July 9, 1969

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION ON H.R. 11995 AND S. 2224 TO THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, HOUSE OF REPRESENTATIVES

This memorandum, written in response to a request by the Committee, sets forth the Commission's views on H. R. 11995 and S. 2224, which embody the pending mutual fund legislation. S. 2224 was favorably reported by the Senate Committee on Banking and Currency with no opposition and was passed by the Senate by unanimous voice vote on May 26, 1969.

Of course, your Committee is fully aware of the history of these efforts to achieve meaningful mutual fund legislation - which led to passage by the Senate of S. 3724 in July 1968, and of S. 2224 on May 26, 1969. As Senator Sparkman pointed out during the floor debate last year, this has certainly been one of the most carefully studied pieces of legislation to come before the Congress in recent years.

This effort began more than a decade ago, in 1958, with the engagement of the Wharton School by the Commission to produce a study of the mutual fund industry. Their report was issued in 1962.1/

Subsequently, the Special Study of Securities Markets examined mutual fund sales practices, especially the sale of contractual

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1/ H. Rep. No. 2274, 87th Cong., 2d Sess. (1962).

plans, and in 1963 that Study was forwarded to the Congress.[2] Among other things, that Study found the operation of contractual plans inimical to the interests of small investors and it recommended abolition of "front-end-load" arrangements in the sale of fund shares, that is deduction of up to one half of the first year's payments for sales charges. The Special Study led to significant amendments to the Securities Exchange Act of 1934,[3] but the legislation passed did not deal with the mutual fund industry; that was left for further study and examination by the Commission. Finally, in 1966, the Commission produced a comprehensive report--"Public Policy Implications of Investment Company Growth,"[4] which made legislative recommendations designed to cope with the serious problems which had developed in the fund industry since 1940 and to deal with a large number of "technical" points which had arisen over the years.

The Commission's recommendations included: the abolition of the front-end-load; the reduction of fund sales charges to a maximum of 5% with the Commission empowered to increase such maximum under appropriate circumstances, as, for example, for small sales, instead of the currently prevailing 9.3%; and the establishment of a court enforced standard of reasonableness for fund

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2/ H. Doc. No. 95, 88th Cong., 1st Sess. (6 vols.) (1963).

3/ Public Law No. 467, 88th Cong., 2d Sess. (1964).

4/ H. Rep. No. 2337, 89th Cong., 2d Sess. (1966).

management fees.

There followed the extensive consideration of these proposals by this Committee and also by the Senate Committee, referred to above. Following this, in July, 1968, the Senate passed S. 3724, which represented an effort to accomplish the major objectives of the Commission while, at the same time, meeting certain of the objections which the investment company industry had to the Commission's proposals.

Earlier in this session, Senator Sparkman introduced S. 34, which was the same as S. 3724 in the prior session, and hearings on this legislation were held in the Senate in April. In connection with these hearings, it was suggested that the Commission and the investment company industry make a further effort to arrive at an understanding with respect to these problems and, as pointed out below, this was done and S. 2224 embodies these understandings. On June 10, 1969, Chairman Moss of your Committee's Subcommittee on Commerce and Finance introduced H.R. 11995, which is identical to S. 2224.

In this memorandum we will not attempt a section-by-section analysis of these bills, since the Senate Committee in its report has already done this.[1/] The important thing is that with respect to the principal areas of controversy between the Commission and the investment company industry, the front-end load, the sales charges and the management fees, the legislation now before you is generally

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1/ S. Rep. No. 91-184, 91st Cong. 1st Sess. (1969).

acceptable both to the Commission and to the Investment Company Institute.

Front-end Loads

First, the bill as reported by the Senate Committee and as passed by the Senate, would not abolish the front-end load. Instead, two alternative methods for employing the front-end load are provided. Under the first alternative, contractual plans may still be sold with the presently authorized front-end load, under which up to 50% of the first year's payments may be deducted for sales commissions, provided that if the investor elects for any reason to redeem his underlying shares for cash during the first three years he would also be entitled to receive a refund of the amount by which all sales charges paid exceed 15% of the total payments made under the plan. The Commission would be authorized to make rules and regulations specifying the form of refund notice required under this alternative and setting forth reserve requirements so that sellers may meet their refund obligations.

In addition, contractual plan sellers could at their option elect a second alternative. Under this alternative, the bills specify a formula whereby the load could not exceed 20% of any payment nor average more than 16% over the first four years.

Sales Loads

The Commission's proposals would have limited the sales load for investment company shares to five per cent of the amount received and invested by the investment company, subject to authority in the Commission to grant exemptions from this provision. Section 12(a) of H.R. 11995 and S. 2224 would replace this provision with a grant of jurisdiction to the National Association of Securities Dealers, Inc., to adopt rules designed to prevent "excessive sales loads" but allowing for reasonable compensation for sales personnel, broker-dealers, and underwriters and for reasonable sales loads to be charged to investors. The Commission would be authorized, after the expiration of 18 months from the enactment of the bill, to alter or supplement such rules of the NASD in the manner provided in Section 15A(k)(2) of the Securities Exchange Act and would also be granted authority, comparable to that of the NASD, with respect to sales loads charged by dealers who are not members of that Association, but such nonmember dealers would have an election to be governed either by the Commission's rules or by the NASD's rules.

Management Fees

The third major area in which the Commission made recommendations was that of management fees. The Commission had recommended that the Investment Company Act should be changed to specify that management fees should be reasonable and to provide for court enforcement of this standard. S. 3724, passed by the Senate in July 1968, substantially adopted that recommendation with certain additional changes designed to meet some of the objections of the industry. S. 34, precursor to the present bill, contained the same provisions. However, the industry continued to oppose the form of the management fee amendments, although no one objected to the basic proposition that management fees should be reasonable.

The Commission had consulted with industry representatives from time to time and had repeatedly expressed its willingness to attempt to work out provisions in this area which would be acceptable to the industry as well as the Commission. Following the April 1969 Senate hearings, the Commission and industry representatives resumed their discussions of this matter and in May 1969 agreed on and jointly submitted to the Senate Banking Committee, a provision in substitution of the reasonableness standard which would specify that the investment adviser has a fiduciary duty with respect to management fee compensation. This is in accord with the Commission's recommendation that the present effective standard of "waste" under state law, and gross abuse of trust under Section 36 of the Act as applied to management fees, be replaced with a more meaningful standard.

The Senate Banking Committee and the Senate adopted the management fee proposal in substantially the language proposed by the Commission and the industry representatives. We understand that the industry representatives do not oppose the adoption of these provisions.

Thus, H. R. 11995 and S. 2224 add a new Section 36(b) to the Investment Company Act to specify that the adviser has a fiduciary duty with respect to compensation for services or other payments paid by the fund or its shareholders to the adviser or to affiliated persons of the adviser. Other persons enumerated in Section 36(a) who may have a similar fiduciary duty with respect to compensation or payments received by them from the fund or its shareholders may also be sued for a breach of such duty. Subsection (b) also provides that payments by the fund to affiliated persons of the adviser are subject to challenge under this section. Approval of the management fee by the directors, and shareholder ratification is to be given such consideration as the court deems appropriate in the circumstances of a particular case.

The adoption of this standard precludes the assertion of a claim of ratification, although a vote of shareholders or directors approving a management contract may be considered by the court in determining the fairness of the contract. The difficult waste test previously prevailing under state law in cases of ratification, and gross abuse of trust under present Section 36 of the Act, have thus been replaced by the more realistic standard, breach of fiduciary duty. The Commission views this as a significant and meaningful improvement over the existing law and at least as helpful as the reasonableness standard of S. 34.

The Commission therefore supports these provisions as a satisfactory and even more effective method than its original proposal to test the reasonableness of mutual fund management fees.

Bank-Administered Funds and Group Variable Annuities

H. R. 11995 and S. 2224 contain provisions to deal with certain questions as to the status under the Federal securities laws, and certain other laws, of bank administered, collective managing agency accounts and bank-administered pension and welfare plans, including H. R. 10 plans. Whether banks should be allowed to enter the field of collective managing agency accounts, which resemble mutual funds, is a matter of national policy within the primary jurisdiction of the Congress. The Commission does not consider that its responsibility extends to this question and it neither expresses nor implies any views thereon.

With respect to group variable annuities administered by insurance companies, we recognize and understand the reasons which led the insurance industry to advance these proposals. Basically, they seek exemptions comparable to those afforded to banks, both under the existing provisions of the Investment Company Act and under the proposals relating to bank-administered funds contained in H. R. 11995 and S. 2224. There are, however, differences, both in method of operation and in existing regulation, between banks and the insurance companies, and at the last session of Congress, the Commission expressed a preference for dealing with the problems of the insurance industry, including its competitive problem, administratively. As we then mentioned, we have been conducting extensive discussions with representatives of the insurance industry in an effort to arrive at a satisfactory solution, and on March 6, 1969 the Commission published for comment a proposed set of rules which would deal with the status of group variable annuities under the Investment Company Act and under the Securities Act. Problems under the Securities Exchange Act have been largely resolved by administrative action. We recognize, of course, that the insurance industry would prefer the broader exemptions contained in S. 2224, particularly if the banks are to expressly receive comparable legislative exemptions.

Other Matters

The bills contain over 40 other amendments, some "technical" others of substantive significance. Thus, the "gross abuse of trust" language of present Section 36 is replaced in Section 36(a) by "breach of fiduciary duty involving personal misconduct."

Three of the "technical" amendments were introduced in the Senate subsequent to the Senate Committee Report. These amendments, involving changes in Sections 22(c), 8(b)(2), 13(a)(3) and 24 of the Investment Company Act, were recommended jointly by the Commission and the Investment Company Institute and are explained in the appendices attached to this memorandum.

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In summary, we believe the controversy over the proper way to test investment company management fees has been satisfactorily resolved consistent with investor protection. With respect to sales loads and the front end load, the Commission believes that the proposals which it advanced at the last session of Congress would more effectively ensure fair treatment to investment company shareholders. On the other hand, enactment of H. R. 11995 and S. 2224 would constitute an important reform. Consequently if your Committee prefers to accept H. R. 11995 and S. 2224 we would accept that decision and support the bill.

APPENDIX A

H.R. 11995 and S. 2224, Section 12(b)

TECHNICAL STATEMENT IN SUPPORT OF A PROPOSED AMENDMENT TO SECTION 22(c) OF THE INVESTMENT COMPANY ACT OF 1940 CLARIFYING THE COMMISSION'S AUTHORITY TO REGULATE THE PRICING OF INVESTMENT COMPANY SHARES FOR THE PURPOSE OF SALE, REPURCHASE, AND REDEMPTION

Section 22(a) of the Investment Company Act authorizes a securities association registered under Section 15A of the Securities Exchange Act of 1934 (i.e., the National Association of Securities Dealers, Inc. ["NASD"]), to make rules respecting the method for pricing of mutual fund shares for sales, redemptions, and repurchases for the purposes of "eliminating or reducing so far as reasonably practical any dilution of the value of such purchase, redemption, or sale which is unfair to holders of such other outstanding securities . . . ."

Section 22(c) of the Act authorizes the Commission to make rules and regulations, applicable to both members and nonmembers of the NASD, covering the same subject matter and for the accomplishment of the same ends prescribed in Section 22(a). Section 22(c) further provides that any rules and regulations made by the Commission supersede any NASD rules made on the same subject matter.1/

1/ Rule 22c-1, adopted October 16, 1968, effective January 13, 1969, superseded NASD Rules 26(e) and 26(h).

Section 22(c) provides that the Commission's rules shall be applicable to "principle underwriters of and dealers in, the redeemable securities of any registered investment company . . . ." The section does not specifically state that such rules shall be applicable to the registered investment company. Because of this wording, it has been suggested that the Commission's rule-making power with respect to pricing of mutual fund shares does not extend to the registered investment company itself.[1/]

The Commission believes that the rule-making power given in Section 22(c), together with the general rule-making power given in Section 38(a), clearly extends to registered investment companies. Indeed, to interpret the section otherwise would allow mutual funds to fix the times as of when net asset value of their shares are to be computed in circumvention of the Commission's regulation of underwriters' and dealers' time of pricing of the same shares. For example, in some cases Commission rules would apply to the timing of the calculation of net asset value of shares for <u>sale</u> and <u>repurchase</u> by dealers and underwriters, and a different time might be used for calculation of net asset value for <u>redemptions</u> of shares of the same

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1/ In most cases sales and repurchases are handled through a dealer and underwriter, but redemptions are normally handled directly by the fund. Also, many no-load funds sell and redeem shares without using a separate underwriter or dealer.

company,[2] subverting one of the main purposes of the section.[3]

Argument on this question would be obviated if the Act were more explicit. Therefore, the Commission recommends that Section 22(c) be amended to insert the phrase "to registered investment companies and" after the phrase "the Commission may make such rules and regulations applicable" in the Section.

2/ Many mutual funds designate underwriters and dealers around the country as their agents for "voluntary repurchase" of their shares. This enables shareholders to shorten the period otherwise required to transmit the actual stock certificates to the fund for statutory "redemption."

3/ Section 1(b) of the Act requires the Commission to interpret the Act to mitigate and, so far as is feasible, to eliminate the conditions enumerated in the section which adversely affect the national public interest and the interest of investors. Section 1(b)(5) of the Act states that the national public interest and the interest of investors are adversely affected when <u>investment companies</u> in computing the asset value of their securities, employ unsound or misleading methods.

APPENDIX B

H.R. 11995 and S. 2224, Sections 3(c) and 3(d)

TECHNICAL STATEMENT IN SUPPORT OF PROPOSED AMENDMENTS TO SECTIONS 8(b)(2) AND 13(a)(3) OF THE INVESTMENT COMPANY ACT OF 1940 CLARIFYING WHICH INVESTMENT POLICIES MAY NOT BE DEVIATED FROM WITHOUT PRIOR SHAREHOLDER APPROVAL

Section 8(b)(1) of the Investment Company Act of 1940 ("Act") requires that every registered investment company, in its registration statement filed under the Act, specifically recite its policy with respect to certain investment and other enumerated activities. Section 8(b)(2) requires a recital in the registration statement of policies "in respect of matters, not enumerated in paragraph (1), which the registrant deems matters of fundamental policy and elects to treat as such."

Section 13 prohibits a registered investment company from deviating from the policies enumerated in Section 8(b)(1) or from any policy which it has elected to treat as "fundamental" pursuant to Section 8(b)(2) without prior shareholder approval.

The Commission believes that "fundamental", as therein used, is simply a term which describes any investment policy which an investment company elects to make changeable only if authorized by shareholder vote, whether or not an investment company <u>labels</u> such a policy "fundamental".

However, it has been argued that Section 13 is not violated when an investment company changes an investment policy without a required prior shareholder approval, unless that policy has been labeled "fundamental". In other words, it was argued that requiring prior shareholder approval for a change in investment policy does not make it "fundamental".

In Green v. Brown, 276 F. Supp. 753 (1967), the District court accepted this so-called "plain meaning" approach despite its "curious result". In a Brief, filed Amicus Curiae with the Court of Appeals, the Commission took the position that the term "fundamental" was simply a term which describes any investment policy which an investment company elects to make changeable only if authorized by shareholder vote. That Court, in Green v. Brown, 398 F. 2d 1006 (C.A. 2, 1968) remanded the case to the District Court with instructions to reconsider the matter with the benefit of the Commission's Brief.

Therefore, while the Commission believes that it has the authority to effect a clarification by rule,1/ to obviate further misunderstanding, it recommends that Sections 8 and 13, be amended to make it clear that deviation from an investment policy which is changeable only by shareholder vote constitutes a violation of Section 13. The amendment would also allow investment companies the opportunity to afford shareholders similar protection from deviation with respect to any other policy. Thus the amended sections would read as follows:

1/ In Investment Company Act Release No. 5565 (Securities Act Release No. 4939) the Commission proposed revisions of its instructions to Form N-8B-1 (and Form N-5) to effect this clarification.

"Sec. 8.

(b). Every registered investment company shall file with the Commission, within such reasonable time after registration as the Commission shall fix by rules and regulations, an original and such copies of a registration statement, in such form and containing such of the following information and documents as the Commission shall by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors:

* * *

(2) [a recital of the policy of the registrant in respect of matters, not enumerated in paragraph (1), which the registrant deems matters of fundamental policy and elects to treat as such;] <u>a recital of all investment policies of the registrant, not enumerated in paragraph (1), which are changeable only if authorized by shareholder vote;</u>

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<u>(3) a recital of all policies of the registrant, not enumerated in Paragraphs (1) and (2), in respect of matters which the registrant deems matters of fundamental policy;</u>

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[(3)] <u>(4)</u>

(Present Paragraph (4) renumbered (4)).

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[(4)] <u>(5)</u>

(Present Paragraph (4) renumbered (5)).

Sec. 13.

(a) No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities --

* * *

(3) deviate from its policy in respect of concentration of investment in any particular industry or group of industries as recited in its registration statement, [or deviate from any fundamental policy recited in its registration statement pursuant to Section 8(b)(2); or] deviate from any investment policy which is changeable only if authorized by shareholder vote, or deviate from any policy recited in its registration statement pursuant to Section 8(b)(3);

APPENDIX C

H. R. 11995 and S. 2224, Section 13(b)

Technical Statement in Support of Proposed Amendment to Section 24 of the Investment Company Act of 1940 to Add a new Subsection (f) to Permit Retro-active Registration of Investment Company Securities.

Occasionally, due to inadvertance, a registered investment company making a continuous offering of its securities, sells more shares than are covered by its registration statement under the Securities Act of 1933. Although the number of shares sold in excess of those registered are not registered under the Act, in practical effect no investor is harmed if each offeree or purchaser is given a current prospectus. However, the inadvertance may result in a violation of Section 5 of the Securities Act and any person who can show that his shares were not actually registered might be entitled to the rescission rights given by Section 12 of the Securities Act.

This suggested Section would permit the Commission to adopt rules allowing retroactive registration of securities sold in excess of the number of securities included in an effective registration statement upon payment of three times the normal registration fee for such shares. The Section also permits the Commission additional flexibility, if it so desires, to adopt rules to permit certain types of investment companies to register an indefinite number of shares.

The text of the proposed amendment follows:

Section 24 of the Investment Company Act of 1940 is Amended by adding a new Subsection (f) to read as follows:

"(f) In the case of securities issued by a face-amount certificate company or redeemable securities issued by an open-end management company or unit investment trust, which are sold in an amount in excess of the number of securities included in an effective registration statement of any such company, such company may, in accordance with such rules and regulations as the Commission shall adopt as it deems necessary or appropriate in the public interest or for the protection of investors, elect to have the registration of such securities deemed effective as of the time of their sale, upon payment to the Commission, within six months after any such sale, of a registration fee of three times the amount of the fee which would have otherwise been applicable to such securities. Upon any such election and payment, the registration statement of such company shall be considered to have been in effect with respect to such shares. The Commission may also adopt rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors to permit the registration of an indefinite number of the securities issued by a face-amount certificate company or redeemable securities issued by an open-end management company or unit investment trust."