PLEASE STAMP AND RETURN TO 150

MAR 7 1972

Mr. Roger S. B. Hartz
Tuscany Apartments, E-2
Baltimore, MD 21210

Dear Mr. Hartz:

Chairman Casey has asked me to answer your letter of February 2, 1972. Your letter suggests that regulation of mutual funds and their managers would help to revive and insure the integrity of the stock markets.

The Securities and Exchange Commission has responsibility for the administration of the Investment Company Act of 1940, the basic federal statute which regulates investment companies. As you well know, any investment in securities involves possible risk of loss to the investor and regulation of investment companies under the Investment Company Act in no way protects the investor against this risk. The Securities Act of 1933, under which securities issued by all registered investment companies must be registered, also requires disclosure of much of the basic information on which the merits of particular securities and the risks inherent in their purchase may be realistically appraised, but the ultimate decision rests with the investor.

Your letter expresses concern over certain actions by fund managers; particularly that they may receive a portion of the broker's commission as compensation. In the area of regulation of management, certain provisions of the Investment Company Act are designed to minimize possible adverse effects on public investors where "insiders", however innocently, act in conflict of interest situations. This is accomplished, in part, by limiting persons who possibly may have conflicting interests to specified percentages of the board of directors of an investment company. For example, Section 10(a) of the Investment Company Act prohibits a registered investment company from having a board of directors more than 60 percent of the members of which are persons who are "interested persons" (as that term is defined in Section 2(a)(19)) of the registered company. Further, it is unlawful for any registered investment company having a board of directors to perform, as well as enter into or renew, any contract whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract and any renewal thereof have been approved by the vote of a majority of directors who are not parties to the contract or interested persons of such party ("disinterested directors"), cast in person at a meeting called for the purpose of voting on such approval.

Moreover, the Commission has taken administrative action in an effort to reduce the number of situations in which conflict of interests may occur. In the matter of Consumer-

Investor Planning Corporation, (Securities Exchange Act Release No. 8542, February 20, 1969), the Commission found that it was unlawful for the manager of the Associated Fund Trust, a registered investment company, to use its fiduciary position in relation to the Fund to cause monetary and other benefits to inure to itself without regard to what was best for the Fund. In that case, the Commission also found that Section 17(e) of the Investment Company Act prohibits an affiliate of an investment company, while acting as agent from accepting compensation in the form of brokerage commissions from brokers who execute fund portfolio transactions solely in consideration for the direction of fund business.

The federal courts have also issued decisions bearing on the duty of fund managers with regard to the placing of fund brokerage. In Moses v. Burgin the U.S. Court of Appeals for the First Circuit held that where a fund could recapture a portion of fund brokerage, the directors of the fund could not choose to allow that amount to be paid to brokers in an effort to stimulate sales of fund shares.

More recently on February 2, 1972, the Commission, in its statement regarding the future structure of the securities markets, expressed its concern about the widespread practice of investment company managers using portfolio brokerage of mutual funds to reward broker-dealers from sales of fund shares. In this regard, the Commission has sent a letter to the National Association of Securities Dealers requesting that Organization to direct its members to discontinue the use of reciprocal brokerage for the sale of investment company shares. If such a response is not forthcoming, the Commission will then consider rulemaking to accomplish the desired result.

The Commission for some time has been very concerned about the level of fees and other charges imposed by investment advisers which manage several funds, which are commonly referred to as fund complexes. In its 1966 Report to Congress on the Public Policy Implications of Investment Company Growth, the Commission concluded that investment advisers to mutual funds have usually not reduced advisory fees to any great extent as funds grow in size, even though it is generally more economical proportionately to manage larger sums of money.

As a result of the Commission's recommendations of 1966 Congress passed the Investment Company Amendments Act of 1970 (P.L. 91-547) ("1970 Act"), on December 14, 1970. Among other things, the 1970 Act adds a new provision to the Investment Company Act of 1940 which specifies that an investment adviser for a mutual fund has a fiduciary duty with respect to the compensation and other material payments it receives from a fund under its management or from the fund's shareholders. This amendment also authorizes the Commission and shareholders to sue for recovery of excessive compensation from any one who breaches such fiduciary duty. In connection with fund complexes, that, is, several funds having the same adviser, the legislative history makes it clear that the court may take into consideration the services rendered by the investment adviser to other funds in the complex and compensation or payments made by such funds for such services.

This new provision does not become effective until June 14, 1972. Of course, until and after that date the directors of a mutual fund will continue to have the initial responsibility for approving investment advisory contracts and management fee arrangements. To assist the directors in discharging their duties, the 1970 Act amends the Investment Company Act to specify that the investment adviser must furnish the directors information reasonably necessary to evaluate the management contract and fee. The amendment also codifies the duty of the directors to evaluate such information in accordance with the best interests of the fund and its shareholders.

Your letter also suggests that the S.E.C. inspect each fund periodically and prohibit short selling by a fund manager. Section 31(b) of the Investment Company Act authorizes the Commission to make periodic and special examinations of registered investment companies and the Commission staff, pursuant to this authority, has conducted an investigation and inspection program. In the past budget limitations have prevented us from being as active in this area as we would like to be, but we have requested more funds from Congress for this purpose and we hope that we will get them.

With regard to short selling by investment companies, Section 12(a) of the Investment Company Act permits such companies to effect short sales except in contravention of rules and regulations of the Commission. To date, no such rules have been adopted. However, the Commission requires that any fund which has a policy permitting short selling fully disclose such policy and its effects in the prospectus. We have also required that while a short position is open, the proceeds of any short sale must remain in hands other than those of the investment company effecting the sale. In order to prevent a short sale by an open-end company from involving the creation of a senior security by providing leverage, in violation of Section 18 of the Act, the selling company must put in a segregated account with a bank an amount of cash or government securities equal to the difference between (a) the market value of the securities sold short and (b) any cash or government securities required to be deposited as collateral with the broker in connection with the short sale (not including the proceeds from the short sale).

We hope this letter has answered your questions on the operation and regulation of investment companies. If you have any further questions, please let me know.

Sincerely yours,

Alan Rosenblat
Chief Counsel

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February 24, 1972