Fidelity
Management & Research Company

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Richard Breeden, Esq.
Deputy Counsel
Task Group on Regulation of
Financial Services
Department of the Treasury
15th Street & Pennsylvania Avenue, N.W.
Washington, DC 20220

Dear Mr. Breeden:

We are writing to add our support to the recommendations you have received from the Investment Company Institute and others regarding amendments to Section 36(b). In our view such an amendment is a matter of the highest priority.

Regrettably we bring significant first-hand perspective to this issue. The Fidelity Group of Mutual Funds presently consists of 39 funds with $19 billion in net assets and over 1,000,000 shareholder accounts. I have been a member of the in-house legal staff of the adviser to the Fidelity Group of Mutual Funds since 1969 and was associated with their outside counsel for five years prior to that. As far as I am aware, on every single day of that period of time at least one shareholder derivative action has been pending against the adviser. Most of these cases involved challenges to the management fee, alleging that the standards of Section 36(b) or its predecessor provision had been violated.

Our difficulty with Section 36(b) is not that it is possible for suits to be commenced against an adviser, but rather that they can be maintained so readily notwithstanding the views of the disinterested directors. In addition, the current standard is so amorphous that it invites the courts to make their own determination about what the fee should be rather than relying on the established mechanics of corporate governance and the discipline of the marketplace.

Two relatively recent cases illustrate these points. The first of these is <u>Burks v. Lasker</u>, 441 U.S. 471 (1979). In that case the Supreme Court reversed a decision of the Second Circuit Court of Appeals and held that the Investment Company Act of 1940 did not, generally speaking, deprive a Board of Directors of the powers it holds under state law to determine that a proposed derivative action should not be maintained. The Court went on to state in a footnote, however, that this general proposition may not be the case for management fee cases since Section 36(b) could be read as giving shareholders an indefeasible right to maintain an action challenging management fees.

The other case of note is <u>Gartenberg v. Merrill Lynch Asset Management, Inc. et al</u>, 528 F. Supp. 1038 (S.D.N.Y. 1981), aff'd 694 F. 2d 923 (2d Cir. 1982), involving a challenge to the management fee charged to investors in Merrill's Ready Asset Trust. While the Court of Appeals affirmed the lower court's finding for the defendants, it did so on the basis of very different legal standards. The lower court essentially adopted the standard of the marketplace, concluding that where there was significant ease of entry into and widespread participation in the market and where individual investors had access to comparative data and could readily redeem shares, the standards of Section 36(b) were satisfied if a fund's fee comported with industry norms. The Court of Appeals expressly rejected the proposition that the marketplace serves as the "standard to test the fairness of the investment advisory fee. . . ," holding that a number of other factors relating specifically to the Adviser must be considered. These included such elements as costs and profits. While the Court did conclude that the plaintiffs had failed to meet their burden of proof this does not change the fact that the decision establishes variable and uncertain standards which will tend to be applied on a subjective basis by judges possessing differing levels of experience with the financial services industry.

Thus, the two major mutual fund cases which have been decided in the last five years take the position that Congress, by enacting Section 36(b), determined to substitute the judgment of the courts for both the considered judgment of disinterested directors and the disciplines of the marketplace. The plaintiffs' securities bar has taken full advantage of these judicial interpretations. The adviser to virtually every successful money market fund has been subjected to litigation irrespective of the fee or expense structure of the fund. Faced with the uncertainty created by the vagueness of the statutory standard and the concommitant time, expense and disruption of the members of senior management responsible for running the business affairs of the adviser, most of the actions have been settled. To the extent that the present structure continues, advisers faced with the almost certain prospect of fee litigation on a successful product will be tempted to establish higher fees at the outset in order to leave room for a settlement when the inevitable suit arises. Whether this happens on a widespread basis or not, however, it is fair to say that the primary beneficiary of the present system is not the fund or its shareholders but plaintiff's counsel who is almost invariably the moving force in the litigation.

We believe that the proposal of the ICI would be a distinct improvement to the current wording of Section 36(b). It would be an important step in the deregulatory process and place the emphasis for the decision where it belongs. Under the provisions of the Investment Company Act of 1940 at least 40% of those directors must be disinterested. If it were felt that a more independent exercise of business judgment would be achieved by requiring a higher percentage of disinterested directors, we would support legislation to increase that percentage to two-thirds or even three-fourths of the Board. (See Section 17(f)(1)(A) of the Act.) Under either requirement, the concept of limiting liability for monetary damages to the actual recipients of the fee should be retained.

A standard under which the ICI's approach could be implemented would be to provide that the reasonableness of the business judgment be measured in terms of commercial alternatives reasonably available to investors. That is, comparisons should be made with the costs and quality of alternative investment services available to investors, either from other investment advisers or banks. This would reflect the reality of the arrangement -- the provision of investment advisory services to individual investors. Since that is the essential service being provided it would seem that the appropriateness of the fee should be determined in that context.

The goal of the Investment Company Act is to protect the interests of investors. The 1970 amendments to that Act were written at a time when the average investor was relatively unsophisticated in financial matters, had limited access to financial news and whose purchase of mutual fund shares was the result of an individual sales call of a commissioned salesman. The pace of developments in the financial services industry over the last decade has changed that scenario. In light of these changes we believe that the protection of investors' interests can best be achieved by the economic disciplines that exist in a competitive and informed marketplace rather than by the costly, erratic and artificial process of litigation.

Very truly yours,

Richard M. Reilly
Vice President

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