SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

March 25, 1968

Honorable W. S. Stuckey, Jr.
House of Representatives
Washington, D. C. 20515

Dear Mr. Stuckey:

This is in reply to your letter of March 22 in which you ask certain questions in connection with H.R. 14742.

We are happy to endeavor to answer them. I will set forth below each of your questions followed by our answer.

1. On page 3 of your testimony before this Subcommittee on March 15, 1968, you stated that, "The provision of the securities laws are intended to and should apply equally to all persons and organizations who offer securities to public investors." Is this statement consistent with the exemption from Section 10(c) of the Investment Company Act of 1940 granted to a bank collective investment fund in the First National City Bank case?

While I did say that the provisions of the securities laws are intended to apply equally to all persons and organizations, this was in the context of a thought that special types of persons or institutions should not receive special or preferential treatment. Naturally, as I said in my second statement, our regulatory requirements must take into account the special characteristics of the numerous and varying organizations to which the securities laws apply. Our reasons for granting an exemption from Section 10(c) of the Investment Company Act to the First National City Bank are set forth in our opinion, a copy of which I placed in the record. In general we felt that the Commingled Investment Account of the First National City Bank was not the type of investment company affiliate of a bank to which Section 10(c) was directed, since accounts of this type were unknown in 1940. Furthermore, a prohibition on the account having as a majority of its directors persons affiliated with the bank would have created difficulties for the bank under the rulings of the bank regulatory authorities with respect to the matter and we felt that it was sufficient under all the circumstances to have 40 percent of the directors unaffiliated with the bank. Section 10 of the Investment Company Act contains various provisions designed for various types of investment companies concerning the affiliations of directors. For example, a majority of the board may be affiliated with the investment adviser but a majority may not be affiliated with the principal underwriter and certain no-load funds, subject to Section 10(d), need have only one unaffiliated director. Thus the Act itself contemplates some variations in this matter.

2. In its application to the Commission, the First National City Bank stated that it would charge a management fee of 1/2 of 1% of the average net asset value of the account. Why did not the Commission take this opportunity – an opportunity to set a precedent for all bank sponsored mutual funds – to object to 1/2 of 1% and insist upon a fee consistent with the SEC's standard of reasonableness?

We have never taken the position that an investment advisory fee of 1/2 of 1% of the average net assets of the investment company would never meet the standard of reasonableness. In fact, the great majority of investment companies are charged a fee in the neighborhood of this amound and we do not believe that all such fees are unreasonable. One of our primary concerns in connection with this standard of reasonableness is that economies of scale have not been adequately shared with stockholders as the funds grew. We, consequently, do not object to small funds just starting our in business being charged a fee of 1/2 of 1% provided that, as they grow, suitable adjustments are made. First National City Bank was starting on that basis.

All of this is, of course, apart from the question whether under the circumstances which prevailed it would be appropriate to condition an exemption otherwise proper upon compliance with legislation not yet enacted.

3. On page 14 and 15 of your testimony you stated your belief that the additional competition created by the entry of banks and insurance companies into the mutual fund industry will not exert a downward pressure on either management fees or sales loads. As the basis for your opinion you relied on past experience and what you call "perverse competition". Since banks, in particular, will be offering no load mutual funds plans, can it be said that this type of competition will be perverse? Furthermore, is not Congress being asked to act inconsistently when, on the one hand, it is asked to admit additional competitors into an industry and, on the other hand, asked to legislate with respect to management fees and sales loads as if this additional competition were not going to exist? At the very least, with the potential growth of the mutual fund industry resulting from the entry of banks and insurance companies, would it not be wiser to adopt a wait and see attitude rather than to over-legislate at this time?

With respect to the first part of this question, my comments with respect to "perverse" competition were addressed to the sales load not to the management fee. My point was that those funds which charge sales loads, and whose shares are sold by salesmen, will not be led to lower their loads by the entry of banks or insurance companies; rather, this additional competition will lead them to bid even more aggressively for the services and favor of salesmen thus tending to create an upward pressure on the loads.

The considerations with respect to management fees are rather different. It is not a matter of "perverse" competition either raising or lowering the management fee. The problem is that for each individual fund its management fees are fixed without either

competition or arm's length bargaining and are, in effect, determined by the management company. The entry of additional organizations into the field is not likely to have any effect upon this situation since it will not change the situation prevailing in any individual fund. Competition between funds has little impact on management fees because this aspect of the matter is not stressed in sales presentations and because, although the amounts involved are very large in the aggregate, the amount directly paid by the average individual small investor is not large enough to particularly attract his attention, especially if he is, as if often the case, somewhat unsophisticated.

As to the second part of your question, Congress is being asked to admit only one limited type of competitor into the industry, the bank administered commingled fund for managing agency accounts. Other types of competitors are, as they always have been, free to enter without legislation. We do not feel that the needs of investors for fair treatment in the area of sales loads and management fees should be neglected in the hope that the problem will somehow go away as a result of competition, which for 28 years has not appeared or provided benefits for fund shareholders. Our experience demonstrates that such a hope is illusory.

4. You have supported legislation which would authorize the SEC to study the economic impact of institutional investors on the market. At the same time, you do not oppose the entry of the banks, huge institutional investors, into the market before the basic problems have been studied. How do you accommodate these two positions?

As is pointed out in the answer to the previous question, the only proposed legislation permitting additional entry into the market relates to commingled managing agency accounts sponsored by banks. These would not, at present nor in the immediate foreseeable future, be significant compared with the other vehicles by which the banks are already in the market, such as pension and profit sharing trusts, common trust funds, and personal and testamentary trust. Consequently, this legislation would not admit banks into the markets for the first time. They are already there, and thus I believe there is no necessary inconsistency between this legislation and the proposed study of institutional investment. I also emphasize that the Commission did not propose the amendments that would admit banks and it neither supports nor opposes such amendments.

5. I understand from your previous testimony that bank salesmen would not be subject to the same rules as to training and supervision which apply to salesmen of mutual funds. Do you feel that this would be in the public interest from the standpoint of protecting the investor?

As I pointed out in my testimony, banks are excluded from the definition of broker and dealer in the Securities Exchange Act, with the result that the provisions of that Act with respect to qualifications, training and supervision of sales personnel do not apply to bank employees and so far as I know these provisions have no counterpart in bank regulation. I asked that Congress give consideration to requiring appropriate

standards of training and qualification for bank personnel engaged in selling participations in commingled managing agency accounts (if banks are permitted to enter this field), commingled funds for H.R. 10 plans and perhaps other types of equity investment. I suggested that this might be done not necessarily by subjecting banks to broker-dealer registration but could be achieved by appropriate amendments to the banking laws. The initial steps in considering such a possibility would presumably be to obtain the views of the federal bank regulatory agencies, to ascertain whether they would have the power to impose such requirements under their existing authority and presumably to make some inquiry into the methods used by banks in selling participations of the type referred to.

6. In answer to questions I asked you the last time you appeared before this Subcommittee, you did not have any economic data to support a statutory ceiling on sales charges. What steps have you taken to obtain such basic economic data since our last meeting in support of your recommendations to the Congress?

My answers to your questions were inaccurate if they suggested that we have no economic data to support a statutory ceiling on mutual fund sales charges.

The Commission's December 2, 1966 Report on Public Policy Implications of Investment Company Growth ("Report") did present data, at page 208, showing that between 1950 and 1966 the principal underwriters of nearly half the large funds increased the sales loads which are applicable to over 90% of lump sum purchases; that none reduced the basic sales loads; and that about two-thirds of the underwriters increased dealer discounts in many cases by proportionately more than the increase in the basic sales load. The perverse competition which results in consumers paying these sales load levels results from dealers being prohibited by Section 22(d) from competing for customers by charging lower prices for shares of a mutual fund.

Other economic data in the Report, at page 210, demonstrated that in the exchange markets, only minimum charges are fixed and these are in the neighborhood of 1% on most transactions. Economic data in the Report showed that if $1,120 (the amount invested in the median lump sum mutual fund purchase) were invested in a listed closed-end investment company, the exchange commission would be 1.8%. The exchange commissions on both purchase and sale would be 3.5% -- less than two-fifths of the typical mutual fund sales charge.

The Report, at pages 211-212, also demonstrated that in the over-the-counter markets, where price fixing is illegal, the sales charges investors pay for purchases plus sales also are typically about two-fifths of what lump sum investors in mutual funds pay. And this substantial disparity exists despite the following statement at page 56 of the August 22, 1966, Over-The-Counter Markets Study prepared for the NASD by Booz, Allen & Hamilton, Inc.:

> "The partners of numerous local firms in the five
> cities visited during the course of this

> study***pointed out that their salesmen had to work much harder to sell over-the-counter stocks than mutual fund shares***."

Further, the Commission's Report presented data, at page 203, which shows that existing shareholders' reinvestment of capital gains and their investment of income dividends in fund shares have usually accounted for from almost half to two-thirds of the sums paid out to those who redeem their fund holdings. Thus, based on the last few years' experience, a statutory ceiling would have to result in more than a two-thirds decline in new sales for it to cause the fund industry to go into a net redemption status.

Whether the 5% statutory ceiling we have recommended would cause sales volume to change and if it does, whether there would be a decline or increase, is an unanswered question. (You may recall that, in testifying in response to your questions, I expressed the opinion that lower sales load charges may cause sales to increase. The reason why the answer to that question remains a matter of opinion and the reasons why, since my appearance before the Subcommittee in October 1967, we have not taken steps to obtain additional economic data to discover the impact on sales of the proposed 5% ceiling are one and the same. It is simply this. The mutual fund industry has never operated under retail price competition. Under Section 22(d) perverse competition for dealers' and salesmen's favor in the sale of load fund shares has prevented cost-lowering price competition. In view of this, and the absence of any other action lowering basic sales load levels, we do not know -- nor has the industry suggested -- what economic data is available from which one might validly predict the impact of the 5% ceiling on sales.

As to data on the possible impact of reduced sales loads on sellers of mutual fund shares, see the Commission's response to Senator Wallace F. Bennett's Question 7, at pages 102-104 of the Hearings Before the Committee on Banking and Currency on S. 1659. See also, at pages 604-607 of the Hearings, the response of Professor Henry C. Wallich to Questions by Representative G. Robert Watkins and the tables produced by the Commission staff which he cites. Professor Wallich, a member of the Council of Economic Advisers during the administration of President Eisenhower, concluded:

> "1) There is no evidence that even the smallest firms cannot survive a cut in the sales load from 9.3 to 5 percent, particularly at a time of expanding securities markets, even though some of these firms may have difficulties. 2) The cost of mutual fund buyers of keeping these firms in business, one the unlikely assumption that otherwise they would mostly go out of business, exceeds the total income of these firms by a multiple of about four. It exceeds the loss that these firms would suffer from the drop in the sales charge by a multiple of almost 17. I can see no justification, either social or economic, for such a policy."

7. With respect to the six sections of Mr. Moss' Bill, H.R. 14742, he has indicated that there is no present agreement between the industry and the SEC. Do you have any suggested alternatives for our Subcommittee to consider?

I understand that the six sections to which you refer relate to (i) a reasonableness test for management fees, (ii) the proposed 5% ceiling on sales charges for lump sum purchases of fund shares, (iii) elimination of the front-end load, (iv) a requirement that transfers of management not be on terms unfair to fund shareholders, (v) substitution of a "breach of fiduciary duty" standard for the "gross abuse of trust" standard in Section 36, and (vi) establishment of rule making authority respecting sales loads on reinvestment of dividends.

Both prior to and since the hearings, the Commission has taken every opportunity to invite industry representative and other interested persons to discuss alternatives to these and other provisions of the Bill. Discussions have been going on, even recently.

Alternatives to the first three proposals mentioned above are discussed in a Memorandum on Principal Recommendations in the Commission's Report, a copy of which appears in the record of the Hearings, at pages 93-95. The Commission carefully evaluated those alternatives and concluded that, while there is much to commend some of these alternatives, our legislative recommendations on balance represent the best solutions. Of course, the Congress may reasonably come to different conclusions after fully considering those alternatives.

In addition to the alternative suggestions discussed in the aforementioned memorandum, another should be mentioned. This relates to the proposed prohibition of breaches of fiduciary duty. The principal concern of the industry appeared to be that the Commission might, by interpretation, extend this beyond instances of misconduct. This was not the Commission's intention and it was our hope that this difficulty could be resolved by appropriate language in the legislative history. I believe that this alternative is available to the Congress as a means of resolving this difficulty.

The Commission knows of no other alternatives it is prepared to suggest to the Congress.

8. Can you advise me as to the extent to which management compensation and sales commissions are regulated by Federal agencies insofar as such competitors of investment companies as bank trust departments, pension trusts, insurance companies, savings and loan associations, and similar financial institutions are concerned?

While the Congress has enacted legislation, in the Investment Company Act of 1940, on the subjects of investment company management compensation and mutual fund sales loads, it has not legislated in respect of such charges by bank trust departments, pension trusts, insurance companies and savings and loan associations. Indeed, Congress has passed legislation exempting from Federal regulation the insurance

business, the only one of the above-mentioned enterprises which imposes sales charges as an entrance fee for its services.

As you know, the management compensation of bank trust departments is subject to state legislative regulation and judicial supervision, and the Congress has not determined that their management compensation ought to be Federally regulated.

Nor are we aware of any demonstration that pension trusts are charged unreasonable management fees. In fact, the Commission's Report presented data showing that bank fee schedules for pension and profit-sharing plans provide greater economies of scale for far smaller sums of managed money than exist in the mutual fund industry. As the Report noted, at pages 114-118, the annual advisory fee charged by banks for a $100 million portfolio was 0.06% or 0.07% of total asset value, and even lower fee rates could be negotiated for portfolios the size of some of the large mutual funds. The lower management fees charged pension trusts by banks are in large measure due to the fact that banks engage in price competition for pension trust accounts among themselves and with life insurance companies. Unlike mutual fund managers, they do not effectively control the selection of the portfolio manager and the fee it is to receive.

Savings and loans can be viewed as charging a management fee -- after allowing for overhead and administrative expenses (other than managerial compensation) and for reserve requirements, the difference between interest rates obtained on money loaned and the rates paid to savers. Except for the limits on the amount of interest they can pay to savers imposed by the Home Loan Bank Board, savings and loan management fees are not regulated by the Federal Government. However, <u>mutual</u> savings and loans do not have external management. As employees, their managers are subject to conventional limitations which obtain as to salaries. <u>Stock</u> savings and loans differ from externally managed mutual funds in two important respects. The first is that the stockholders of such a savings and loan make a substantial capital investment in the enterprise, which supplies a margin of safety to the savers. The shareholders of a mutual fund management company make no such capital contribution to the fund. The other significant difference between the two situations is that competitive price pressures for saver favor are far more intense in the savings and loan field than they are in the investment company area. Since those who place their funds in savings and loan pay no sales charges, and since they can withdraw their funds without ever incurring a liability for capital gains taxes, they are free to move their money to other savings media where interest rates are more favorable. In the mutual fund case, on the other hand, the sales load, which can never be recovered, and the capital gains taxes, which often have to be paid, discourage investors from transferring their assets to lower cost companies.

9. What will be the effect on the free enterprise system generally, for Congress to establish the principle of Federal regulation of management compensation and sales commissions for non-public utilities, if it enacts into law the SEC's proposals respecting such regulations in the investment companies field?

I think that all agree that private saving and private investment are at the heart of the free enterprise system. Hence legislation that protects savers and investors from overreaching is bound to strengthen that system by enhancing confidence in it and by encouraging productive investment.

As your question suggests, a free enterprise system is one in which economic activity is regulated for the most part by free prices set in free markets rather than by governmental fiat. This, however, is a general rule to which exceptions have traditionally been made in cases where because of special circumstances the market mechanism leads, if left alone, to inequitable results. The public utility field to which you refer is one such exception. But it is by no means the only one. For example, the business of lending money is not generally regarded as a public utility. Yet because there is a class of necessitous borrowers who are not as a general rule able to bargain on an equal footing with lenders, all states have usury laws. Similarly, a man who runs an employment agency is not operating a public utility. Yet his charges are regulated in many states because his strategic position is deemed to enable him to take undue advantage of those who are desperately searching for jobs. At the Federal level, producers of basic agricultural commodities have for more than a generation been aided by various types of governmental price support programs. Then, too, Federal law has since 1938 prescribed minimum wage and maximum hours for most areas of the economy. And, as your next question recognizes, quite apart from legislation, Anglo-American courts have long recognized that legal intervention is sometimes needed in order to restrain corporate managers from rewarding themselves with undue generosity at the expense of the shareholders whose money they manage.

Opinions differ as to the wisdom of some of these departures from total laissez faire. But, most believers in free enterprise would, I think, agree that there are special cases in which the law ought to try in a limited way to redress the grosser disparities in bargaining power and that the steps taken in that direction over the years have actually strengthened our basic institutions of private property and private enterprise.

The investment company field presents, I submit, one of those special cases. This is so because of the two unique characteristics of that field, both of which stem from existing law. The first such characteristic is a system of external management found nowhere else in the American economy that makes for far higher levels of managerial compensation than would prevail under the normal corporate model. The other is a system of resale price maintenance backed up by the full power and authority of Federal law, indeed by a Federal criminal statute. Experience shows that each of these institutions imposes unnecessarily high costs on the millions of Americans who invest in American enterprise through investment companies and who indeed in legal theory own those companies.

Under the status quo in the investment company world the law permits artificially high costs to investment company shareholders and confers artificially generous benefits on investment company promoters and managers. To call this “free enterprise” strikes

me as possibly a misnomer. (As you may know, one witness before the Senate Committee on Banking and Currency said that it is more like "Socialism for the rich.")

It follows that:

(a) Thoroughgoing adherence to classic free enterprise doctrine would require that we scrap the external management system and the resale price maintenance provisions of the Investment Company Act so that: (i) the compensation of investment company managers would be subject to the same limitations (legal and conventional) that apply to other types of managerial compensation; and (ii) the sales charges paid by purchasers of investment company securities would find their own level in the marketplace just as most other types of sales charges do. (As you know, the investment company industry is even more opposed to this free enterprise solution to the problems created by existing law than it is to the far more moderate steps that the Commission has proposed.)

(b) Because H.R. 14742 seeks to cope with so peculiar a situation, a situation created in such large measure by earlier Federal legislation, it could not possibly become a valid precedent for Governmental interference with free market forces.

10. In connection with the above question, it is my understanding that every officer and director of every corporation, whether it is an investment company or not, has fiduciary responsibility and must meet fiduciary standards of conduct. Why is it not adequate for investor protection to rely upon existing laws plus the additional safeguard of the Investment Company Act of 1940, such as the requirement of 40% unaffiliated directors and the SEC's authority under Section 36 to regulate management compensation and sales commissions?

Mutual fund advisory contracts, like arrangements for executive compensation generally, are classic examples of self-dealing transactions. If, like ordinary corporations, mutual funds were managed by their own officers, their shareholders would have the protection of the independent business judgment of the directors who can look to the guidelines set by competitive forces in the market for executive talent which is reflected in executive compensation patterns of other companies of like size and kind.

But the structure of mutual funds is unique and its managers are not compensated like managers of ordinary commercial corporations. They are compensated by management fees, which pay not only for executive salaries but for all or most of the management services required by a fund in its normal operations. In the mutual fund industry the only guidelines generally available to directors have been the traditional management fee rate of .50 percent of net assets, a fee rate established when the industry was only a fraction of its present size. Despite the substantial economics of size that have accompanied the tremendous growth of mutual funds in recent years, directors have been powerless to obtain a substantial departure from the traditional .50 management fee rate.

The industry, while persisting in its argument that directors exercise an effective control over management fee rates, has cited only one instance where a director has been instrumental in securing reductions of management fees and we know of no others in almost three decades of experience since enactment of the Investment Company Act in 1940.

Recent reductions in management fee rates, which largely reflect the result of court litigation and the threat of such litigation, have not been substantial. This has been so because the courts have been precluded by existing law from effectively enforcing traditional fiduciary standards. The courts have held that because of the requirements of the Investment Company Act for approval of advisory contracts by shareholders and unaffiliated directors, the courts cannot inquire into the fairness of such fees unless they are so excessive as to constitute "waste" of the fund's assets. Proof of waste, as we have pointed out, requires not only a showing that fees are excessive, but that they are "excessively excessive". Thus, the Act's requirements for approval of advisory fees by unaffiliated directors, which the Congress intended as a protection to shareholders, have actually insulated the fees from judicial scrutiny.

Absent express recognition of a standard of reasonableness governing mutual fund management fees, the means provided in the existing provisions of the Act for the enforcement of fiduciary duties are unclear and inappropriate. Under Section 36 of the Act, the Commission has power to seek injunctions preventing investment advisers and other persons affiliated with an investment company from continuing to serve the company if they are "guilty" of "gross misconduct" or "gross abuse of trust." But regardless of whether Section 36 can fairly be construed to affect current levels of advisory fee rates, the very harshness of the sanction impairs its usefulness as a means for enforcing fiduciary obligations in the management fee area. The failure of a mutual fund adviser to share the economies of size with the fund it serves does not suggest that it has otherwise failed to discharge its obligations faithfully. Pending consideration by the Congress of more appropriate means for achieving reasonableness in mutual fund management compensation, the Commission has been reluctant to ask the courts to stigmatize advisers with findings that they are "guilty" of "gross abuse of trust" solely for this reason. If investors are to receive fair treatment with respect to management charges, the "few elementary safeguards" that Congress has provided for the small investment company industry of 1940 must now be supplemented by a readily enforceable standard of reasonableness with respect to management compensation.

Although Congress in 1940 provided for approval of underwriting contracts by the unaffiliated directors of mutual funds, it believed that competition among the underwriters for various funds would take care of the problem of sales loads. In fact, however, sales loads have increased as the result of a process of "perverse" competition. This perverse competition, fostered by existing provisions of the Act, seriously inhibits retail price competition in the sale of mutual fund shares. Given the insulation from meaningful price competition provided by the provisions of existing law, which the industry strenuously seeks to preserve, I submit that only legal restraints on sales load charges such as contained in H.R. 14742 can protect investors against overreaching.

11. Since a mutual fund management agreement terminates automatically upon assignment, and must be approved annually by the independent and unaffiliated directors or by the shareholders, and since the present proxy rules insure that the shareholders are advised of every detail of management compensation, and since these same shareholders must elect directors every year, it is not clear to me why the SEC feels it must substitute its judgment for that of the shareholders who own a mutual fund and the directors they elect annually on such internal matters as management compensation and sales commissions. I have studied your testimony and I cannot reconcile the SEC's proposal with the basic principles of corporate democracy. Can you explain this to me in some detail?

Contrary to the suggestion contained in the question, I believe there is nothing in the Bill that would permit the Commission to "substitute its judgment for that of the shareholders." Under the statutory standard of reasonableness only the courts, not the Commission, would determine whether fees are unreasonable. A court could act only if it were convinced by a preponderance of the evidence that a particular advisory contract calls for the payment of unreasonable fees.

About three decades of experience under the Investment Company Act make clear that shareholder voting cannot be an effective control over advisory fee rates in the mutual fund industry. This is hardly surprising. It is well accepted that in the absence of organized opposition most shareholders either do not return their proxies or mark them in favor of management. In the case of mutual funds the possibility of organized opposition is particularly unrealistic. Advisers do not compete for advisory contracts with each other by organizing proxy contests and the possibility of a shareholder initiated contest is particularly remote in the context of mutual funds where no one shareholder or group of shareholders has a significantly large interest in the fund.

Shareholder acquiescence in the prevailing level of management fees reflects the fact that they have little alternative but to accept management's proposal. If shareholders should by any chance vote down an investment advisory contract proposed by management, they would leave the fund without any management and jeopardize their investment. Under these conditions shareholder democracy is not a realistic substitute for the effective enforcement of fiduciary obligations provided by a statutory standard of reasonableness.

Similarly, while directors are elected by shareholders, they are invariably persons who have been selected by the fund's adviser. When a person is nominated by management to serve as a director, all parties look forward to a harmonious relationship. It is not unreasonable to understand that a director accepts the position on this assumption. Should an unaffiliated director vigorously propose to reduce the prevailing level of advisory fees, the harmony of the board would in all probability be disrupted. Thus, there are powerful forces which tend to prevent unaffiliated directors from taking effective steps in this area. Indeed, some unaffiliated directors do not consider bargaining with respect to management fees to be a part of their function.

This completes our responses to your questions.

Sincerely,

Manuel F. Cohen
Chairman