November 5, 1969

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION ON H. R. 12867 TO THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, HOUSE OF REPRESENTATIVES

This memorandum, prepared in response to a request by the Committee, sets forth the Commission's views on H.R. 12867, introduced by Congressman W. S. ("Bill") Stuckey in the House of Representatives on July 15, 1969, to amend the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933 and the Securities Exchange Act of 1934. To summarize the conclusions of the detailed discussion which follows, the Commission strongly opposes the adoption of this bill since it would in many important respects be contrary to the Commission's major legislative **recommendations for improving investor protection and in some cases, would significantly reduce present standards of investor protection, under the Investment Company Act.**

The Commission's recommendations were the result of a long series of studies of the investment company industry culminating in the Commission's 1966 Report to Congress on the Public Policy Implications of Investment Company Growth in 1966.[1/] On May 26, 1969, the Senate passed S. 2224 and sent it to the House of Representatives. In addition to the adverse consequences mentioned above, H. R. 12867 in effect, eliminates the progress which resulted from the negotiations between representatives of the Commission and the investment company industry, which were undertaken at the suggestion of the chairmen and members of the Congressional committees concerned with this legislation. The agreement between the Commission and major segments of the mutual fund industry is represented by S. 2224, the bill that passed the Senate without opposition and is now before your Committee as H.R. 11995. We support H.R. 11995.[2/]

With the exception of the discussion of front-end loads which follows the section on sales loads, the discussion below generally is organized to follow the catagories of matters referred to by Mr. Stuckey in his explanatory statement of July 15, 1969 which appears at page E 5925 of the Congressional Record of that date (copy attached).

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

2/ The Commission's favorable views on S. 2224 and H.R. 11995 are set forth in its memorandum to your Committee dated July 9, 1969.

Investment Advisory Contracts

Section 8(b) of H. R. 12867 would provide that a mutual fund which has at least 50% of its board of directors made up of unaffiliated and disinterested persons and which has obtained approval of its management contract within a year by a vote of two-thirds of its outstanding shares and all of the unaffiliated and disinterested directors would be exempt from private and SEC-initiated court actions to test the reasonableness of the advisory fee.

As the Commission's studies and the Report of the Senate Banking and Currency Committee point out, and as further explained below, presently the majority of directors of most mutual funds are unaffiliated with their investment adviser.[3/] The Senate Committee in its Report on S. 2224 stated:

> "Mutual funds, with rare exception, are not operated by their own employees. Most funds are formed, sold, and managed by external organizations, that are separately owned and operated. These separate organizations are usually called investment advisers. These advisers select the funds' investments and operate their businesses. For these services they receive management or advisory fees. These fees are usually calculated at a percentage of funds' net assets and fluctuate with the value of the funds' portfolio.

3/ Senate Rep. No. 91-184, 91st Cong., 1st Sess. (1969) ("Senate Committee Report") p. 5.

> "Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy." 4/

The Investment Company Act of 1940 ("Act") presently includes a requirement that at least 40% of the fund's directors be unaffiliated with the investment adviser and that a majority of the fund's directors be unaffiliated with the fund's principal underwriter. Since the adviser and underwriter are usually the same or related entities, a majority of the directors of most funds are unaffiliated with their managers.

As stated in the Senate Committee Report:

> "These provisions did not provide any mechanism by which the fairness of management contracts could be tested in court. Under general rules of law, advisory contracts which are ratified by the shareholders, or in some States approved by a vote of the disinterested directors, may not be upset in the courts except upon a showing of 'corporate waste.' As one court put it, the fee must 'Shock the conscience of the court.' Such a rule may not be an improper one when the protections of arm's-length bargaining are present. But in the mutual fund industry where these marketplace forces are not likely to operate as effectively, your committee has decided that the standard of 'corporate waste' is unduly restrictive and recommends that it be changed." 5/

4/ Id.

5/ Id.

To solve these problems, Section 20 of S. 2224, in substantially the form passed by the Senate, was jointly submitted to the Senate Banking Committee by the Commission and the Investment Company Institute after extensive negotiations. The Section provides that the mutual fund investment adviser has a specific fiduciary duty with respect to management fee compensation. The Commission considers this section of S. 2224 to be an important and vitally needed improvement over the present provisions of the Act. Section 8(b) of H.R. 12867, on the other hand, would reject the industry-supported solution and in effect provide complete immunity for investment advisory fees if the approvals specified in that section have been obtained. This bill not only rejects the agreement reached by the Commission and the industry, it would even go so far as to negate the present common law prohibition against the adviser taking a management fee amounting to waste as well as vitiating the gross abuse of trust provision of present Sec. 36 of the Act, in so far as it relates to fees.

With respect to advisory fees based on performance, H.R. 12867 deletes the amendment in Section 24(a) of S. 2224 and H.R. 11995 to Section 203(b) of the Investment Advisers Act of 1940 requiring registration under that Act of investment advisers whose only clients are investment companies. H.R. 12867 also provides in Section 25 that incentive management fees charged to an investment company based on performance which increase and decrease proportionately will not be required to decrease below the level of no compensation or operating costs, if the parties agree.[6/]

S. 2224 and H.R. 11995 would permit a performance fee for the investment adviser if the fee increases or decreases proportionately on the basis of investment performance measured against an appropriate index of securities prices or other appropriate measure of performance. Although the Commission had originally recommended a flat prohibition on performance based fees, it later agreed to this compromise because of industry objections.[7/]

Section 25 of H. R. 12867 would permit an adviser, for example, to have a base fee set at 1/2 of 1%, if the fund's performance equaled that of a securities index, to go upwards to an unlimited amount depending upon the fund's performance, but go down only to the adviser's actual operating cost (including unrestricted salaries for the advisers top officials). Thus, while the adviser could participate to an unlimited amount in the fund's profits, if the

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6/ See additional discussion of performance fees charged non-investment company clients, p. 16 below.

7/ See Public Policy Implications of Investment Company Growth, pp. 344-345 and Senate Committee Report, p. 45-46.

See also Hearings Before the Subcommittee on Commerce and Finance of the Committee on Interstate Commerce on H.R. 9510 and H.R. 9511, October 10, 1967, 90th Cong., 1st. Sess. at pp. 86 and 92-93.

fund suffered a loss or if its performance was below the appropriate index, the adviser would lose nothing since he would be able to recover all of his expenses while paying substantial salaries to the top officials. Such a fee arrangement would not only be unfair to the fund's shareholders, it would provide a strong incentive for the adviser to gamble with the fund's portfolio on extremely speculative securities since the adviser has little to lose and everything to gain from the fund's performance.

H.R. 12867 would have another anomalous and perhaps unintended result, arising from its failure to amend Section 203(b) of the Investment Advisers Act to require registration under that Act of investment advisers whose only clients are investment companies. The effect of this would be to exempt such investment advisers from the provisions of Section 205 of that Act, as amended by H.R. 12867 to place limits on investment company performance fees. The net result would be: (1) an investment adviser whose only clients were investment companies would not be subject to the limitations on performance fees in Section 205 of the Advisers Act as amended by the bill (although still subject to the substantially weakened fiduciary standards contained in Sections 8(b) and 36(b) of H.R. 12867); but, (2) an investment adviser registered or subject to registration under the Advisers Act because of the adviser's having other non-investment company clients could not charge an investment company a performance fee unless it complied with the limitations in Section 25 of H.R. 12867.

Sales Loads

Section 8 of H. R. 12867 provides that the sales charge for the sale of mutual fund shares is conclusively presumed to be fair and equitable providing that the underwriting contract has within a year been approved by a 2/3 vote of the outstanding shares and all of the unaffiliated directors.

This provision rejects the solution reached by the Senate Committee and the Senate with the mutual fund industry and the National Association of Securities Dealers, Inc. ("NASD"), embodied in Section 12 of S. 2224, which would authorize the NASD to make rules to prohibit excessive sales loads on the sale of mutual fund shares, with Commission oversight.

In discussing the problems created by the present mutual fund sales load structure, the Senate Committee Report on S. 2224 stated:

> "The function of selling mutual fund shares is almost always contracted out by the fund to an organization called a principal underwriter. In most cases the principal underwriter is either the adviser itself or a close affiliate of the adviser's. Principal underwriters use two different distribution techniques. Some confine themselves to wholesaling and leave the actual retail selling to independent broker dealers. Others have their own retail sales organizations called captive sales forces. In both instances, the principal

underwriter regards the retail seller as the key figure in the distribution process. The principal underwriter's interest therefore, is to make the price of the shares it distributes as attractive as possible to dealers and salesmen. Since the underwriter is either the same person or organization as the investment adviser this underwriting function-which is the supplying to selling dealers of sales materials and the shares offered-may be performed at cost or even at a loss. The real financial return to the underwriter or the affiliated investment adviser in these instances is the management fee which increases automatically as the fund grows in size.

"The basic sales commission charged for mutual fund shares is in most instances about 8 1/2 percent of the total payment or 9.3 percent of the amount invested. This charge is protected by section 22(d) of the Investment Company Act which provides for a unique scheme of retail price maintenance. Under this section, all dealers, regardless of the source of the shares they sell, are prohibited by law from cutting the sales charge fixed by a mutual fund underwriter. Price cutting in this field is a Federal crime." 8/

When the Act was originally passed in 1940 and as presently written it does not require that underwriting contracts be submitted for shareholders vote. Congress recognized that a mutual fund shareholder, after he buys the security, has little further interest in the distributor or distribution contract. In this situation, it is the function of the directors of the fund, and not the shareholders, to select the person to distribute its securities and to determine what the compensation should be. H. R. 12867 overlooks this

8/ Senate Committee Report, p. 7-8.

distinction, by making the approval of present shareholders, a group of persons who have already paid a sales load and therefore generally have no further interest in it, except to the extent that they might wish to buy additional shares, binding on a much larger group of prospective purchasers.

H.R. 12867 would not only permit a general increase in the sales loads of mutual fund shares but also give sellers complete immunity to charge any rate no matter how excessive or unreasonable. Indeed in cases where the requisite shareholders' and directors' approval were obtained it would even remove the present inadequate protection given by Section 22(b) of the Act, which permits the NASD and the Commission to make rules to prohibit "unconscionable or grossly excessive" sales loads. As the Commission's Report and the testimony before Congress have demonstrated, present competition is perverse in that it affects mutual fund sales loads by driving the loads up to gain the favor of dealers rather than driving them down to gain the favor of investors.

Front-end Loads

The Commission had originally recommended abolition of the front-end load, that is, a method of deducting sales commissions by which up to one-half of the investor's first year's payments is taken for such commissions.

As the Senate Report succinctly states:

> "It is of course obvious that such an arrangement is usually detrimental to the investor, particularly if for any reason he discontinues his payments at an early date. Unless the stock market rises rapidly, he is almost certain to lose money." 9/

However, S. 2224 and H. R. 11995 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

9/ Senate Report p. 9.

payment nor average more than 16% over the first four years.

We are aware that contractual plan sponsors oppose certain provisions of S. 2224 and H.R. 11995, particularly the three-year refund provision, and we have been discussing the matter with them to see if it is possible to arrive at modifications which would be acceptable both to the sponsors and to the Commission. We think it likely that this can be done. We would not, however, be prepared to go so far as H.R. 12867 in reducing protections to investors in contractual plans, and it is our belief that the contractual plan sponsors themselves would not insist on such extensive reductions from the investor protections provided in S. 2224 and H.R. 11995.

Restrictions on Commission Officers and Employees

Section 2 of H.R. 12867 would expand the definition of "interested person" of an investment company, its investment adviser and principal underwriter contained in S. 2224 to include any person who had been an employee of the Commission during the last two fiscal years of the investment company. The effect of this provision, among other things, might be to prevent a former Commission employee from becoming a director of an investment company, depending upon how many other directors were interested persons. This result is due to the fact that Section 10 of the Act as amended by both S. 2224 and H.R. 12867 would provide that (1) no registered investment company could have a board of directors more than 60 percent of whose members are interested persons of such company and (2) if any officer, director, or employee of the investment company acts as, or is an interested person of, its principal underwriter or regular broker, a majority of the board must consist of persons other than those who are interested persons of such principal underwriter or regular broker.[10/] Moreover, Section 20 of the Bill would impose criminal penalties on SEC personnel who, within two years after termination of their employment, acted as agent or attorney in any capacity in a matter involving any party subject to jurisdiction of the Commission while they were employed by the Commission.[11/]

Assuming that these provisions were not designed primarily to penalize persons who have worked for the Commission, the bill would appear to be intended to prohibit conflicts of interest between former Commission personnel and mutual funds. The bill, however, does not accomplish a great deal other than penalizing persons for working at the Commission. This is the case because the function of provisions limiting the number of interested persons on an investment company board of directors is to supply an individual check on management and to provide a means for the protection of shareholders interests in investment company affairs. Unlike other interested persons, as that term is defined in S. 2224 (e.g., persons having beneficial interests in the investment adviser or principal underwriter), whose conflict of interest positions arise from their relationship to management or to benefits which they may receive

10/ See Senate Committee Report, pp. 32-34.

11/ This provision as presently written prohibits such conduct if it occurrs "within a period of two years prior to the termination of such employment" (emphasis added), but this appears to be a drafting error.

from business dealings with the company or its management, there would appear to be no conflict of interest between former SEC personnel and mutual funds that would adversely affect mutual funds or their shareholders.

Other kinds of possible conflicts of interest, those which might affect a Commission employee's performance of his official duties while he is employed by the Commission, are adequately covered by the federal conflict-of-interest statutes and the Commission's rules of conduct.

Suits Against Mutual Funds And Other Matters Affecting Companies Under The Jurisdiction Of The Commission.

Section 20(b)(7) of H.R. 12867 would also impose federal criminal penalties on any person who knowingly acts as attorney or agent in connection with any judicial, administrative or other proceeding or matter involving any party subject to the jurisdiction of the Commission, if he acts "without justifiable cause." As far as we could determine, there is no parallel provision in any other regulatory statute.

This provision is apparently designed to protect mutual fund managements from unjustifiable harassing litigation. Leaving open the questions of whether the provision would be consistent with the protections of free speech and the right to counsel contained in the First and Sixth Amendments to the Constitution, and whether present judicial procedure does not adequately prevent unjustifiable litigation, Section 20 is written so broadly that it could have startling and drastic effects. For example: (1) no attorney, even one defending a party in an administrative proceding before the Commission could do so without fear of arrest and imprisonment if he failed in his defense, because he could then be accused of acting "without justifiable cause;" and (2) no attorney or accountant could write a letter to the Commission staff asking for an interpretation of the federal securities laws or participate in the preparation or filing of an application for relief from a provision of the federal securities laws without fear that if his request for a favorable interpretation or application for relief were denied he could be fined and imprisoned for acting "without justifiable cause."

In any event, with respect to harassing litigation against mutual fund managements, we believe that any disadvantages of allowing shareholders full access to the courts are far outweighed by the protections such access gives against abuses which might otherwise find no remedy. Moreover, if any restrictions are needed in addition to those provided by the Federal Rules of Civil Procedure and similar State rules against unfounded shareholder suits, we believe that the adverse effects of the approach taken in this bill greatly exceed any possible benefits it might give the public. 12/

12/ See letter dated April 22, 1969 to Senator John Sparkman from Commissioner Hugh F. Owens setting forth the Commission's position on the advantages of shareholder derivative litigation. Senate Banking and Currency Committee Hearings on S. 34 and S. 296, 91st Cong., 1st Sess. (1969) at p. 30.

Investment Advisers Act

Section 25 of H.R. 12867 would provide that Section 205 of the Investment Advisers Act of 1940 would not be applicable to advisory agreements between non-United States clients and registered United States investment advisers, and that registered United States investment advisers would not be prohibited from having incentive contracts including performance fees with unregistered investment companies. We believe that the provisions in the Investment Advisers Act concerning investment advisory contracts and fees between registered investment advisers and their clients should not be altered so that any group of clients would be adversely affected and lose the protection of that Act.

Investor confidence in the activities of registered investment advisers is enhanced by the belief among investors that these advisers are prohibited from engaging in activities harmful to the interest of their clients and from overreaching in setting their advisory fees. If foreign investors are to be encouraged to seek the advice of United States registered investment advisers, the confidence which is engendered by the present regulatory system should be retained. However, we would not oppose a modification of S. 2224 to allow registered investment advisers to charge foreign unregistered investment companies a performance fee subject to the same limitations as those imposed on fees charged registered investment companies.

Oil and Gas Funds

H.R. 12867 would continue the present exemption from the Act for any investment company all of whose business is holding oil, gas, or other mineral royalties or leases. Section 3(b)(5) of S. 2224 and H.R. 11995 would amend Section 3(c)(11) to delete the exclusion for oil and gas investment companies when these companies issue redeemable securities, periodic payment plan certificates, or face-amount certificates of the installment type. As explained at pages 328 and 329 of the Commission's Report on the Public Policy Implications of Investment Company Growth, when the Act was originally written, certain companies in the factoring, discounting and real estate businesses, as well as companies holding oil, gas, or other mineral royalties or leases were excluded from the definition of "investment company", although it was clear that were it not for these exclusions, they would have been subject ot the registration and other regulatory provisions of the Act. When the Act was written, interests in oil, gas, and other mineral royalties and leases were generally sold in relatively large amounts to affluent, sophisticated investors.

The growth in number and dollar amount of offerings of interests in oil and gas programs registered with the Commission in recent years has been remarkable. Thus, in 1964 there were only 31 offerings aggregating $78,000,000, but in 1968 there were 90 filings aggregating $694,000,000 and in the first 6 months of 1969 there have been 69 offerings aggregating $649,500,000, which is an annual rate exceeding one billion dollars.

Not all of these issuers would be affected by the deleted amendment, since oil and gas funds in which the investor makes only a single payment and does not receive a security redeemable at his option would still be excluded from the definition of investment company in the Act. However, a substantial proportion of these oil and gas funds would be subject to the Act. Many of them market their securities in the same manner as mutual funds and their shares are sold to relatively unsophisticated investors. Thus more than 64% of dollar amount in securities of oil and gas fund registered in the first six months of the calendar year have been offered in programs allowing for minimum investments of less than $10,000.

For example, one of these funds sells a $1,300 investment program in which the investor can make a down payment of as little as $150 with 21 subsequent monthly payments of $50. The prospectuses and sales literature of many of these funds are modeled on conventional mutual funds. Indeed, at a mutual fund convention in Washington several years ago, one of these oil and gas funds maintained a booth from which it distributed sales literature to mutual fund salesmen and to others.

We realize that applying the provisions of the Investment Company Act might raise substantial problems for this industry. However, the provisions of S. 2224 and H. R. 11995 postpone the effective date of the section dealing with oil and gas funds to 18 months from the date of enactment. As indicated in the Senate consideration of S. 2224, during that period the Commission is to work together with the oil and gas fund industry to devise a regulatory scheme to fit the unique characteristics of that industry through the use of the Commission's exemptive powers. The Commission staff has already had several meetings with representatives of this industry in an effort to work out an equitable arrangement for regulation that would protect and safeguard the investors, and would not impose an unreasonable burden on the industry.

In this connection, representatives of the industry have suggested a further amendment to the section, embodied in S. 2224 and H.R. 11995 as Section 3(b)(5). This amendment would continue the present complete exclusion for oil and gas companies if their investment contracts (1) require the participants to pay $10,000 or more during every consecutive 12 months, (2) do not afford the participants any cash surrender or redemption rights, and (3) provide that there be no front-end load or other disproportionate charges. The Commission supports these modifications rather than the complete deletion of the amendment provided by H.R. 12867.

Administrative Procedure Act

Sections 12(a) and 20 of H.R. 12867 among other things specify that the Administrative Procedure Act "(APA") would be applicable to certain Commission activities. Thus, under Section 12(a) of the bill (page 26, lines 24 and 25) in a Commission rulemaking proceeding to limit excessive sales loads on mutual fund shares, pursuant to Section 22(b) of the Act, the proceeding would have to be conducted "in accordance with the Administrative Procedure Act (5 U.S.C. 553, 556)".[13/] However, Commission rule-making is presently subject to the APA, so no specific reference to the APA in the bill is necessary.

Section 20 of the Bill (page 44, lines 10-14) would also provide that before the Commission instituted court proceedings to enjoin a breach of fiduciary duty involving personal misconduct, the Commission shall have afforded "the defendant a fair opportunity to comply in accordance with the Administrative Procedure Act (5 U.S.C. 558)."

While this provision is by no means clear it would seem to have the effect of removing protection from investors rather than increasing them. In a situation in which the Commission had enough evidence of abuse of trust involving personal misconduct to request a court to enjoin such conduct, the Commission might first be required to hold an administrative hearing, thus giving the prospective defendants an opportunity to continue such activities unabated during the pendancy of the hearing.[14/]

13/ We assume that any rules adopted under this section of the bill would not apply where management obtained shareholder approval and the other approvals specified in Section 8 of the bill (page 19, lines 5-13; see pages 8-10 above).

14/ Section 558(c)(1) and (2) of the APA require that the agency give the licensee notice and an opportunity to comply with all lawful requirements in connection with a proposed "withdrawal, suspension, revocation or annulment of a license." No such proceeding would be involved in an action to enjoin a breach of fiduciary duty under Section 36(a) of the Investment Company Act as amended by Section 20 of H.R. 12867. However, for purposes of this discussion we assume that the intent of H.R. 12867 is to require such notice and opportunity for compliance as a prerequisite to all Section 36(a) injunctive cases. Nevertheless, presumably the Commission could rely on the exception contained in Section 558 of the APA which allows the institution of proceedings without prior notice or opportunity for compliance "in cases of willfulness or those in which public health, interest or safety requires otherwise."

We are in full accord with the principle that before any person is deprived of a license, e.g.,an effective registration as a broker-dealer under the Exchange Act or as an investment adviser under the Advisers Act, he should be afforded all the protections given by the Administrative Procedure Act and the Commission Rules of Practice. On the other hand, an entirely different though sometimes parallel procedure is appropriate when it appears necessary for the protection of investors that activities detrimental to investors and in violation of the federal securities laws be stopped by court injunction, as presently specifically provided in Section 214 of the Investment Advisers Act and Section 27 of the Exchange Act. Of course, all of the procedural safeguards applicable to court proceedings are available even in those cases for the protection of defendants.

Other Matters

H.R. 12867 contains a number of other modifications of S. 2224 and H.R. 11995. These modifications would remove needed investor protection, add needless procedural complications or unnecessarily limit Commission discretion.

We will not discuss all of these modifications in detail, since all of them are summarized in the comparative table attached to this memorandum together with summaries of the matters discussed above.

However, three examples of these changes are:

(1) H.R. 12867 deletes Section 3(b)(3) of S. 2224 and H.R. 11995 which would subject to the provisions of the Investment Company Act certain factoring, discounting and real estate companies which issue redeemable securities (see discussion of similar provision respecting oil and gas funds at pp. 17-19 above).

(2) Section 2(3) of H.R. 12867 appears to require the Commission to hold a hearing in each case in which the Commission determines any person is an interested person, whether the affected person wants it or not, rather than "notice and opportunity for hearing" as presently required by Section 40 of the Investment Company Act.

(3) Section 4(b) of H.R. 12867 authorizes the Commission to bar persons guilty of specified types of misconduct from acting in certain capacities for an investment company "for such period of time as is reasonable under the circumstances" rather than "either permanently or for such period of time as it in its discretion shall deem appropriate in the public interest," as provided by Section 4(b) of S. 2224 and H.R. 11995. We do not believe that Section 4(b) of H.R. 12867 enunciates a substantive standard any different from the equivalent provision of S. 2224 and H.R. 11995, but the difference in language would tend to set the stage for needless arguments on the matter.

Conclusion

As the foregoing makes clear, H.R. 12867 would in fact cut back the protections now offered by the Investment Company Act of 1940 and the Investment Advisers Act of 1940. The voluminous record already adduced before your Committee, as well as the Commission's own studies and reports fully support the proposition that present regulation must be augmented, at least to the extent contemplated by S. 2224 and H.R. 11995. H.R. 12867 is not only inadequate in this regard, but seriously erodes present protections.

In our opinion, the enactment of H.R. 12867 would represent a substantial setback for fund shareholders which might have the effect of undermining vital shareholder confidence in the mutual fund industry--without which the industry could not long survive in its present state. The proposed bill, in effect, eliminates the progress, negotiation and agreement represented by S. 2224 and H.R. 11995, the bill that passed the Senate without opposition and is now pending before your Committee. The major industry groups have supported the Senate passed bill and, as we have previously informed your committee, the Commission supports that bill because, despite the revision of our original recommendations, S. 2224-H.R. 11995 still represents a major improvement in existing mutual fund regulation in meeting the needs of investors in the critical areas of concern indicated by the Commission's study

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of the fund industry.

There is no reason to substitute for S. 2224 and H.R. 11995, the products of such long negotiation, having the support of major industry groups and the Commission, and having passed the Senate, a bill which so substantially lessens key elements of mutual fund shareholder protection.

AMENDMENT OF INVESTMENT COMPANY ACT

HON. W. S. (BILL) STUCKEY

OF GEORGIA

IN THE HOUSE OF REPRESENTATIVES

Tuesday, July 15, 1969

Mr. STUCKEY. Mr. Speaker, on May 26 the Senate passed S. 2224, a bill proposing to amend the Investment Company Act of 1940 in many significant ways. As I indicated in remarks when I introduced H.R. 8980 on March 13, 1969, many of the features of this bill will update the mutual fund laws and will provide more investor protection without interfering with the right of shareholders and directors to manage their mutual funds. However, some of the provisions of that bill are so far reaching in their consequences, that I thought it important to introduce my own bill in the House as a basis for discussion when this legislation comes before the committee of which I am a member.

The legislative process invites compromise and accommodation and we seek to resolve conflicting views in order to promote a broader public purpose and serve the common good. Now that I have studied S. 2224 in comparison to my own bill, I believe it will further advance the legislative process to revise my bill to include as much as possible of the bill passed by the Senate and introduced in the House by our committee chairman, JOHN MOSS, as H.R. 11995. The revised bill I am introducing today differs from the Senate bill in these important areas.

First, mutual funds which have at least 50 percent of the board of directors made up of unaffiliated and disinterested persons and which obtain approval of their management or distribution contracts by a two-thirds vote of outstanding shares and all of the unaffiliated directors within 1 year will be exempt from having the SEC and the NASD review management compensation and sales commissions if such approval is not obtained, these agreements will be subject to SEC review. Second, former SEC personnel along with lawyers and accountants will be included among a new category of "interested persons" barred from affiliation with mutual funds for a reasonable period of time. Third, incentive management fees based on performance and which increase and decrease proportionately will be encouraged, but will not be required to decrease below the level of no compensation or actual operating costs, if the parties agree. Fourth, the Investment Advisers Act of 1940 will not be applicable to advisers' agreements between non-U.S. entities and U.S. investment advisers registered under the act. Fifth, U.S. investment advisers will not be prohibited from having incentive contracts including performance fees with unregistered companies. Sixth, penalties will be imposed on those who bring lawsuits against mutual funds without justifiable cause. Seventh, former SEC personnel will be prohibited for 2 years from suing mutual funds. Eighth, the existing exemption from the 1940 act—but not the 1933 and 1934 acts—for oil exploration funds will be continued. These funds are completely regulated under Federal securities laws, and I see no reason to try and treat them as mutual funds when they are not. Ninth, I have tried to treat front-end-load contractual plans a little more equitably. They must compete with insurance policies where salesmen get from 65 to 120 percent front-end load and sell with no prospectus.

There are other minor differences in my bill, most of which involve a requirement that the SEC conform to the Administrative Procedure Act in its administrative activities, and that its actions be reasonable. The SEC now is permitted to exercise its discretion without the checks and balances required by due process under the Federal Constitution. I am hopeful that Members of Congress will review my revised bill with care, as I believe it is important we bring the controversy surrounding this legislation to a close. High interest rates, uncertainties in our fiscal and monetary policy, and unsettled conditions in Vietnam are rapidly eroding investor confidence as reflected in the sharp decline in securities prices in recent weeks. Far-reaching policy changes in antitrust law enforcement have added to investor unrest, and have caused share declines in the prices of securities of conglomerates. Actions of the Securities and Exchange Commission and the New York Stock Exchange respecting minimum rates, customer-directed commission sharing, access of nonmembers to the exchange markets, and reciprocal business arrangements, are all taking their toll of investor confidence. I urge my colleagues to be thoughtful and to be reasonable and above all to remember that securities salesmen are entitled to earn a fair living in these times of inflation along with everyone else. My bill will preserve their income at approximately the present level with an added opportunity for increased earnings. The Senate bill in its present form will, in my opinion, cut the income of mutual fund salesmen by approximately 50 percent. I think any such action by Congress at this time would be highly discriminatory and inconsistent with our ideas of equal protection under the law. I do not believe it is the function of the SEC or minority shareholders to second-guess majority shareholders or directors of companies as to the value of management compensation or the level of sales commissions. Competition in the mutual fund industry fixes the price of these services at a level considered reasonable by the buyers and sellers involved. My bill will protect this principle of corporate democracy and at the same time protect the right of investors to make their own decision as to the value of the services for which they pay.