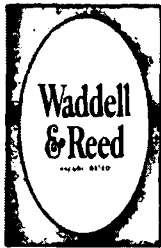


FINANCIAL SERVICES

ONE CROWN CENTER P.O. BOX 1343 KANSAS CITY, MISSOURI 64141

RODNEY O. McWHINNEY
Senior Vice President
Secretary
and General Counsel
816-283-4054

August 2, 1983

Richard Breeden, Esquire
Task Group on Regulation
of Financial Services
Department of the Treasury
15th Street & Pennsylvania Ave., N.W.
Washington, D. C. 20220

Subject: Amendments to Investment Company Act of 1940

Dear Mr. Breeden:

We are writing in furtherance of the recommendations of the Investment Company Insitute ("ICI") for changes to the Investment Company Act of 1940 (the "Act") as stated in its letter to you of July 11, 1983.

Waddell & Reed, Inc., a member of the ICI, is the investment adviser and principal underwriter for the United Group of Mutual Funds. This Group consists of ten separate registered investment companies with combined assets in excess of $3 billion, representing the investments of over 400,000 shareholders.

The ICI has stated excellent reasons in support of its recommendations and we will not repeat all of them here. Instead we will focus on the role of the independent directors and the need for key Sections of the Act to be amended to allow these directors to exercise their responsibilities free from regulatory impediments and second-guessing by the courts. We believe that the independent directors are best suited to understand the business requirements of the mutual fund and its manager (the investment adviser and its affiliates) and to judge whether new developments and innovations advanced by the manager are in the interests of the mutual fund and its shareholders. The limitations placed on the exercise of the directors' responsibilities by the Securities and Exchange Commission's ("SEC") rules, interpretations and procedural requirements and the uncertainties arising out of strike suits have inhibited and at times completely stifled the development of new financial products and services and distorted the ability of the mutual fund industry to compete equally in the growing financial services industry.

continued . . .

AUG 8 REC'D

The reforms recommended by the ICI would not only create a better environment for innovation and development but would also result in more effective oversight by directors who are directly and immediately charged with responsibility for assuring that mutual funds are managed and operated in the best interests of the mutual fund and its public shareholders.

In 1970, after several years of review, Congress enacted the Investment Company Amendments Act of 1970, the first substantive review and reform of the Act since its adoption in 1940. A major thrust of the 1970 legislation was to strengthen independent checks on investment company management by amendments designed to assure that control and ultimate responsibility for the affairs of the investment company were vested in a board of truly independent directors (or trustees). Underlying the 1970 legislation was the fundamental premise that a board of independent directors were in the best position to be informed of and to evaluate the relationships of the mutual fund with its investment manager, underwriter and sponsor and to take actions that would be in the best interests of the fund and its shareholders. Sections 36(b), 12(b) and 17(d) of the Act have been applied or interpreted so as to materially restrict or even ignore the responsibilities of the independent directors. Developments in the past thirteen years have demonstrated that in order to clearly place responsibility with the independent directors statutory changes are needed. Adoption of new Rules and interpretations by the SEC is not enough and it is doubtful in any event that the SEC would act without clear Congressional direction and statutory authority.

Section 36(b) of the Act

This Section governs the economic relationship between a mutual fund and its investment adviser by providing:

> ". . . the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser."

This Section authorizes litigation to be brought by the SEC or by a shareholder of a mutual fund challenging the compensation paid by the mutual fund to the adviser or its affiliates. Although under Section 15 of the Act the independent directors are charged with carefully evaluating and approving the investment management agreements, Section 36(b) provides that the courts in reviewing payments made by a mutual fund can give such consideration to the approval of the independent directors

continued . . .

as the court wishes. The result has been at least thirty-seven lawsuits filed against mutual fund advisers, in effect, seeking de novo determinations by the court of the fairness of the advisory fee despite the approval by independent directors. This means that no compensatory arrangement can be relied upon until blessed by a court. This uncertainty surrounding any compensatory arrangements for services furnished to a mutual fund has pointed entreprenurial capital toward other financial services and products where the risks are judged by the marketplace, not by the uncertainties and vagrancies of litigation. The ICI in its letter points to commodity pools and insurance products as such alternatives. Waddell & Reed, Inc., which has sponsored and distributed many such pooled investment and insurance products since 1970, could serve as the archetype of the ICI's reference.

The ICI's proposed amendment to Section 36(b) provides that the independent directors shall approve all compensatory arrangements. The amendment eliminates much of the second-guessing, yet at the same time preserves the important right of shareholders to challenge true abuse, by providing for actions contesting whether the directors in fact did exercise reasonable business judgment but not whether the court agrees with these judgments. Proposed Section 36(b) recognizes that the independent directors are in the best position to make determinations, as is their duty in Section 15 of the Act, and then provides that, if the directors do discharge their duty, their judgments are not subject to second-guessing.

Section 12(b) of the Act

This Section of the Act, as implemented by the SEC's Rule 12b-1, concerns mutual funds bearing expenses for distribution of their shares. Historically, a mutual fund could not compensate or reimburse its manager or underwriter or others for services in distributing fund shares. The cost of distribution was covered by sales commissions paid by the investor. When commissions were not sufficient, as generally has been true during the past several years, and in the case of no-load funds where the investor does not pay any commissions, distribution costs were borne by the fund's manager from whatever sources of capital or revenues it might have, normally the investment advisory fee.

Many, including Waddell & Reed, Inc., believe that it is lawful under the Act without benefit of SEC Rules for a mutual fund to pay for distribution of its shares if such payments are deemed by the fund's board of directors in the best

continued . . .

interests of the fund and its shareholders. The SEC has strongly disagreed. With the growing popularity of no-load funds, and particularly money market funds, as well as the economic realities of the marketplace pressing the need to find alternative sources to support the cost of distribution, in 1980 the SEC adopted a Rule of questionable parentage permitting a mutual fund to bear distribution expenses under a set of cumbersome and circumspect restrictions, as more fully detailed in the ICI's July 11, 1983 letter to you. Rule 12b-1 is so cumbersome and limiting that it has largely been ignored by most mutual funds other than money market funds which distribute their shares through non-affiliated brokers. Besides the Rule's elaborate requirements that go beyond those even prescribed by the Act as to any other compensation paid by a mutual fund to the investment adviser or its affiliates, the Rule fails to recognize that most mutual funds are part of a complex and that the distribution requirements are those of the complex and not necessarily those of any individual fund.

The Act is silent as to a mutual fund's bearing distribution expenses. Section 12(b) was enacted in 1940 apparently to address a very minor matter long since forgotten. The Section provides that it is unlawful for a mutual fund to distribute its shares, except through an underwriter, in contravention of such rules as the SEC might adopt. After forty years it was seized upon through some intellectual gyrations as the peg on which to regulate the very important and complex issue of the economics of mutual fund distribution. The use of Section 12(b) as the authority for the adoption of Rule 12b-1 is doubtful because the Section by its very terms does not apply to distribution through an underwriter, the practice followed by most mutual funds. However, in view of the SEC's long-standing and strong bias against the use of fund assets to support distribution, no one, including Waddell & Reed, has dared challenge the SEC's position without legislative reform. Possibly the most important step the Task Group could take is to support legislation clearly providing that the decision to use mutual fund assets to support distribution of that fund's shares and of any other fund within a complex is solely within the judgment of the independent directors. These directors, as is true in other expenditures made by a mutual fund, are in the best position to determine if such use of fund assets is in the interests of the mutual fund and its shareholders.

Mutual funds are unique because their shares are redeemable on request. Without effective distribution to replace redeemed shares a fund would quickly go out of existence. Correct judgments as to how much fund monies to spend and for

continued . . .

what programs and market strategies can mean the very survival of the mutual fund. The marketplace and the public demand for financial services are rapidly evolving and changing. The market demands often require prompt decisions and a willingness to take novel and innovative actions. However, such demands cannot be met if the freedom of the independent directors to make these decisions is proscribed and fettered by procedural rules and regulatory agency inflexibility and delay. It took the SEC eight years of public hearings and review from the time it first recognized there were serious distribution issues until it adopted Rule 12b-1 in October, 1980.

While we support the ICI's proposed revision of Section 12(b) of the Act as set forth in the appendix to its July 11, 1983 letter, we believe it is a modest step and that the Act should be amended to provide that the approval of the use of fund assets to support distribution is subject to the same requirements as approval of the underwriting agreement -- that is, approval by the independent directors unfettered by regulatory limitations and procedural waltzes. The ICI's proposal still allows for SEC rulemaking, and we believe the SEC's role should be the same as its role with respect to the investment managment and underwriting agreements and other agreements between the fund and its investment adviser, being the right to challenge the arrangements under Section 36(a) and (b) of the Act as Congress originally meant when it adopted Section 36 in 1970. This Section gives the SEC the ability not only to correct, through appropriate court action, past abuses but to enjoin any threatened act constituting a breach of fiduciary duty involving personal misconduct with respect to a mutual fund.

Section 17(d) of the Act

This Section is the basic provision of the Act addressed to conflicts of interest not expressly covered elsewhere in the Act. As such it is apt to be involved in almost any new development or creative innovation. Many of the problems included within its broad coverage involve business arrangements which by their very nature require the understanding and insights that only someone as close to the day-to-day operations of a fund as its board of directors would possess. As pointed out in the ICI's letter, while there are some mechanics under Rule 17d-1 that provide for handling certain common or repetitive situations such as joint liability insurance policies, most problems must be presented to the SEC in a formal application for an exemptive order. This at best is a slow and cumbersome process designed not to solve business problems but to satisfy the

continued . . .

staff of the SEC that the fund's participation in the proposed arrangement is consistent with statutory standards for exemption. In the case of a major innovation it may be years before a decision is reached. For example, an application with respect to whether the assets of a particular fund in a complex of funds may support distribution of the shares of other funds in the complex has been before the SEC for several years. If problems arising under Section 17(d) were placed with the independent directors, they could be resolved promptly and by those persons in the best position to reach a decision based on interests of the fund and its shareholders. Again, if there are abuses as pointed out in the ICI's letter, the SEC can correct these abuses under Section 36 of the Act.

---o---

Above we have supported proposed legislative reform to design to carry out what we believe Congress intended but did not, in hindsight, accomplish in 1970 -- to place responsibility with the independent directors for approving and monitoring basic relationships between a mutual fund and its investment adviser, underwriter or sponsor and to permit these directors to discharge their responsibilities in a manner they believe is in the best interests of the mutual fund and its shareholders, free from second-guessing and regulatory hoops and limitations. We pointed to Section 36(a) of the Act as the tool to be employed by the SEC to assure that these directors do in fact discharge the responsibilities rather than to exercise its regulatory authority through rules, exemptive orders and control over content of disclosure documents.

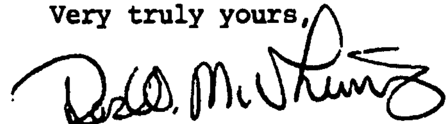
Beyond these key provisions of the Act, there are a number of provisions adopted in 1940 based on problems that existed at that time but, forty-three years later, are no longer germane. Many of these can be categorized as deadwood to be discarded when the Act is overhauled. Some, however, have become serious detriments to the functioning of mutual funds. One such provision is Section 12(d)(3) of the Act, which at least as applied by the SEC, prohibits a mutual fund from purchasing securities of an issuer who directly or indirectly through subsidiaries derives significant revenues from activities as a broker-dealer or investment adviser. The ICI in its letter points out the problems. We will not repeat them but simply observe that it is an anomaly that the industry, which advertises itself as investing in a cross-section of America's greatest corporations, by law may be barred from investing in such corporations as Sears, Roebuck & Co. and American Express.

---o---

continued . . .

In this letter we have criticized certain actions of the Securities and Exchange Commission. We do not wish to leave the impression that all of our problems are caused by the SEC; rather, we have found the SEC's actions generally to be enlightened with a real concern for the growth and vitality of the industry which it regulates. This can be seen in its response to the growth of money market funds and in its initiative in recognizing the important role played by the independent directors in many areas not discussed in this letter. However, we believe that further basic reform cannot be expected unless there is legislative guidance through adoption of the amendments recommended by the Investment Company Institute.

Very truly yours,



Rodney O. McWhinney
Senior Vice President

ROM:mh

cc: Investment Company Institute,
Attn: Mr. David Silver