36 now authorizes the Commission to bring an action in a U.S. district court to enjoin any officer, director, advisory board member, investment adviser, depositor, or principal underwriter of investment companies from acting in such capacities if such a person has been "guilty" of "gross misconduct" or "gross abuse of trust" with respect to the investment company which he serves. Under section 36 the court must enjoin such person from so serving if it finds that he has been "guilty" of such conduct.

Section 20 of the bill would amend section 36 of the act to authorize the Commission to seek injunctive relief against persons who engage,

have engaged, or are about to engage in acts or practices which involve a breach of fiduciary duty with respect to any investment company they serve. If the evidence establishes that a person has engaged or is about to engage in such misconduct, the court in its discretion could enjoin that person from occupying positions of responsibility with a registered investment company and could grant such other relief as is deemed necessary or appropriate for the protection of investors.

The mandatory sanction of section 36 as it presently reads and the stigma that attaches to the required finding of "gross abuse of trust" or "gross misconduct" both tend to make action under section 36 an unduly harsh and correspondingly limited remedy for significant types of misconduct encountered by the Commission in the administration of the act. Under the antifraud provisions of the Exchange Act and the Investment Advisers Act, the courts are permitted to deal more flexibly with the misconduct of broker-dealers and investment advisers in dealings with their clients. The proposed amendment would give the courts comparable power with respect to affiliated persons of investment companies who occupy no less a position of trust than do broker-dealers or investment advisers to noninvestment company clients.

PART G: COVERAGE

The Commission in its day-to-day administration and enforcement of the Act has encountered a number of recurring problems with certain exemptions provided in the act and with a number of related provisions dealing with the applicability of the act in certain situations. The amendments suggested in this part are designed to deal with these problems.

SECTION 3(a), AMENDING SECTION 3(b)(2)—REQUIREMENT OF GOOD FAITH

Under section 3(b)(2) of the act any issuer, other than a registered investment company, may file an application for an order of the Commission declaring it to be exempt from regulation under the act in accordance with the standards of that section. The filing of such application provides an automatic 60-day exemption from all provisions of the act; during this 60-day period, an applicant may engage in activities prohibited under the act even though the Commission may ultimately deny the application.

Section 3(a) of the bill would amend section 3(b)(2) to specify that this automatic 60-day exemption is available only if the application is filed in "good faith."

While the Commission believes that a requirement of "good faith" is implicit in the statute, the existing statutory language does not so provide. By making the requirement an explicit one, companies would be placed on notice that an automatic exemption cannot be obtained by the filing of a frivolous application not presenting a colorable claim to the exemption from regulation provided for by section 3(b)(2).

SECTION 3(b)(2), AMENDING SECTION 3(c)(6) MODIFICATION OF EXCLUSION FOR COMPANIES ENGAGED IN FACTORING, DISCOUNTING AND REAL ESTATE BUSINESSES

Under the existing provisions of section 3(c)(6) companies engaged primarily in factoring, discounting and real estate are excluded from the definition of an investment company unless they are engaged in the business of issuing face-amount certificates of the installment type or periodic payment plan certificates. These limitations reflect widespread abuses prior to 1940 in sales of such securities on an installment basis, usually to relatively unsophisticated investors of modest means.

Section 3(b)(2) of the bill would amend section 3(c)(6) of the act to provide that, in addition to existing limitations, the exclusion from the definition of an investment company provided by that section would be unavailable to any such company issuing a security redeemable at the election of the holder.

Although the companies enumerated in section 3(c)(6) have portfolios of securities in the form of notes, commerical paper, or mortgages and other liens on and interests in real estate, they are excluded from the act's coverage because they do not come within the generally understood concept of a conventional investment company investing in stocks and bonds of corporate issuers. The proposed amendment would have the effect of extending the regulatory provisions of the act to certain of these companies which in recent years have attempted to capitalize on the popularity of open end companies by issuing redeemable securities.

A redeemable security is defined in section 2(a)(31) of the act as "any security other than short-term paper, under the terms of which the holder, upon its presentation . . . is entitled . . . to receive approximately his proportionate share of the issuer's current net assets or the cash equivalent thereof." Thus, the proposed amendment would in no way affect companies which issue securities redeemable at the option of the issuer—the conventional form of redeemable security commonly used in corporate financing. The amendment applies only to those companies which purport to model themselves after open end companies by issuing a security redeemable at the option of the holder.

SECTION 3(b)(3), AMENDING SECTION 3(c)(8) DELETION OF EXCLUSION FOR COMPANY 90 PERCENT OR MORE OF WHOSE SECURITIES ARE THOSE OF CERTAIN SINGLE ISSUERS

Section 3(c)(8) excludes from the statutory definition of an investment company a company 90 percent or more of the value of whose investment securities are those of any single bank, insurance company, or other financial institutions of the types enumerated in sections 3(c) (5), (6), and (7) of the act. Section 3(b)(3) of the bill would delete this paragraph from the act.

The availability of the section 3(c)(8) exemption to companies which hold, solely as an investment, securities of certain types of financial institutions appears to be wholly inconsistent with the statutory policy of the coverage of the act and should be removed. Its deletion from the act will not affect existing exclusions for com-

panies which control or manage the enterprises whose securities they hold.

SECTION 3(b)(4), AMENDING SECTION 3(c)(10)—CLARIFICATION OF EXEMPTION FOR HOLDING COMPANY REGISTERED UNDER PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

Section 3(c)(10) now excludes from the coverage of the act any company "with a registration statement in effect as a holding company under the Public Utility Holding Company Act of 1935." Section 3(b)(4) of the bill would amend section 3(c)(10) of the act to make the exclusion provided by that section available to companies "subject to regulation under the Public Utility Holding Company Act of 1935."

A holding company may register under the Holding Company Act and subsequently obtain an order exempting it from all or substantially all the provisions of that act. It has been contended that such a company is still "registered" under that act even though it is no longer regulated thereunder. The proposed amendment would make it clear that a company which is in fact unregulated under the Holding Company Act is not excluded from the coverage of the Investment Company Act.

SECTION 3(b)(5), AMENDING SECTION 3(c)(11)—MODIFICATION OF EXCLUSION FOR COMPANIES HOLDING OIL, GAS, OR OTHER MINERAL ROYALTIES

Section 3(c)(11) of the act excludes from the definition of investment company any company substantially all of whose business is holding oil, gas, or other mineral royalties or leases. Section 3(b)(5) of the bill would amend section 3(c)(11) to delete the exclusion for companies described in that section when they issue redeemable securities, periodic payment plan certificates, or face-amount certificates of the installment type. The proposed amendment is similar in purpose to the proposed amendment to section 3(c)(6).

SECTION 10, AMENDING SECTION 18(f)(2)—MODIFICATION OF DEFINITION OF SENIOR SECURITY

Section 18(f) of the act makes it unlawful for any registered open-end investment company to issue or sell any senior security. The term "senior security" does not, under present section 18(f)(2) include shares of a particular "series" the holders of which are preferred over the holders of all other series in respect of assets specifically allocated to that series.

A number of "series companies" existed at the time the act was passed, and new "series companies" have subsequently been created. Each of these companies is a single registered investment company. Thus, at present, matters affecting the interests of holders of shares of a particular series are voted on by the holders of shares of all existing series and such vote may be controlled by the holders of an unaffected series. In effect, the shareholders of different series, whose interests may be inconsistent, are lumped together.

Section 10 of the bill would amend section 18(f)(2) to prevent in the future the creation of a new series by existing "series companies" and would prohibit the creation of any new "series companies" under the act. The proposed amendment would not affect the organizational structure of existing series companies. Such companies could, in effect, issue new series of shares by registering the new series as a separate investment company. Similarly, in the future, a group of separate registered investment companies could be organized—designated (if desired) as "Series A," "Series B" and so on—but each having the same management or adviser or underwriter.

PART II: MANAGEMENT-SHAREHOLDER RELATIONSHIPS

The suggested amendments under this part deal with a variety of minor inconsistencies, ambiguities, and anomalies in provisions which relate generally to the area of management-shareholder relationships.

SECTION 2(c), AMENDING SECTION 2(a)(19)—DEFINITION OF INVESTMENT ADVISER

Under section 2(c) of the bill the exception from the definition of investment adviser for "bona fide officer, director, trustee, member of an advisory board, or employee," presently contained in section 2(a)(19) would be limited to natural persons.

Section 2(a)(19) of the act defines the term "investment adviser" to an investment company as any person who regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or is empowered to determine what securities or other property shall be purchased or sold by such company.

That section specifies a number of exceptions to this general definition of investment adviser, including one for a "bona fide officer, director, trustee, member of an advisory board or employee" of an investment company to which he is rendering advice. Section 15(a) of the act prohibits "an investment adviser" from providing services to an investment company except pursuant to a written contract containing certain specified provisions. Among other things, the intent of this exception was to exclude managements and staffs of internally managed funds from the requirements of section 15(a). However, if read literally, section 2(a)(19) also exempts from the section 15(a) contract requirements a management organization which performs the same functions as an investment adviser simply because it is organized as a business trust rather than as a corporation or partnership. By limiting the exceptions from the definition of investment adviser to natural persons, the proposed amendment would preclude this anomaly.

SECTIONS 8(c) AND 18, AMENDING SECTIONS 15(c) AND 32(a)—ATTENDANCE AT DIRECTORS' MEETINGS

Sections 15(a), 15(b), 15(c), and 32(a) of the act provide for: (a) renewal of advisory contracts; (b) approval and renewal of underwriting contracts; and (c) the selection of independent auditors by the board of directors of an investment company, including a majority of the unaffiliated directors. These sections do not require the attendance in person of the members of the board of directors at meetings

where required action is taken, even though their vote is necessary to meet the statutory requirements.

Sections 8(c) and 18 of the bill would amend sections 15(c) and 32(a) of the act to provide that the voting requirements of sections 15 and 32 can be satisfied only by directors who are personally present at a meeting at which their votes are taken. The proposed amendment is intended to assure informed voting on matters which require action by the board of directors of registered investment companies.

Sections 8(a) and 8(b), Amending Sections 15(a)(4) and 15(b)(2)—Assignment of Advisory and Underwriting Contracts

Section 15(a)(4) of the act requires that an investment advisory contract provide for automatic termination upon its "assignment by the investment adviser." Similarly, section 15(b)(2) requires that underwriting contracts provide for automatic termination upon their "assignment by such underwriter."

Section 8(a) of the bill would amend section 15(a)(4) of the act to delete the words "by the investment adviser" and section 8(b) of the bill would amend section 15(b)(2) to delete the words "by such underwriter."

Section 2(a)(4) defines the term "assignment," among other things as occurring when some action is taken by persons other than the investment adviser or underwriter. Thus, under the definition, assignment includes any direct or indirect transfer of a controlling block of outstanding voting securities by a security holder of the adviser or underwriter. Section 15, however, introduces an ambiguity into the act because it refers only to an "assignment" by the adviser or underwriter itself and not by a person holding a controlling block of stock of the adviser or underwriter. The proposed amendment will remove this ambiguity.

Section 9(a), Amending Section 17(f)—Cash Assets Included Under Bank Custody

Under section 17(f), an investment company of the management type must place "its securities and similar investments" in the custody of (1) a bank, (2) a stock exchange firm subject to rules prescribed by the Commission or (3) itself, subject to rules or orders prescribed by the Commission. If a company chooses to retain the custody of its securities, it must deposit them with certain specified institutions for safekeeping, subject to certain rules as to access, earmarking and inspection.

Section 9(a) of the bill would amend section 17(f) of the act to provide that if an investment company employs a bank as custodian for "securities and similar investments," then all of its cash assets, including proceeds from the sale of its own securities and income on its holdings shall likewise be held by a bank, subject to appropriate direction as to expenditure and disposition by proper company officials.

The proposed amendment would not require an investment company to employ a bank as custodian. If, however, a company chooses to use a bank as custodian, its shareholders would appear entitled to expect that the cash held by the company would be afforded a degree of protection similar to that given to securities. The proposed amendment would permit maintenance of a checking account or accounts in one or more banks in amounts not to exceed the amount of the fidelity bond covering persons authorized to draw on the accounts, as required under section 17(g) of the act. It would also provide that more than one bank may act as custodian. The Commission would have authority to allow specified amounts of petty cash to be held apart from bank custody.

Section 14, Amending Section 25(c)—Reorganization Standards

Section 25(c) of the act now authorizes any district court of the United States, upon proceedings instituted by the Commission, to enjoin the consummation of any plan of reorganization of a registered investment company only "if such court shall determine any such plan to be grossly unfair or to constitute gross misconduct or gross abuse of trust on the part of the officers, directors, or investment advisers of such registered company or other sponsors of such plan."

Section 14 would amend section 25(c) of the act to provide that a court may, upon proceedings instituted by the Commission, enjoin the consummation of any plan of reorganization of a registered investment company which the court finds not "fair and equitable" to all persons affected.

The proposed amendment would eliminate a standard which unduly restricts courts from passing upon plans of reorganization of registered investment companies. It would replace this standard with the "fair and equitable" standard which has had a long history of judicial interpretation in equity receiverships and reorganizations under section 77B and chapter X of the Bankruptcy Act and section 11(e) of the Public Utility Holding Company Act. It would thus place the courts in a better position to carry out the congressional intent of protecting the security holders of the investment company for which a plan of reorganization is filed.

Section 15(a), Amending Section 26—Substitution of Underlying Investments of Unit Investment Trust

Section 26(a)(4)(B) of the act now requires that the trust instrument of a unit investment trust provide that the sponsor or trustee will notify the shareholders of the unit investment trust within 5 days after a substitution of the underlying securities.

Section 15(a) of the bill would add a new subsection (b) to section 26 of the act to make it unlawful for any depositor or trustee of a registered unit investment trust to substitute underlying securities without Commission approval.

The proposed amendment recognizes that notification to shareholders does not provide adequate protection since the only relief available to the shareholders, if dissatisfied, would be to redeem their shares. A shareholder who redeems and reinvests the proceeds in another unit investment trust or in an open-end company would under most circumstances be subject to a new sales load. The proposed amendment would close this gap in shareholder protection by providing for Commission approval of the substitution. The Commission would be required to issue an order approving the substitution if it finds the substitution consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the act.

SECTION 19, AMENDING SECTION 33—TRANSMISSION TO THE COMMISSION OF PAPERS FILED IN SHAREHOLDER ACTIONS

Section 33 of the act now requires registered investment companies and their affiliated persons who are defendants in derivative suits involving "an alleged breach of official duty" to transmit to the Commission copies of the pleadings and the record in such actions after a verdict or final judgment on the merits has been rendered or a settlement or compromise of the action has been approved by a court of competent jurisdiction.

Section 19 of the bill would amend section 33 of the act to require prompt filing with the Commission of copies of all pleadings, settlements, discontinuances, or judgments served or filed in suits by a registered investment company or a security holder thereof against an officer, director, investment adviser, trustee, or depositor of such company. In addition, the section would require that copies of motions and other documents be filed with the Commission if it requests them.

The proposed amendment would permit the Commission to be kept informed of the progress of the litigation from its outset at the trial court, and make it possible for the Commission promptly to take such action as may be appropriate.

PART I: FORMAL

The suggested amendments in this part are concerned with miscellaneous anomalies and inconsistencies in the act.

SECTION 2(a), AMENDING SECTION 2(a)(5)—CHANGE IN REFERENCE TO ANOTHER STATUTE WHICH HAS BEEN AMENDED

Section 2(a) of the bill would substitute in section 2(a)(5) of the act the words "under the authority of the Comptroller of the Currency" for the words "section 11(k) of the Federal Reserve Act, as amended." Section 11(k) of the Federal Reserve Act has been repealed, and as a result certain authority over banks formerly exercised by the Federal Reserve Board is now exercised by the Comptroller of the Currency.

SECTION 3(b)(1), AMENDING SECTION 3(c)—DELETION OF SUPERFLUOUS REFERENCE AND RENUMBERING

Section 3(b)(1) of the bill would amend section 3(c) of the act by deleting reference to subsection 3(b) of the act. Section 3(c) excludes certain categories of companies from the definition of an investment company which is found in subsection (a) of section 3. Since only subsection (a) defines an investment company and subsection (b) merely contains exceptions from that definition, the reference to subsection (b) in subsection (c) is meaningless.

Section 3(b)(1) would also renumber paragraphs (5) through (7) and (9) through (15) of subsection 3(c) to reflect the deletion of paragraph (4) thereof by Public Law 89-418, 89th Congress, second session (1966).

SECTION 3(b)(1), AMENDING SECTION 3(c)(13)—UPDATING REFERENCE TO INTERNAL REVENUE CODE

Section 3(b)(1) of the bill would amend section 3(c)(13) of the act to make an appropriate substitution with respect to an exception

provided for an employee's stock bonus, pension, or profit-sharing trust which qualifies under section 165 of the Internal Revenue Code, as amended. Section 165 was replaced by section 401(a) when the Internal Revenue Code was revised in 1954.

SECTION 5(c), AMENDING SECTION 10(c)—CORRECTING INCONSISTENCY IN PROHIBITING PERSONS FROM SERVING AS DIRECTORS OF INVESTMENT COMPANY

Section 10(c) of the act prohibits a registered investment company from having a majority of its board of directors consist of officers or directors of any one bank. Section 5(c) of the bill would add the word "employee" to the first clause of section 10(c). The second clause of section 10(c) provides a limited exception from the prohibition for any registered investment company which on March 14, 1940, had as a majority of its board of directors, the officers, directors, or employees of any one bank. While the first clause does not include employees, the second clause does include them. The proposed amendment would correct this apparent inconsistency.

SECTIONS 8(c) AND 8(d), AMENDING SECTIONS 15(c) AND 15(d)—ELIMINATION OF OUTDATED REFERENCE AND SECTION

Section 8(c) of the bill would delete the words "except a written agreement which was in effect prior to March 15, 1940," in section 15(c) of the act. Section 8(d) of the bill would delete section 15(d) from the act. That section prohibits any person after March 15, 1945, from acting as investment adviser to, or principal underwriter for, any registered investment company pursuant to a written contract in effect prior to March 15, 1940, unless such contract was renewed prior to March 15, 1945, in such form as to make it comply with sections 15(a) or 15(b). The 1940–45 period mentioned in sections 15(c) and 15(d) passed long ago, and references to it are meaningless today. There are no persons who are or will hereafter be affected by section 15(d) or the above clause of section 15(c).

SECTION 12(d), AMENDING SECTION 22(d)—DELETION OF LANGUAGE REQUIRED BY PROPOSED AMENDMENTS

Section 12(d) of the bill would amend section 22(d) of the act so as, among other things, conform that section to the proposed amendment to section 11(b) of the act by deleting reference to clause (2) of section 11(b) in section 22(d) of the act. Section 22(d) of the act provides, in relevant part, that it shall not prevent a sale made "pursuant to an offer of exchange permitted by section 11 hereof including any offer made pursuant to clause (1) or (2) of section 11(b)." The Commission in section 6 of the bill has proposed that clause (2) of section 11(b) be deleted from the act.

SECTION 13, AMENDING SECTION 24(d)—UPDATING OF A STATUTORY REFERENCE

Section 13 of the bill would amend section 24(d) to refer to section 4(3) of the Securities Act of 1933. Among other things, section 24(d) of the act states that the exemption provided by clause 3 of section 4(1) of the Securities Act of 1933 shall not be applicable to face amount certificate companies, open end management companies, or

unit investment trusts. When the Securities Act of 1933 was amended in 1964, what had previously been the third clause of section 4(1) became section 4(3).

Section 21, Amending Section 38(a)—Clarification of Commission Rulemaking Power Under the Act

Section 21 of the bill would amend section 38(a) so that the language conferring rulemaking powers thereunder will be the same as the language in the Public Utility Holding Company Act of 1935. The difference in the language of the rulemaking provisions of the Investment Company Act and those in the other securities acts do not appear substantive, and it is desirable to conform the language of the Investment Company Act to that of the Public Utility Holding Company Act to avoid varying interpretations.

Sections 22 and 23, Amending Sections 43(a) and (44)—Updating Statutory References

Sections 22 and 23 of the bill would amend sections 43(a) and 44, respectively, to conform references to the Judicial Code with the present designation of the sections involved. Section 43(a) of the act provides for court review of Commission orders. It refers to sections 239 and 240 of the Judicial Code which have been redesignated section 1254 of title 28 of the United States Code, as amended. Similarly, section 44 of the act, which gives the district courts of the United States jurisdiction of violations of the act or rules and regulations thereunder, refers to sections 128 and 240 of the Judicial Code, as amended, which have been redesignated as sections 1254 and 1291-1294 of title 28 of the United States Code.

PART 4: AMENDMENTS TO THE INVESTMENT ADVISERS ACT OF 1940

The Investment Advisers Act of 1940 is a companion statute to the Investment Company Act. It regulates the activities of those who receive compensation for advising others with respect to investments in securities or who are in the business of issuing analyses or reports concerning securities. Like other Federal securities statutes, the Advisers Act prohibits fraudulent practices and requires those subject to its provisions to register with the Commission and to keep books and records in accordance with Commission rules. It also empowers the Commission to make regular inspections and to take administrative remedial action against applicants for registration and registered advisers under that statute.

The proposed amendments have two purposes. First, they would remove provisions of the Advisers Act which now afford investment advisers to invest companies special exemptions from regulation under the Advisers Act. In connection with these changes the Commission would be given broad exemptive authority to administer the Advisers Act in a flexible manner. Second, they would strengthen existing disciplinary controls over registered investment advisers by making them more comparable to the provisions of section 15(b) of the Exchange Act relating to broker-dealers in securities and to the proposed amendments to section 9 of the Investment Company Act.

Congress in 1964 amended the Securities Exchange Act to permit the Commission to proceed directly against an offending individual with or without proceeding also against his firm. This was done in response to the recommendation of the Special Study of the Securities Markets that "the individual rather than the firm is the appropriate unit for many regulatory purposes, in the interest of fairness as well as efficiency." No comparable change was made in the Investment Advisers Act apparently as the result of oversight. The proposed amendments to the Investment Advisers Act, like the proposed amendments to section 9 of the Investment Company Act contained in the bill, would bring all three of these closely related statutes into conformity with the congressional decision of 1964.

Sections 25, 26, and 27, Amending Sections 203 and 205 and Adding New Section 207—Exemptions From Provisions of the Act

1. AMENDING SECTION 203—REMOVAL OF EXEMPTIONS FOR INVESTMENT ADVISERS TO INVESTMENT COMPANIES

Section 25(a) of the bill would amend paragraphs (2) and (3) of section 203(b) of the Investment Advisers Act to make inapplicable to investment advisers to investment companies the exemptions from registration under the Advisers Act now available to most of them. Section 203(b)(2) of the Advisers Act now exempts "any investment adviser whose only clients are investment companies" from the registration requirements of that statute, while section 203(b)(3) of that act provides a similar exemption for "any investment adviser who during the course of the preceding 12 months has had fewer than 15 clients and who does not hold himself out generally to the public as an investment adviser." Some mutual fund advisers are registered under the Advisers Act, but most of them, particularly those that serve the large funds and fund complexes, fall within these two exemptions from registration.

While the antifraud provisions of the Advisers Act apply to all investment advisers, whether or not registered, the bookkeeping and inspection requirements of section 204 of that act do not extend to investment advisers specifically exempted from registration pursuant to section 203(b). The Commission's authority to oversee the activities of investment advisers should not depend (as it now does) on whether they offer their services to the public directly or through the medium of an investment company, and the shareholders of investment companies should have the same protections now provided for clients of investment advisers who obtain investment advice on an individual basis.

The proposed amendment will not affect the existing exemptions from registration for investment advisers whose only clients are insurance companies and for investment advisers other than those advising investment companies who neither hold themselves out generally to the public as such nor have 15 or more clients. The intrastate exemption of section 203(b)(1) of the Advisers Act also would remain unchanged.

2. AMENDING SECTION 205—REMOVAL OF EXEMPTION FOR ADVISORY CONTRACTS WITH INVESTMENT COMPANIES

Section 26 of the bill would amend section 205 of the Investment Advisers Act to delete the exemption for advisory contracts with investment companies from the prohibition against contracts that

provide "for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client."

The prohibitions of section 205(1) protect advisory clients from compensation arrangements that give advisers special incentives "to take undue risks with the funds of clients" (H. Rept. 2639, 76th Cong., 3d sess. (1940), 29), on what the Senate Committee on Banking and Currency described in 1940 as a "heads I win, tails you lose" basis (S. Rept. 1775, 76th Cong., 3d sess. (1940), 22). Although arrangements that would be barred by section 205(1) because they give the adviser a share of the investment company's capital gains are not common in the investment company industry, some do exist now, and the number of such contracts appears to be increasing. By extending section 205(1) to advisory contracts with investment company clients the bill would insulate investment company shareholders from arrangements that give investment managers a direct pecuniary interest in pursuing high risk investment policies.

The proposed extension of section 205(1) to investment company advisory contracts would prohibit a contract which provides that any part of the adviser's fee shall be a specified amount of the company's capital appreciation. As noted, clause (B) of proposed section 15(d)(2) of the Investment Company Act (see section 8(d) of this bill) expressly states that the "quality of the services provided" is a factor to be considered in passing on the reasonableness of an adviser's fee. Hence, an investment adviser whose efforts in the past have resulted in superior investment performance for the company would be entitled, all other things being equal, to a higher fee for its services than another adviser who had not shown comparable results. Thus, the overall effect of this bill would be to permit investment company advisory fee rates to reflect the adviser's historical performance records but to prohibit arrangements that supply advisers with direct pecuniary inducements to pursue hazardous investment policies.

Section 205(1) of the Advisers Act forbids only those sharing arrangements which involve a sharing of capital appreciation. The proposed amendment will not invalidate contracts under which the adviser's fee consists of a percentage of the investment company's ordinary investment income, provided that the adviser's compensation meets the reasonableness test of proposed new section 15(d).

3. PROPOSED SECTION 207—COMMISSION EXEMPTIVE AUTHORITY

Section 27 of the bill would add a new section 207 to the Investment Advisers Act. It would empower the Commission by rule, regulation or order to exempt conditionally or unconditionally any person or transaction from any or all provisions of the act if and to the extent such action is necessary or appropriate in the public interest and consistent with the purposes fairly intended by the policy and provisions of the act. (Existing secs. 207 through 222 would be redesignated secs. 208 through 223, respectively.)

The proposed amendment would be the counterpart of section 6(c) of the Investment Company Act, which gives the Commission broad power to exempt any person, transaction or security from any provision of that statute. The flexibility which this amendment would introduce into the administration of the Advisers Act is appropriate in view of the broader coverage provided for by this bill. Under proposed section 207, the Commission would in appropriate cases be able to exempt persons from the registration requirements of section 203 and from the ban on performance-based advisory compensation in section 205(1) of the Advisers Act if and to the extent such action is appropriate in the public interest and consistent with the protection of investors and the policy of the act.

SECTIONS 24 AND 25. AMENDING THE ACT BY STRENGTHENING DISCIPLINARY CONTROLS OVER INVESTMENT ADVISERS

1. AMENDING SECTION 202(a)—DEFINITION OF PERSON ASSOCIATED WITH INVESTMENT ADVISER; AMENDING SECTION 203(f)—ADMINISTRATIVE ACTION AGAINST SUCH ASSOCIATED PERSONS; AND AMENDING SECTION 203(e)—DISCIPLINARY PROCEEDINGS

Section 24 of the bill would amend section 202(a) of the Investment Advisers Act to add a new paragraph (17) thereto, which would define the term "person associated with an investment adviser." (Pars. (17) through (20) of existing sec. 202(a) would be redesignated paragraphs (18) through (21), respectively.)

This amendment would be a counterpart to section 3(a)(18) of the Securities Exchange Act and would add a purely definitional section to the classes of persons now referred to in clause (F) of existing section 203(c)(1) and paragraphs (2) and (3) of existing section 203(d) of the Advisers Act. In addition, the new term would be used in proposed section 203(f) of the Advisers Act (see sec. 25(c) of the bill), which would give the Commission, after making the required findings, authority to bar or suspend individuals from associating with an investment adviser. This express reference to employee would make no change in present law, since an employee is considered a controlled person.

The proposed definition specifically would exclude from its terms employees whose functions are clerical or ministerial, except that under proposed section 203(f) a person guilty of misconduct could be barred from associating with an investment adviser even in a clerical or ministerial capacity. Under the proposed definition the Commission would have authority to classify for statutory purposes persons, including employees, controlled by an investment adviser.

The proposed amendments to section 203(e) of the Advisers Act would revise slightly the provisions relative to disciplinary proceedings. One of these revisions would make failure to supervise employees a ground for discipline. This conforms to the 1964 amendments to the Securities Exchange Act.

2. PROPOSED SECTION 203(d)—REQUIREMENT FOR JURISDICTIONAL PROOF

Section 25(c) of the bill would amend section 203 of the Advisers Act to add a new subsection (d). This would specify that any provisions of that act (other than sec. 203(a), the provision that imposes a general requirement of registration on investment advisers), which prohibits any act or conduct if the mails or any means or instrumentality of interstate commerce are used in connection therewith also would prohibit such act or conduct by a registered investment adviser or by a

person acting on behalf of such investment adviser whether or not the mails or any instrumentality of interstate commerce are used. (Existing subsec. (d) of sec. 203 would be redesignated as subsec. (e) and existing subsec. (e) through (g) would be redesignated as subsec. (g) through (i).)

Various provisions of the act prohibit activities of an investment adviser only if they involve a use of the mails or means or instrumentality of interstate commerce. The effect of the proposed amendment would be to prohibit such activities by a registered investment adviser under the act irrespective of proof that the mails or instrumentalities of interstate commerce were used in connection with the particular activity.

The proposed amendment is comparable to the provisions of section 15(b)(4) of the Securities Exchange Act as added in 1964 with respect to registered broker-dealers. Since investment advisers are required to register under the act because they use the mails or instrumentalities of interstate commerce in their business, judicial decisions have made it clear that the act of registration furnishes a sufficient basis for Federal regulation of the activities of an investment adviser. The proposed amendment, therefore, would eliminate time-consuming searches for evidence which has no bearing on the substance of such a case.

PART K: EFFECTIVE DATES

SECTION 28—EFFECTIVE DATES OF THE AMENDMENTS PROVIDED FOR IN THE BILL

Unless otherwise noted, the amendments in this bill would take effect on the date of its enactment. A delayed effective date of 1 year is provided for the following provisions of the bill which may require companies to modify existing arrangements. They are:

(1) Section 2(4), amending redesignated section 2(a)(2) of the Investment Company Act, by removing corporate trustees from the exception to the definition of investment adviser;

(2) Sections 5 (a), (b), (c), and (d), amending sections 10 (a), (b), (c), and (d) of the Investment Company Act, by replacing the term "affiliated person" with the term "interested person";

(3) Sections 8 (a), (c), and (d), amending sections 15 (a), (c), and (d) of the Investment Company Act, by providing for the statutory standard of reasonableness with respect to advisory contracts;

(4) Section 9(a), amending section 17(f) of the Investment Company Act, by modifying existing provisions of the act relating to custody of investment company assets;

(5) Section 11, amending section 19 of the Investment Company Act, by prohibiting capital gains distributions more often than once a year; and

(6) Sections 25 and 26, amending sections 203(b) and 205 of the Investment Advisers Act, by removing certain exemptions for investment advisers to investment companies.

In addition, section 28 of the bill provides for a delayed effective date of 6 months for the amendments to sections 27(a) and 28 (a)(2) and (d) of the Investment Company Act which would prohibit the front-end load in the sale of contractual plans and face-amount certificates.

COMPARATIVE PRINT OF THE BILL SUBMITTED BY THE SECURITIES AND EXCHANGE COMMISSION

Changes in existing law made by the bill are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

A BILL To amend the Investment Company Act of 1940 and the Investment Advisers Act of 1940 to define the equitable standards governing relationships between investment companies and their investment advisers and principal underwriters, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Investment Company Amendments Act of 1967".

SEC. 2. Section 2(a) of the Investment Company Act of 1940 is amended as follows:

(1) Paragraph (5) thereof is amended to read as follows:

"(5) Bank means (A) a banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve System, (c) any other banking institution or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under [section 11(k) of the Federal Reserve Act, as amended,] *the authority of the Comptroller of the Currency*, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this title, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph (5)"

(2) Paragraphs (19) through (42) thereof are redesignated as paragraphs (20) through (43), respectively.

(3) A new paragraph (19) is inserted immediately after paragraph (18) to read as follows:

"*(19) 'Interested person' of another person means (A) when used with respect to an investment company, (i) any affiliated person of such company, (ii) any member of the immediate family of any natural person who is an affiliated person of such company, (iii) any person who either has, or within the preceding three years has had, any direct or indirect material business or professional relationship with such investment company or any other investment company with the same adviser, its chief executive officer, or any of its controlling persons, and (iv) any interested person of any investment adviser of or principal underwriter for such company, and (B) when used with respect to an investment adviser, principal underwriter, regular broker, or investment banker, (i) any affiliated person of such investment adviser, principal underwriter, regular broker, or investment banker, (ii) any member of the immediate family of any natural person who is an affiliated person of such investment adviser, principal underwriter, regular broker, or investment banker, (iii) any person who has any direct or indirect beneficial interest in or who holds as trustee, executor, or guardian any legal interest in any security issued either by such investment adviser, principal underwriter, regular broker, or investment banker or by any controlling person of such investment adviser, principal underwriter, regular broker, or investment banker, and (iv) any person who either has, or within the preceding three years has had, any direct or indirect material business or professional relationship with such investment adviser, principal underwriter, regular broker, or investment banker, its chief executive officer, or any of its controlling persons. For purposes of this title member of the immediate family means any parent, spouse of a parent, child, spouse of a child, spouse, brother or sister, and includes step and adoptive relationships.*"

(4) Redesignated paragraph (20) thereof is amended as follows:

"[(19)] *(20)* 'Investment adviser' of an investment company means (A) any person (other than *a natural person who is* a bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities

or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company, and (B) any other person who pursuant to contract with a person described in clause (A) regularly performs substantially all of the duties undertaken by such person described in clause (A); but does not include (i) a person whose advice is furnished solely through uniform publications distributed to subscribers thereto, (ii) a person who furnishes only statistical and other factual information, advice regarding economic factors and trends, or advice as to occasional transactions in specific securities, but without generally furnishing advice or making recommendations regarding the purchase or sale of securities, (iii) a company furnishing such services at cost to one or more investment companies, insurance companies, or other financial institutions, (iv) any person the character and amount of whose compensation for such services must be approved by a court, or (v) such other persons as the Commission may by rules and regulations or order determine not to be within the intent of this definition."

SEC. 3. (a) Paragraph (2) of section 3(b) of the Investment Company Act of 1940 is amended to read as follows:

"(2) Any issuer which the Commission, upon application by such issuer, finds and by order declares to be primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities either directly or (A) through majority-owned subsidiaries or (B) through controlled companies conducting similar types of businesses. The filing of an application under this paragraph in *good faith* by an issuer other than a registered investment company shall exempt the applicant for a period of sixty days from all provisions of this title applicable to investment companies as such. For cause shown, the Commission by order may extend such period of exemption for an additional period or periods. Whenever the Commission, upon its own motion or upon application, finds that the circumstances which gave rise to the issuance of an order granting an application under this paragraph no longer exist, the Commission shall by order revoke such order."

(b) Section 3(c) of said Act is amended as follows:

(1) The material preceding paragraph (1) thereof is amended to read as follows:

"(c) Notwithstanding subsection[s] (a) [and (b)], none of the following persons is an investment company within the meaning of this title:"

(2) Strike paragraphs (4) and (8) thereof and redesignate paragraphs (5) through (15) thereof as paragraphs (4) through (13), respectively.

(3) Redesignated paragraph (5) thereof is amended to read as follows: "[(6)] (5) Any person who is not engaged in the business of issuing *redeemable securities*, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in one or more of the following businesses: (A) Purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate."

(4) Redesignated paragraph (8) is amended to read as follows:

"[(10)] (8) Any company [with a registration in effect as a holding company] *subject to regulation* under the Public Utility Holding Company Act of 1935."

(5) Redesignated paragraph (9) thereof is amended to read as follows:

"[(11)] (9) Any person *who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic plan certificates, and* substantially all of whose business consists of owning or holding oil, gas, or other mineral royalties or leases, or fractional interests therein, or certificates of interest or participation in or investment contracts relative to such royalties, leases, or fractional interests."

(6) Redesignated paragraph (11) thereof is amended to read as follows:

"(11) Any employees' stock bonus, pension, or profit-sharing trust which meets the [conditions of section 165] *requirements of section 401(a)* of the Internal Revenue Code as amended of 1954."

SEC. 4. (a) Section 9(a) of the Investment Company Act of 1940 is amended to read as follows:

"(a) It shall be unlawful for any of the following persons to serve or act in the capacity of *employee*, officer, director, member of an advisory board, investment adviser, or depositor of any registered investment company, or principal under-

writer for any registered open-end company, registered unit investment trust, or registered face-amount certificate company:

"(1) any person who within ten years has been convicted of any felony or misdemeanor involving the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer, or investment adviser, or as an affiliated person, salesman, or employee of any investment company, bank, or insurance company;

"(2) any person who, by reason of any misconduct, is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an underwriter, broker, dealer, or investment adviser, or as an affiliated person, salesman, or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security; or

"(3) a company any affiliated person of which is ineligible, by reason of paragraph (1) or (2), to serve or act in the foregoing capacities.

For the purposes of paragraphs (1), (2), and (3) of this subsection, the term 'investment adviser' shall include an investment adviser as defined in title II of this Act."

(b) Section 9 of said Act is further amended by redesignating subsection (b) thereof as subsection (c) and inserting immediately after subsection (a) a new subsection (b) to read as follows:

"*(b) The Commission may, after notice and opportunity for hearing, by order prohibit, conditionally or unconditionally, either permanently or for such period of time as it in its discretion shall deem appropriate in the public interest, any person from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter if such person:*

"*(1) has willfully made or caused to be made in any registration statement application or report filed with the Commission under this title any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such registration statement, application or report any material fact which was required to be stated therein; or*

"*(2) has willfully violated any provision of the Securities Act of 1933, or of the Securities Exchange Act of 1934, or of title II of this Act, or of this title, or of any rule or regulation under any of such statutes; or*

"*(3) has willfully caused, aided, abetted, counseled, commanded, induced, or procured the violation by any other person of the Securities Act of 1933, or of the Securities Exchange Act of 1934, or of title II of this Act, or of this title, or of any rule or regulation under any of such statutes.*"

SEC. 5. (a) Section 10(a) of the Investment Company Act of 1940 is amended to read as follows:

"(a) No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are [investment advisers of, affiliated persons of an investment adviser of, or officers or employees of, such registered company.] *interested persons of such registered company, except that no person shall be deemed an interested person of a registered investment company solely because of membership on its board of directors or advisory board or ownership of its securities.*"

(b) Section 10(b) of said Act is amended to read as follows:

"(b) No registered investment company shall

"(1) employ as regular broker any director, officer, or employee of such registered company, or any person of which any such director, officer, or employee is an [affiliated] *interested* person, unless a majority of the board of directors of such registered company shall be persons who are not such brokers or [affiliated] *interested* persons of any of such brokers,

"(2) use as a principal underwriter of securities issued by it any director, officer, or employee of such registered company or any person of which any such director, officer, or employee is an [affiliated] *interested* person unless a majority of the board of directors of such registered company shall be persons who are not such principal underwriters or [affiliated] *interested* persons of any of such principal underwriters; or

"(3) have as director, officer, or employee any investment banker, or any [affiliated] *interested* person of an investment banker, unless a majority of the board of directors of such registered company shall be persons who are

not investment bankers or [affiliated] *interested* persons of any investment banker. For the purposes of this paragraph, a person shall not be deemed an [affiliated] *interested* person of an investment banker solely by reason of the fact that he is an [affiliated] *interested* person of a company of the character described in section 12(d)(3) (A) and (B)."

(c) Section 10(c) of said Act is amended to read as follows:

[After the effective date of this title, no] "(c) *No* registered investment company shall have a majority of its board of directors consisting of persons who are officers, directors, or employees of any one bank, [*Provided*, That] *except that*, if on March 15, 1940, any registered investment company shall have had a majority of its directors consisting of persons who are directors, officers, or employees of any one bank, such registered company may continue to have the same percentage of its board of directors consisting of persons who are directors, officers, or employees of such bank."

(d) Section 10(d) of said Act is amended to reads follows.

"(d) Notwithstanding subsection (a) and subsection (b)(2) *of this section* a registered investment company may have a board of directors all the members of which, except one, are [affiliated] *interested* persons of the investment adviser of such company, or are officers or employees of such company, if—

"(1) such investment company is an open-end company,

"(2) such investment adviser is registered under title II of this Act and such investment adviser is engaged principally in the business of rendering investment supervisory services as defined in title II;

"(3) no sales load is charged on securities issued by such investment company;

"(4) any premium over net asset value charged by such company upon the issuance of any such security, plus any discount from net asset value charged on redemption thereof, shall not in the aggregate exceed 2 per centum;

"(5) no sales or promotion expenses are incurred by such registered company; but expenses incurred in complying with laws regulating the issue or sale of securities shall not be deemed sales or promotion expenses,

"(6) such investment adviser is the only investment adviser to such investment company, and 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;

"(7) all executive salaries and executive expenses and office rent of such investment company are paid by such investment adviser; and

"(8) such investment company has only one class of stock outstanding, each share of which has equal voting rights with every other share."

SEC. 6. Section 11(b) of the Investment Company Act of 1940 is amended to read as follows:

"(b) The provisions of this section shall not apply to any offer made pursuant to [(1)] any plan of reorganization, which is submitted to and requires the approval of the holders of at least a majority of the outstanding shares of the class or series to which the security owned by the offeree belongs. [; or (2) the right of conversion, at the option of the holder, from one class or series into another class or series of securities issued by the same company upon such terms as are specified in the charter, certificate of incorporation, articles of association, by-laws or trust indenture subject to which the securities to be converted were issued or are to be issued.]

SEC. 7. Section 12(d) of the Investment Company Act of 1940 is amended to read as follows:

"(d)(1) It shall be unlawful *(A)* for any registered investment company and any company or companies controlled by such registered investment company to purchase or otherwise acquire any security issued by or any other interest in the business of [— (1)] any other investment company, [of which such registered investment company and any company or companies controlled by such registered company shall not at the time of such purchase or acquisition own in the aggregate at least 25 per centum of the total outstanding voting stock, if such registered investment company and any company or companies controlled by it own in the aggregate or as a result of such purchase or acquisition will own in the aggregate more than 5 per centum of the total outstanding voting stock of such other investment company if the policy of such other investment company is the concentration of investments in a particular industry or group of industries, or more than 3 per centum of the total outstanding voting stock of such other investment company if the policy of such other investment company is not the concentration of investments in a particular industry or group of industries, except] *(B) for any investment company and any company or companies controlled by such investment company to purchase or otherwise acquire any security issued by or any other interest in the business of any registered investment company, and (C) for any registered investment company, any principal underwriter thereof, or any broker or dealer in securities knowingly to sell any security issued by or any other interest in the business of any registered investment company to another investment company and any company or companies controlled by such investment company. The provisions of this paragraph shall not apply to* [(A)] *(i)* a security received as a dividend or as a result of an offer of exchange approved pursuant to section 11 or of a plan of reorganization of any company (other than a plan devised for the purpose of evading the foregoing provisions), or [(B)] *(ii)* a security purchased with the proceeds of payments on periodic payment plan certificates [pursuant to the terms of the trust indenture under which such certificates are issued; or] *which are issued by a unit investment trust the depositor of or principal underwriter for which is a broker or dealer registered under section 15(b) of the Securities Exchange Act of 1934 and the assets of which are the securities of a single registered management company. The Commission, by rules, regulations or, after notice and opportunity for hearing, by order may direct that the issuer of any security purchased or otherwise acquired in violation of this paragraph (1) cancel the certificates evidencing an interest in such security on such terms and conditions as the Commission finds necessary or appropriate in the public interest and for the protection of investors.*

"(2) *It shall be unlawful for any registered investment company and any company or companies controlled by such registered investment company to purchase or otherwise acquire any security issued by or any other interest in the business of* any insurance company of which such registered investment company and any company or companies controlled by such registered company shall not at the time of such purchase or acquisition own in the aggregate at least 25 per centum of the total outstanding voting stock, if such registered company and any company or companies controlled by it own in the aggregate or as a result of such purchase or acquisition will own in the aggregate more than 10 per centum of the total outstanding voting stock of such insurance company, except a security received as a dividend or as a result of a plan of reorganization of any company (other than a plan devised for the purpose of evading the foregoing provisions).

"(3) *It shall be unlawful for any registered investment company and any company or companies controlled by such registered investment company to purchase or otherwise acquire any security issued by or any other interest in the business of* any person who is a broker, a dealer, is engaged in the business of underwriting, or is either an investment adviser of an investment company or an investment adviser registered under title II of this Act, unless (A) such person is a corporation all the outstanding securities of which (other than short-term paper, securities representing bank loans and directors' qualifying shares) are, or after such acquisition will be, owned by one or more registered investment companies; and (B) such person is primarily engaged in the business of underwriting and distributing securities issued by other persons, selling securities to customers, or any one or more of such or related activities, and the gross income of such person normally is derived principally from such business or related activities."

SEC. 8. (a) Section 15(a) of the Investment Company Act of 1940 is amended to read as follows:

"(a) [After one year from the effective date of this title it] *It* shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, [unless in effect prior to March 15, 1940,] has been approved by the vote of a majority of the outstanding voting securities of such registered company and

"(1) precisely *and separately* describes all compensation to be paid thereunder *for (A) investment advisory services and (B) for all other services;*

"(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;

"(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

"(4) provides, in substance, for its automatic termination in the event of its assignment. [by the investment adviser.]"

(b) Section 15(b) of said Act is amended to read as follows:

"(b) [After one year from the effective date of this title, it] *It* shall be unlawful for any principal underwriter for a registered open-end company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, except pursuant to a written contract with such company, which contract [, unless in effect prior to March 15, 1940]—

"(1) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company; and

"(2) provides, in substance, for its automatic termination in the event of its assignment. [by such underwriter.]"

(c) Section 15(c) of said Act is amended to read as follows:

"(c) In addition to the requirements of subsections (a) and (b) *of this section* it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, [except a written agreement which was in effect prior to March 15, 1940,] whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved [(1)] by the vote of a majority of the directors who are not parties to such contract or agreement or [affiliated] *interested* persons of any such party, [, or (2) by the vote of a majority of the outstanding voting securities of such company,] *cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may be reasonably necessary to determine the reasonableness of compensation provided for in any contract whereby a person undertakes regularly to serve or act as investment adviser of such company.*"

(d) Section 15 of said Act is further amended by striking subsection (d) thereof and inserting immediately after subsection (c) a new subsection (d) to read as follows:

[(d) It shall be unlawful for any person—

(1) to serve or act as investment adviser of a registered investment company, pursuant to a written contract which was in effect prior to March 15, 1940, after March 15, 1945, or the date of termination provided for in such contract, whichever is the prior date, or after assignment thereof subsequent to March 15, 1940, by the person acting as investment adviser thereunder; or

(2) as principal underwriter for a registered open-end investment company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, pursuant to a written contract which was in effect prior to March 15, 1940, after March 15, 1945, or the date of termination provided for in such contract, whichever is the prior date, or after assignment thereof subsequent to March 15, 1940, by the person acting as principal underwriter thereunder:

Provided, however, That the limitation to March 15, 1945, shall not apply in either case if prior to that date such contract is renewed in such form that it complies with the requirements of subsection (a) or (b) of this section, as the case may be, and is approved in the manner required by this section in respect of a contract of the same character made after March 15, 1940.]

"(d)(1) All compensation for services to a registered investment company received by an investment adviser, officer, director, or controlling person of or principal underwriter for such company and any affiliated person of such investment adviser, officer, director, controlling person, or principal underwriter shall be reasonable. This subsection shall not apply to sales loads for the acquisition of any security issued by a registered investment company.

"(2) In determining whether the compensation provided for in a contract whereby any person undertakes to serve or act as investment adviser of a registered investment company is reasonable, the factors considered shall include but not be limited to the following:

"(A) The nature and extent of the services to be provided pursuant to such contract, including separate evaluations of the compensation to be received for investment advisory services and of the compensation to be received for other services;

"(B) The quality of the services theretofore rendered to such investment company by the person undertaking to serve or act as investment adviser, or, if no such services have been theretofore rendered, the quality of the services rendered to other investment clients, if any, by such person;

"(C) The extent to which the compensation provided for in such contract takes into account economies attributable to the growth and size of such investment company and any such economies attributable to the operation of other investment companies under common management with such company, giving due consideration to the extent to which such economies are reflected in the charges made or compensation received for investment advisory services and other services provided to investment companies having no investment adviser, other clients of investment advisers and other financial institutions, but with due allowance for any relevant differences in the nature and extent of the services provided;

"(D) The value of all benefits, in addition to compensation provided for in such contract, directly or indirectly received or receivable by the person undertaking to serve or act as investment adviser by reason of his relationship to such investment company;

"(E) Such other factors as are appropriate and material.

"(3) In any action pursuant to this subsection, no finding shall be made that any compensation provided for in a contract or other arrangement approved or otherwise authorized in compliance with the provisions of this title (other than the requirement of reasonableness in paragraph (1) of this subsection (d)) is unreasonable unless the party seeking such finding sustains the burden of proving by a preponderance of evidence that such compensation is unreasonable.

"(4) No action shall be maintained pursuant to this subsection to recover compensation paid more than two years prior to the date on which such action was instituted.

"(5) No person shall be held liable in any action pursuant to this subsection for damages in excess of the difference between the amount of compensation actually received by such person and the amount determined to be reasonable compensation for the period for which the action is brought and the interest on the difference between such amounts.

"(6) A finding that any compensation subject to the provisions of this subsection is unreasonable shall not be deemed to be a finding of a violation of this title for purposes of sections 9 and 49 of this title, section 15 of the Securities Exchange Act of 1934, and section 203 of title II of this Act."

(e) Section 15 of said Act is further amended by adding a new subsection (g) to read as follows:

"(g) It shall be unlawful for any investment adviser of a registered investment company or any affiliated person of such investment adviser to sell any assets of or any securities issued by such investment adviser or a controlling person of such investment adviser, or otherwise to receive any benefit, in connection with a transaction by which another person obtains control of such investment adviser or succeeds to any relationship between such investment adviser and a registered investment company, if any terms, conditions, or understandings, express or implied, in connection with such transaction are likely to impose additional burdens on the investment company or limit its freedom of future action or otherwise is inequitable to such investment company.

SEC. 9.(a) Section 17(f) of the Investment Company Act of 1940 is amended to read as follows:

"(f) Every registered management company shall place and maintain its securities and similar investments in the custody of (1) a bank or banks having the qualifications prescribed in paragraph (1) of Section 26(a) of this title for the trustees of unit investment trusts; or (2) a company which is a member of a national securities exchange as defined in the Securities Exchange Act of 1934, subject to such rules and regulations as the Commission may from time to time prescribe for the protection of investors; or (3) such registered company, but only in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors. Rules, regulations and orders of the Commission under this subsection, among other things, may make appropriate provision with respect to such matters as the earmarking, segregation, and hypothecation of such securities and investments, and may provide for or require periodic or other inspections by any or all of the following: independent public accountants, employees and agents of the Commission, and such other persons as the Commission may designate. No such member which trades in securities for its own account may act as custodian except in accordance with rules and regulations prescribed by the Commission for the protection of investors. *If a registered company maintains its securities and similar investments in the custody of a qualified bank or banks, the cash proceeds from the sale of such*

securities and similar investments and other cash assets of the company shall likewise be kept in the custody of such a bank or banks or in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors, except that such a registered company may maintain a checking account in a bank or banks having the qualifications prescribed in paragraph (1) of section 26(a) of this title for the trustees of unit investment trusts with the balance of such account or the aggregate balances of such accounts at no time in excess of the amount of the fidelity bond maintained pursuant to section 17(g) of this title, covering the officers or employees authorized to draw on such account or accounts."

(b) Section 17 of said Act is further amended by adding a new subsection (j) to read as follows:

"(j) It shall be unlawful in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, for any affiliated person of or principal underwriter for a registered investment company, or any affiliated person of an investment adviser of or principal underwriter for a registered investment company, to purchase or sell securities of any issuer whose securities are owned by such registered investment company or to purchase or sell securities of any issuer the securities of which such investment company is contemplating purchasing."

SEC. 10. Section 18(f)(2) of the Investment Company Act of 1940 is amended to read as follows:

"(2) 'Senior security' shall not, in the case of a registered open-end company include a class or classes or a number of series of preferred or special stock each of which is preferred over all other classes or series in respect of assets specifically allocated to that class or series *and which was issued and outstanding prior to December 31, 1967: Provided,* (A) That such company has outstanding no class or series of stock which is not so preferred over all other classes or series; or (B) that the only other outstanding class of the issuer's stock consists of a common stock upon which no dividend (other than a liquidating dividend) is permitted to be paid and which in the aggregate represents not more than one-half of 1 per centum of the issuer's outstanding voting securities."

SEC. 11. Section 19 of the Investment Company Act of 1940 is amended to read as follows:

"SEC. 19(a) It shall be unlawful for any registered investment company to pay any dividend, or to make any distribution in the nature of a dividend payment, wholly or partly from any source other than—

"(1) such company's accumulated undistributed net income, determined in accordance with good accounting practice and not including profits or losses realized upon the sale of securities or other properties; or

"(2) such company's net income so determined for the current or preceding fiscal year;

unless such payment is accompanied by a written statement which adequately discloses the source or sources of such payment. The Commission may prescribe the form of such statement by rules and regulations in the public interest and for the protection of investors.

"(b) It shall be unlawful in contravention of such rules, regulations, or orders as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors for any registered investment company to distribute long-term capital gains, as defined in the Internal Revenue Code of 1954, more often than once every twelve months."

SEC. 12. (a) Section 22 of the Investment Company Act of 1940 is amended by striking subsection (b) thereof and redesignating subsection (c) thereof as (b).

(b) Redesignated section 22(b) of said Act is amended to read as follows:

[(b) Such a securities association may also, by rules adopted and in effect in accordance with said section 15A, and subject to all provisions of said section applicable to the rules of such an association, prohibit its members from purchasing, in connection with a primary distribution of redeemable securities of which any registered investment company is the issuer, any such security from the issuer or from any principal underwriter except at a price equal to the price at which such security is then offered to the public less a commission, discount, or spread which is computed in conformity with a method or methods, and within such limitations as to the relation thereof to said public offering price as such rules may prescribe, in order that the price at which such security is offered or sold to the public shall not include an unconscionable or grossly excessive sales load.]

"(b) [(c) After one year from the effective date of this Act, the] *The Commission* may make rules and regulations applicable to principal underwriters of,

and dealers in, the redeemable securities of any registered investment company, whether or not members of any securities association, to the same extent, covering the same subject matter and for the accomplishment of the same ends as are prescribed in subsection[s] (a) [and (b)] of this section in respect of the rules which may be made by a registered securities association governing its members, and any rules and regulations so made by the Commission, to the extent that they may be inconsistent with the rules of any such association, shall so long as they remain in force supersede the rules of the association and be binding upon its members as well as all other underwriters and dealers to whom they may be applicable."

(c) Section 22 of said Act is further amended by inserting immediately after redesignated subsection (b) a new subsection (c) to read as follows:

"(c)(1) No registered investment company, except an investment company operating under the Small Business Investment Company Act of 1958, shall offer or sell, through a principal underwriter or otherwise, any security issued by it at a public offering price which includes a sales load of more than 5 per centum of that portion of the proceeds from the sale of the security which is received and invested or held for investment by the issuer (or in the case of a unit trust by the depositor or trustee).

"(2) The Commission, by rules and regulations or by order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from the provisions of paragraph (1) of this subsection (c), if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

"(3) The Commission is authorized to adopt rules and regulations to prohibit or restrict sales loads in transactions where the imposition of such charges would be inequitable to investors, including transactions where dividends declared by issuers of redeemable securities are applied to the purchase price of additional securities issued by such companies."

(d) Section 22(d) of said Act is amended to read as follows:

"(d) No registered investment company shall sell any redeemable security issued by it to any person except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus, and, if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter or the issuer, except at a current public offering price described in the prospectus. Nothing in this subsection shall prevent a sale made (i) pursuant to an offer of exchange permitted by section 11 hereof including any offer made pursuant to [clause (1) or (2) of]section 11(b); (ii) pursuant to an offer made solely to all registered holders of the securities, or of a particular class or series of securities issued by the company proportionate to their holdings or proportionate to any cash distribution made to them by the company (subject to appropriate qualifications designed solely to avoid issuance of fractional securities); or (iii) in accordance with rules and regulations of the Commission made pursuant to subsection (b) of section 12."

SEC. 13. Section 24(d) of the Investment Company Act of 1940 is amended to read as follows:

"(d) The exemption provided by paragraph (8) of section 3(a) of the Securities Act of 1933 shall not apply to any security of which an investment company is the issuer. The exemption provided by paragraph (11) of said section 3(a) shall not apply to any security of which a registered investment company is the issuer, except a security sold or disposed of by the issuer or bona fide offered to the public prior to the effective date of this title, and with respect to a security so sold, disposed of, or offered, shall not apply to any new offering thereof on or after the effective date of this title. The exemption provided by [the third clause of section 4(1)] *section 4(3)* of the Securities Act of 1933, shall not apply to any transaction in a security issued by a face-amount certificate company or in a redeemable security issued by an open-end management company or unit investment trust, if any other security of the same class is currently being offered or sold by the issuer or by or through an underwriter in a distribution which is not exempted from section 5 of said Act, except to such extent and subject to such terms and conditions as the Commission, having due regard for the public interest and the protection of investors, may prescribe by rules or regulations with respect to any class of persons, securities, or transactions."

SEC. 14. Section 25(c) of the Investment Company Act of 1940 is amended to read as follows:

"(c) Any district court of the United States in the State of incorporation of a registered investment company or any such court for the district in which such company maintains its principal place of business is authorized to enjoin the consummation of any plan of reorganization of such registered investment company upon proceedings instituted by the Commission (which is authorized so to proceed upon behalf of security holders of such registered company, or any class thereof), [if such court shall determine any such plan to be grossly unfair or to constitute gross misconduct or gross abuse of trust on the part of the officers, directors, or investment advisers of such registered company or other sponsors of such plan.] *if such court shall determine that any such plan is not fair and equitable to all security holders.*"

SEC. 15. (a) Section 26 of the Investment Company Act of 1940 is amended by redesignating subsections (b) and (c) thereof as subsections (c) and (d), respectively, and inserting immediately after subsection (a) a new subsection (b) to read as follows:

"*(b) It shall be unlawful for any depositor or trustee of a registered unit investment trust to substitute a security for another security in which the security holders of such unit investment trust have undivided interests unless the Commission shall have approved such substitution. The Commission shall issue an order approving such substitution if the evidence establishes that it is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.*"

(b) Redesignated section 26(c) of said Act is amended to read as follows:

"[(b)] *(c)* In the event that a trust indenture, agreement of custodianship, or other instrument pursuant to which securities of a registered unit investment trust are issued does not [at the effective date of this title] comply with the requirements of subsection (a) of this section 26, such instrument will be deemed to meet such requirements if a written contract or agreement binding on the parties and embodying such requirements has been executed by the depositor on the one part and the trustee or custodian on the other part, and three copies of such contract or agreement have been filed with the Commission."

SEC. 16. (a) Section 27(a) of the Investment Company Act of 1940 is amended to read as follows:

"(a) It shall be unlawful for any registered investment company issuing periodic payment plan certificates, or for any depositor of or underwriter for such company, to sell any such certificate, if—

[(1) the sales load on such certificate exceeds 9 per centum of the total payments to be made thereon;

(2) more than one-half of any of the first twelve monthly payments thereon, or their equivalent, is deducted for sales load;

(3) the amount of sales load deducted from any one of such first payments exceeds proportionately the amount deducted from any other such payment, or the amount deducted from any subsequent payment exceeds proportionately the amount deducted from any other subsequent payment;]

"*(1) the amount of sales load deducted from any one payment exceeds proportionately the amount deducted from any other payment;*

"[(4)] *(2)* the first payment on such certificates is less than $20, or any subsequent payment is less than $10;

"[(5)] *(3)* if such registered company is a management company, the proceeds of such certificate or the securities in which such proceeds are invested are subject to management fees (other than fees for administrative services of the character described in clause (C), paragraph (2), of section 26(a)) exceeding such reasonable amount as the Commission may prescribe, whether such fees are payable to such company or to investment advisers thereof; or

"[(6)] *(4)* if such registered company is a unit investment trust the assets of which are securities issued by a management company, the depositor of or principal underwriter for such trust, or any affiliated person of such depositor or underwriter, is to receive from such management company or any affiliated person thereof any fee or payment on account of payments on such certificate exceeding such reasonable amount as the Commission may prescribe."

(b) Section 27 of said Act is further amended by striking subsection (b) thereof and redesignating subsection (c) thereof as subsection (b).

[(b) If it appears to the Commission, upon application or otherwise, that smaller companies are subjected to relatively higher operating costs and that in

order to make due allowance therefor it is necessary or appropriate in the public interest and consistent with the protection of investors that a provision or provisions of paragraph (1), (2), or (3) of subsection (a) relative to sales load be relaxed in the case of certain registered investment companies issuing periodic payment plan certificates, or certain specified classes of such companies, the Commission is authorized by rules and regulations or order to grant any such company or class of companies appropriate qualified exemptions from the provisions of said paragraphs.]

SEC. 17. (a) Section 28(a)(2) of the Investment Company Act of 1940 is amended to read as follows:

"(2) such company maintains at all times minimum certificate reserves on all its outstanding face-amount certificates in an aggregate amount calculated and adjusted as follows:

"(A) the reserves for each certificate of the installment type shall be based on assumed annual, semiannual, quarterly, or monthly reserve payments according to the manner in which gross payments for any certificate year are made by the holder, which reserve payments shall be sufficient in amount, as and when accumulated at a rate not to exceed 3½ per centum per annum compounded annually, to provide the minimum maturity or face amount of the certificate when due. [Such reserve payments may be graduated according to certificate years so that the reserve payment or payments for the first certificate year shall amount to at least 50 per centum of the required gross annual payment for such year and the reserve payment or payments for each of the second to fifth certificate years inclusive shall amount to at least 93 per centum of each such year's required gross annual payment and for the sixth and each subsequent certificate year the reserve payment or payments shall amount to at least 96 per centum of each such year's required gross annual payment: *Provided*, That such aggregate reserve payments shall amount to at least 93 per centum of the aggregate gross annual payments required to be made by the holder to obtain the maturity of the certificate.] *Such reserve payments shall amount to at least 95.24 per centum of the required gross payment during each certificate year.* The company may at its option take as loading from the gross payment or payments for a certificate year, as and when made by the certificate holder, an amount or amounts equal in the aggregate for such year to not more than the excess, if any, of the gross payment or payments required to be made by the holder for such year, over and above the percentage of the gross annual payment required herein for such year for reserve purposes. Such loading may be taken by the company prior to or after the setting up of the reserve payment or payments for such year and the reserve payment or payments for such year may be graduated and adjusted to correspond with the amount of the gross payment or payments made by the certificate holder for each year less the loading so taken;

"(B) if the foregoing minimum percentages of the gross annual payments required under the provisions of such certificate should produce reserve payments larger than are necessary at 3½ per centum per annum compounded annually to provide the minimum maturity or face amount of the certificate when due, the reserve shall be based upon reserve payments accumulated as provided under preceding subparagraph (A) of this subsection except that in lieu of the 3½ per centum rate specified therein, such rate shall be lowered to the minimum rate, expressed in multiples of one-eighth of 1 per centum, which will accumulate such reserve payments to the maturity value when due;

"(C) if the actual annual gross payment to be made by the certificate holder on any certificate issued prior to or after the effective date of this Act is less than the amount of any assumed reserve payment or payments for a certificate year, such company shall maintain as a part of such minimum certificate reserves a deficiency reserve equal to the total present value of future deficiencies in the gross payments, calculated at a rate not to exceed 3½ per centum per annum compounded annually;

"(D) for each certificate of the installment type the amount of the reserve shall at any time be at least equal to [(1)] *(i)* the then amount of the reserve payments set up under section 28(a)(2)(A) or (B); [(2)] *(ii)* the accumulations on such reserve payments as computed under subparagraphs (A) or (B) of this paragraph (2); [(3)] *(iii)* the amount

of any deficiency reserve required under subparagraph (C) hereof; and [(4)] *(iv)* such amount as shall have been credited to the account of each certificate holder in the form of any credit, or any dividend, or any interest in addition to the minimum maturity amount specified in such certificate, plus any accumulations on any amount or amounts so credited, at a rate not exceeding 3½ per centum per annum compounded annually;

"(E) for each certificate which is fully paid, including any fully paid obligations resulting from or effected upon the maturity of the previously issued certificate, and for each paid-up certificate issued as provided in subsection (f) of this section prior to maturity, the amount of the reserve shall be at least *95.24 per centum of the gross consideration paid by the purchaser of such fully paid certificate and at any time be at least* equal to [(1)] *(i)* such amount as and when accumulated at any rate not to exceed 3½ per centum per annum compounded annually, will provide the amount or amounts payable when due and [(2)] *(ii)* such amount as shall have been credited to the account of each such certificate holder in the form of any credit, or any dividend, or any interest in addition to the minimum maturity amount specified in the certificate, plus any accumulations on any amount or amounts so credited, at a rate not exceeding 3½ per centum per annum compounded annually.

"(F) for each certificate of the installment type under which gross payments have been made by or credited to the holder thereof covering a payment period or periods or any part thereof beyond the then current payment period as defined by the terms of such certificate, and for which period or periods no reserve has been set up under subparagraph (A) or (B) hereof, an advance payment reserve shall be set up and maintained in the amount of the present value of any such unapplied advance gross payments, computed at a rate not to exceed 3½ per centum per annum compounded annually;

"(G) such appropriate contingency reserves for death and disability benefits and for reinstatement rights on any such certificate providing for such benefits or rights as the Commission shall prescribe by rule, regulation, or order based upon the experience of face-amount companies in relation to such contingencies.

"At no time shall the aggregate certificate reserves herein required by subparagraphs (A) to (F), inclusive, be less than the aggregate surrender values and other amounts to which all certificate holders may be then entitled.

"For the purpose of this subsection (a), no certificate of the installment type shall be deemed to be outstanding if before a surrender value has been attained the holder thereof has been in continuous default in making his payments thereon for a period of one year."

(b) Section 28(d) of said Act is amended to read as follows:

"(d) It shall be unlawful for any registered face-amount certificate company to issue or sell any face-amount certificate, or to collect or accept any payment on any such certificate issued by such company on or after the effective date of this title, unless such certificate contains a provision or provisions to the effect—

[(1) that, in respect of any certificate of the installment type, during the first certificate year the holder of the certificate, upon surrender thereof, shall be entitled to a value payable in cash not less than the reserve payments as specified in subparagraph (A) or (B) of paragraph (2) of subsection (a) and at the end of such certificate year, a value payable in cash at least equal to 50 per centum of the amount of the gross annual payment required thereby for such year;]

"[(2)] *(1)* that, in respect of any certificate of the installment type, at any time [after the expiration of the first certificate year and] prior to maturity, the holder of the certificate, upon surrender thereof, shall be entitled to a value payable in cash not less than the then amount of the reserve for such certificate required by items [(1)] *(i)* and [(2)] *(ii)* of subparagraph (D) of paragraph (2) of subsection (a) hereof[, less a surrender charge that shall not exceed 2 percentum of the face or maturity amount of the certificate, or 15 percentum of the amount of such reserve, whichever is the lesser, but in no event shall such value be less than 50 per centum of the amount of such reserve.]

The amount of the surrender value for the end of each year shall be set out in the certificate;

"[(3)] *(2)* that, in respect of any certificate of the installment type, the holder of the certificate, upon surrender thereof for cash or upon receipt of a paid-up certificate as provided in subsection (f) hereof, shall be entitled to a value payable in cash equal to the then amount of any advance payment reserve under such certificate required by subparagraph (F) of paragraph (2) of subsection (a) hereof in addition to any other amounts due the holder hereunder;

"[(4)] *(3)* that at any time prior to maturity, in respect of any certificate which is fully paid, the holder of the certificate, upon surrender thereof, shall be entitled to a value payable in cash not less than the then amount of the reserve for such certificate required by item [(1)] *(i)* of subparagraph (E) of paragraph (2) of subsection (a) hereof [,]. [less a surrender charge that shall not exceed 2 per centum of the face or maturity amount of the certificate or 15 per centum of the amount of such reserve whichever is the lesser: *Provided, however,* That such surrender charge shall not apply as to any obligations of a fully paid type resulting from the maturity of a previously issued certificate.] The amount of the surrender value for the end of each certificate year shall be set out in the certificate;

"[(5)] *(4)* that in respect of any certificate, the holder of the certificate, upon maturity, upon surrender thereof for cash or upon receipt of a paid-up certificate as provided in subsection (f) hereof, shall be entitled to a value payable in cash equal to the then amount of the reserve, if any, for such certificate required by item [(4)] *(iv)* of subparagraph (D) of paragraph (2) of subsection (a) hereof or item [(2)] *(ii)* of subparagraph (E) of paragraph (2) of subsection (a) hereof in addition to any other amounts due the holder hereunder.

"The term 'certificate year' as used in this section in respect of any certificate of the installment type means a period or periods for which one year's payment or payments as provided by the certificate have been made thereon by the holder and the certificate maintained in force by such payments for the time for which the same have been made, and in respect of any certificate which is fully paid or paid-up means any year ending on the anniversary of the date of issuance of the certificate.

"Any certificate may provide for loans or advances by the company to the certificate holder on the security of such certificate upon terms prescribed therein but at an interest rate not exceeding 6 per centum per annum. The amount of the required reserves, deposits, and the surrender values thereof available to the holder may be adjusted to take into account any unpaid balance on such loans or advances and interest thereon, for the purposes of this subsection and subsections (b) and (c) hereof.

"Any certificate may provide that the company at its option may, prior to the maturity thereof, defer any payment or payments to the certificate holder to which he may be entitled under this subsection (d), for a period of not more than thirty days. In the event such option is exercised by the company, interest shall accrue on any payment or payments due to the holder, for the period of such deferment at a rate equal to that used in accumulating the reserves for such certificate. The Commission may, by rules and regulations or orders in the public interest or for the protection of investors, make provision for any other deferment upon such terms and conditions as it shall prescribe."

SEC. 18. Section 32(a) of the Investment Company Act of 1940 is amended to read as follows:

"(a) It shall be unlawful for any registered management company or registered face-amount certificate company to file with the Commission any financial statement signed or certified by an independent public accountant, unless

"(1) such accountant shall have been selected at a meeting held within thirty days before or after the beginning of the fiscal year or before the annual meeting of stockholders in that year by *the vote, cast in person, of a* majority of those members of the board of directors who are not [investment advisers of, or affiliated persons of an investment adviser of, or officers or employees of,] *interested persons* of such registered company;

"(2) such selection shall have been submitted for ratification or rejection at the next succeeding annual meeting of stockholders if such meeting be held, except that any vacancy occurring between annual meetings, due to the death or resignation of the accountant, may be filled by the *vote of a majority of those members of the* board of directors *who are not interested persons of such registered company, cast in person at a meeting called for the purpose of voting on such action;*

"(3) the employment of such accountant shall have been conditioned upon the right of the company by vote of a majority of the outstanding voting securities at any meeting called for the purpose to terminate such employment forthwith without any penalty; and

"(4) such certificate or report of such accountant shall be addressed both to the board of directors of such registered company and to the security holders thereof:

[*Provided*, That if] *If* the selection of an accountant has been rejected pursuant to paragraph (2) or his employment terminated pursuant to paragraph (3) the vacancy so occurring may be filled by a vote of a majority of the outstanding voting securities, either at the meeting at which the rejection or termination occurred or, if not so filled then at a subsequent meeting which shall be called for the purpose. In the case of a common-law trust of the character described in section 16(b) no ratification of the employment of such accountant shall be required but such employment may be terminated and such accountant removed by action of the holders of record of a majority of the outstanding shares of beneficial interest in such trust in the same manner as is provided in said section 16(b) in respect of the removal of a trustee, and all the provisions therein contained as to the calling of a meeting shall be applicable. In the event of such termination and removal the vacancy so occurring may be filled by action of the holders of record of a majority of the shares of beneficial interest either at the meeting, if any, at which such termination and removal occurs, or by instruments in writing filed with the custodian, or if not so filled within a reasonable time then at a subsequent meeting which shall be called by the trustees for the purpose. The provisions of paragraph [(40)] *(41)* of section 2(a) as to a majority shall be applicable to the vote cast at any meeting of the shareholders of such a trust held pursuant to this subsection."

SEC. 19. Section 33 of the Investment Company Act of 1940 is amended to read as follows:

"SEC. 33. Every registered investment company which is a party and every affiliated person of such company who is a party defendant to any action or claim by a registered investment company or a security holder thereof in a derivative *or representative* capacity against an officer, director, investment adviser, trustee, or depositor of such company, [for an alleged breach of official duty, which such action or claim is commenced or asserted after the effective date of this title, shall transmit, unless already transmitted to the Commission, the documents specified in subsection (b) hereof if—

(1) such action has been compromised or settled and such settlement or compromise has had the approval of a court having jurisdiction to approve such settlement or compromise; or

(2) a verdict has been rendered or final judgment entered on the merits in such action.

(b) Within thirty days after such settlement or compromise, verdict or final judgment, copies of all pleadings and any written record made in such action, together with a statement of the terms of settlement or compromise, if such terms be not included in the record, shall be transmitted to the Commission; and any information contained in any such documents may be used by the Commission in connection with any report or study which may be made by the Commission of lawsuits whether of investment companies or companies generally: *Provided*, That the names of persons involved shall not be disclosed.] *shall file with the Commission, unless already so filed, (A) a copy of all pleadings, verdicts or judgments filed with the court or served in connection with such action or claim, (B) a copy of any proposed settlement, compromise or discontinuance of such action, and (C) a copy of such motions, transcripts, or other documents filed in or issued by the court or served in connection with such action or claim as may be requested in writing by the Commission—*

"(1) if delivered to such company or party defendant, within five days of receipt; or

"(2) if filed in such court or delivered by such company or party defendant, within two days of such filing or delivery."

SEC. 20. Section 36 of the Investment Company Act of 1940 is amended to read as follows:

"SEC. 36. The Commission is authorized to bring an action in the proper district court of the United States or United States court of any Territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has [been guilty, after the enactment of this title and] *engaged within five years of the commencement of the action*, [of gross misconduct or gross abuse of trust] *or is about to engage in*

any act or practice constituting a breach of fiduciary duty in respect of any registered investment company for which such person so serves or acts:

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If [the Commission's] *such* allegations [of such gross misconduct or gross abuse of trust] are established, the court [shall] *may* enjoin such person from acting in *any or all* such [capacity or] capacities either permanently or [for such period of time] *temporarily and award such injunctive or other relief against such person* as it in its discretion [shall] deems appropriate *in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 1(b) of this title.*"

SEC. 21. Section 38(a) of the Investment Company Act of 1940 is amended to read as follows:

"(a) The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as [are] *it may deem* necessary or appropriate to [the exercise of the powers conferred upon the Commission elsewhere in] *carry out the provisions of* this title, including rules and regulations defining accounting, technical, and trade terms used in this title and prescribing the form or forms in which information required in registration statements, applications, and reports to the Commission shall be set forth. For the purposes of its rules or regulations the Commission may classify persons, securities, and other matters within its jurisdiction and prescribe different requirements for different classes of persons, securities, or matters."

SEC. 22. Section 43(a) of the Investment Company Act of 1940 is amended to read as follows:

"(a) Any person or party aggrieved by an order issued by the Commission under this title may obtain a review of such order in the court of appeals of the United States within any circuit wherein such person resides or has his principal place of business, or in the United States Courts of Appeals for the District of Columbia, by filing in such court, within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall be forthwith transmitted by the clerk of the court to any member of the Commission, or any officer thereof designated by the Commission for that purpose and thereupon the Commission shall file in the court the record upon which the order complained of was entered, as provided in *section 2112 of title 28, United States Code*. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record shall be exclusive, to affirm, modify, or set aside such order, in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission or unless there were reasonable grounds for failure to do so. The findings of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If application is made to the court for leave to adduce additional evidence, and it is shown to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such additional evidence in the proceeding before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which, if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court affirming, modifying, or setting aside, in whole or in part, any such order of the Commission shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in [sections 239 and 240 of the Judicial Code, as amended] *section 1254 of title 28, United States Code*.

SEC. 23. Section 44 of the Investment Company Act of 1940 is amended to read as follows:

"SEC. 44. The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have jurisdiction of violations of this title or the rules, regulations, or orders thereunder, and, concurrently with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of, this title or the rules, regulations, or orders thereunder.

Any criminal proceeding may be brought in the district wherein any act or trans-
action constituting the violation occurred. A criminal proceeding based upon a
violation of section 34, or upon a failure to file a report or other document required
to be filed under this title, may be brought in the district wherein the defendant
is an inhabitant or maintains his principal office or place of business. Any suit
or action to enforce any liability or duty created by, or to enjoin any violation of,
this title or rules, regulations, or orders thereunder, may be brought in any such
district or in the district wherein the defendant is an inhabitant or transacts
business, and process in such cases may be served in any district of which the
defendant is an inhabitant or transacts business or wherever the defendant
may be found. Judgments and decrees so rendered shall be subject to review as
provided in sections [128 and 240 of the Judicial Code, as amended, and section
7, as amended, of the Act entitled "An Act to establish a court of appeals for
the District of Columbia," approved February 9, 1893] 1254, 1291, 1292, and
1293 of title 28, United States Code. No costs shall be assessed for or against the
Commission in any proceeding under this title brought by or against the Com-
mission in any court. *The Commission may intervene as a party in any action or
suit to enforce any liability or duty created by, or to enjoin any non-compliance with,
sections 15(d) and (g) of this title or rules, regulations, or orders thereunder brought
by or on behalf of a registered investment company at any stage of such action or suit
prior to final judgment therein.*"

SEC. 24. Section 202(a) of the Investment Advisers Act of 1940 is amended by
redesignating paragraphs (17) through (20) thereof as paragraphs (18) through
(21), respectively, and inserting immediately after paragraph (16) a new paragraph
(17) to read as follows:

"*(17) The term 'person associated with an investment adviser' means any partner,
officer, or director of such investment adviser (or any person performing similar
functions), or any person directly or indirectly controlling or controlled by such
investment adviser, including any employee of such investment adviser, except that
for the purposes of section 203 of this title, (other than subsection (f) thereof) persons
associated with an investment adviser whose functions are clerical or ministerial
shall not be included in the meaning of such term. The Commission may by rules
and regulations classify, for the purposes of any portion or portions of this title,
persons, including employees controlled by an investment adviser.*"

SEC. 25. (a) Section 203(b) of the Investment Advisers Act of 1940 is amended
to read as follows:

"(b) The provisions of subsection (a) shall not apply to—

"(1) any investment adviser all of whose clients are residents of the State
within which such investment adviser maintains his or its principal office
and place of business, and who does not furnish advice or issue analyses or
reports with respect to securities listed or admitted to unlisted trading priv-
ileges on any national securities exchange;

"(2) any investment adviser whose only clients are [investment companies
and] insurance companies; or

"(3) any investment adviser who during the course of the preceding twelve
months has had fewer than fifteen clients and who [does not hold] *neither*
holds himself out generally to the public as an investment adviser *nor acts*
as an investment adviser to any investment company registered under title I of
this Act."

(b) Section 203(c) of said Act is amended to read as follows:

"(c) Any investment adviser, or any person who presently contemplates
becoming an investment adviser, may register under this section by filing with
the Commission an application for registration. Such application shall contain
such of the following information, in such form and detail, as the Commission
may by rules or regulations prescribe as necessary or appropriate in the public
interest or for the protection of investors:

"(1) information in respect of—

"(A) the name and form of organization under which the investment
adviser engages or intends to engage in business; the name of the State
or other sovereign power under which such investment adviser is or-
ganized; the location of his or its principal business office and branch
offices, if any, the names and addresses of his or its partners, officers,
directors, and persons performing similar functions or, if such an in-
vestment adviser be an individual, of such individual; and the number
of his or its employees;

"(B) the education, the business affiliations for the past ten years,
and the present business affiliations of such investment adviser and of

his or its partners, officers, directors, and persons performing similar
functions and of any controlling person thereof;

"(C) the nature of the business of such investment adviser, including
the manner of giving advice and rendering analyses or reports;

"(D) the nature and scope of the authority of such investment adviser
with respect to clients' funds and accounts;

"(E) the basis or bases upon which such investment adviser is com-
pensated; and

"(F) whether such investment adviser or any [partner, officer,
director thereof, or any person performing similar functions, or any
person directly or indirectly controlling or controlled by] *person directly
or indirectly associated with* such investment adviser; is subject to any
disqualification which would be a basis for denial, suspension, or revoca-
tion of registration of such investment adviser under the provisions of
subsection [d] *(e)*, and

"(2) a statement as to whether the principal business of such investment
adviser consists or is to consist of acting as investment adviser and a state-
ment as to whether a substantial part of the business of such investment
adviser consists or is to consist of rendering investment supervisory services.
Except as hereinafter provided, such registration shall become effective
thirty days after receipt of such application by the Commission, or within
such shorter period of time as the Commission may determine. Any amend-
ment of an application filed not more than fifteen days after the filing of
such application shall be deemed to have been filed with and as a part of
such application. Any amendment of an application filed more than fifteen
days after the filing of such application becomes effective shall be deemed a
new application incorporating by reference the unamended items of the
earlier application. Any amendment filed after the application has become
effective shall become effective thirty days after the filing thereof, or at such
earlier date as the Commission may order."

(c) Section 203 of said Act is further amended by redesignating subsection (d)
thereof as subsection (e) and redesignating subsection (e) as subsection (g) and
inserting a new subsection (d) to read as follows:

"*(d) Any provision of this title (other than subsection (a) of this section) which
prohibits any act, practice, or course of business if the mails or any means or instru-
mentality of interstate commerce are used in connection therewith shall also prohibit
any such act, practice, or course of business by any investment adviser registered
pursuant to this section or any person acting on behalf of such an investment adviser,
irrespective of any use of the mails or any means or instrumentality of interstate
commerce in connection therewith.*"

(d) Redesignated section 203(e) of said Act is amended to read as follows:

"[d]*(e)* The Commission shall, after appropriate notice and opportunity for
hearing, by order *censure*, deny registration to, or suspend for a period not exceed-
ing twelve months, or revoke the registration of, an investment adviser, if it
finds that such *censure, denial, suspension*, or revocation is in the public interest
and that [(1)] such investment adviser *or any person associated with such invest-
ment adviser*, whether prior to or subsequent to becoming such, [or (2) any
partner, officer or director thereof, or any person performing similar functions,
or (3) any person directly or indirectly controlling or controlled by such invest-
ment adviser, whether prior to or subsequent to becoming such,]

[(A)] "*(1)* has willfully made or caused to be made in any application for
registration or report filed with the Commission under this title, or in any
proceeding before the Commission with respect to registration, any statement
which was at the time and in the light of the circumstances under which it
was made false or misleading with respect to any material fact, or who has
omitted to state in any such application or report any material fact which is
required to be stated therin; or

[(B)] "*(2)* has been convicted within ten years preceding the filing of the
application or at any time thereafter of any felony or misdemeanor which the
Commission finds [(i)] *(A)* involves the purchase or sale of any security,
[(ii)] *(B)* arises out of the conduct of the business of a broker, dealer, or
investment adviser, [(iii)] *(C)* involves embezzlement, fraudulent conver-
sion, or misappropriation of funds or securities, or [(iv)] *(D)* involves the
violation of section 1341, 1342, or 1343 of title 18, United States Code [as
heretofore or hereafter amended]; or

[(C)] "*(3)* is permanently or temporarily enjoined by order, judgment, or
decree of any court of competent jurisdiction from acting as an investment

adviser, underwriter, broker, or dealer, or as an affiliated person or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security; or

"[(D)] (4) has willfully violated any provision of the Securities Act of 1933, or of the Securities Exchange Act of 1934, *or of title I of this Act,* or of this title, [as any of such statutes heretofore have been or hereafter may be amended] or of any rule or regulation under any of such statutes; or

"[(E)] (5) has aided, abetted, counseled, commanded, induced, or procured the violation by any other person of the Securities Act of 1933, or the Securities Exchange Act of 1934, *or of title I of this Act,* or of this title, [as any of such statutes heretofore have been or hereafter may be amended] or of any rule or regulation under any of such statutes *or has failed reasonably to supervise, with a view to preventing violations of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this paragraph (5) no person shall be deemed to have failed reasonably to supervise any person, if—*

"(A) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

"(B) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

"(6) is subject to an order of the Commission entered pursuant to subsection (f) of this section barring or suspending the right of such person to be associated with an investment adviser, which order is in effect with respect to such person."

(c) Section 203 of said Act is further amended by redesignating subsections (f) and (g) thereof as subsection (h) and (i), respectively, and inserting a new subsection (f) to read as follows:

"(f) The Commission may, after appropriate notice and opportunity for hearing, by order censure any person or bar or suspend for a period not exceeding twelve months any person from being associated with an investment adviser, if the Commission finds that such censure, barring, or suspension is in the public interest and that such person has committed or omitted any act or omission enumerated in paragraphs (1), (4) or (5) of subsection (e) of this section or has been convicted of any offense specified in paragraph (2) of said subsection (e) within ten years of the commencement of the proceedings under this subsection or is enjoined from any action, conduct or practice specified in paragraph (3) of said subsection (e). It shall be unlawful for any person as to whom such an order barring or suspending him from being associated with an investment adviser is in effect willfully to become, or to be, associated with an investment adviser, without the consent of the Commission, and it shall be unlawful for any investment adviser to permit such a person to become, or remain, a person associated with such investment adviser without the consent of the Commission, if such investment adviser knew, or in the exercise of reasonable care should have known, of such order."

SEC. 26. Section 205 of the Investment Advisers Act of 1940 is amended to read as follows:

"SEC. 205. No investment adviser, unless exempt from registration pursuant to section 203(b), shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to enter into, extend, or renew any investment advisory contract, or in any way to perform any investment advisory contract entered into, extended, or renewed on or after the effective date of this title, if such contract—

"(1) provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client;

"(2) fails to provide, in substance, that no assignment of such contract shall be made by the investment adviser without the consent of the other party to the contract; or

"(3) fails to provide, in substance, that the investment adviser, if a partnership, will notify the other party to the contract of any change in the membership of such partnership within a reasonable time after such change. [As used in this section "investment advisory contract" means any contract or agreement whereby a person agrees to act as investment adviser or to manage any investment or trading account for a person other than an investment company.] Paragraph (1) of this section shall not be construed to

prohibit an investment advisory contract which provides for compensation based upon the total value of a fund averaged over a definite period, or as of definite dates, or taken as of a definite date. *As used in paragraphs (2) and (3) of this section, 'investment advisory contract' means any contract or agreement whereby a person agrees to act as investment adviser or to manage any investment or trading account for another person."*

SEC. 207. The Investment Advisers Act of 1940 is further amended by redesignating sections 208 through 222 thereof as sections 209 to 223, respectively, and inserting immediately after section 206 a new section 207 to read as follows:

"SEC. 207. The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person or transaction, or any class or classes of person, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

SEC. 28. The amendments made by this Act shall take effect as follows:

"(1) The amendments to redesignated section 2(a)(20), and sections 10(a), (b), (c) and (d), 15(a), (c) and (d), 17(f), 19 and 32(a) of the Investment Company Act of 1940 and sections 203(b) and 205 of the Investment Advisers Act of 1940, contained in Sections 2(4), 5(a), (b), (c) and (d), 8(a), (c), and (d), 9(a), 11, 18, 25 and 26 of this Act shall take effect one year from the date of its enactment.

"(2) The amendments to sections 27(a) and 28(a)(2) and (d) of the Investment Company Act of 1940, contained in sections 16(a) and 17(a) and (b) of this Act shall take effect 6 months from the date of its enactment.

"(3) All other amendments in this Act shall take effect on the date of its enactment.