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AUG 1 1958

The Honorable John A. Burns
House of Representatives
Washington 25, D. C.

My Dear Mr. Burns:

As promised in our letter to you dated July 16, 1958, we are enclosing two copies of a memorandum which we have prepared in reply to your letter of July 14, 1958, requesting our comments on the views of one of your constituents regarding management fees paid by mutual funds.

Please let us know if we can be of any further assistance to you.

Very truly yours,

John E. Loomis
Associate Director

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MEMORANDUM WITH RESPECT TO THE AMOUNT OF MANAGEMENT FEES PAID BY MUTUAL FUNDS, PREPARED BY THE DIVISION OF CORPORATE REGULATION, SECURITIES AND EXCHANGE COMMISSION, FOR REPLY TO LETTER DATED JULY 14, 1958 FROM THE HONORABLE JOHN A BURNS, DELEGATE AT LARGE, HAWAII

Mutual funds, or open-end investment companies, as well as other types of investment companies, are subject to regulation under the Investment Company Act of 1940, which this Commission administers. One of the purposes of the Congress in enacting this statute, as expressed in Section 1(b) of the Act, was to mitigate, and so far as feasible, eliminate the adverse effect on investors and the public resulting from the operation or management of investment companies in the interest of directors, officers, or investment advisers rather than in the interest of the security holders. In fulfilling this objective, however, the Congress did not give this Commission any direct authority to pass upon or regulate the compensation paid to management or the fees paid to investment advisers. The Congress instead established a number of limitations on the affiliations of directors in Section 10 of the Act, including a requirement that at least 40% of the members of the board of directors of an investment company must be persons who are not investment advisers, affiliated persons of the investment adviser, or officers or employees of the investment company. In addition, Section 15 of the Act sets forth various requirements for investment advisory contracts. An investment advisory contract must be approved by the vote of a majority of the outstanding voting securities of the company. It must precisely describe all compensation to be paid thereunder. It may continue in effect for a period more than two years from the date of its execution only if such continuance is expressly approved at least annually by a majority of the outstanding voting securities or by a vote of the board of directors, including a majority of the directors who are not parties to the contract or affiliated persons of any such party. It must provide that it may be terminated at any time, without penalty, by the board of directors or by vote of a majority of the outstanding voting securities, and that it automatically terminates in the event of assignment by the investment adviser.

The Act also gives the Commission authority to prescribe rules and regulations governing the solicitation of proxies by investment companies. The rules the Commission has promulgated require, among other things, that, when proxies are solicited for the election of directors and for approval or renewal of an investment advisory contract, disclosure must be made of the compensation paid to officers and directors and of the fees paid to the investment adviser. Officers and directors of the investment company who are affiliated with the investment adviser or manager must also be identified. Such information is also required to be set forth in the prospectus through which the securities of investment companies are offered to the public.

Your constituent may also be interested in knowing that the Commission's proxy rules also contain provisions designed to facilitate the problems faced by stockholders who wish to communicate with other stockholders. We enclose a copy of the General Rules and Regulations under the Securities Exchange Act of 1934. Regulation 14 thereof also governs the solicitation of proxies by registered investment companies. It will be noted that Rule 14a-7 (page 39) sets forth the requirements under which an investment company, at the request of a security holder, must either mail communications to other security holders or furnish a list of their names and addresses. Rule 14a-8 (page 39) sets forth the requirements under which an investment company must include in the management's proxy material, with provision for a separate ballot thereon, a proper proposal which a security holder intends to present for action at a meeting of security holders, together with a statement of not more than 100 words to be included in the proxy statement in support of the proposal if it is opposed by the management.

It would, of course, as your constituent points out, be very difficult, as a practical matter, for a shareholder to conduct a proxy contest in an effort to appoint a new investment adviser or to obtain a reduction of the management fee. However, as previously noted, the Investment Company Act provides, as another check on the investment advisory arrangement, that renewals of such contracts must be approved annually either by the vote of the holders of a majority of the outstanding voting securities or by a majority of the directors who are not parties to the contract or affiliated persons of such a party. Presumably, in the cases referred to by your constituent where the stockholders have not had an opportunity to vote on renewal of the advisory contract, the independent directors who have approved the continuance of the contract have been satisfied with the services rendered by the adviser and have considered that the fees paid therefor have been reasonable. Moreover, it is the primary responsibility of the directors to assure proper management at reasonable cost, and if they have acted improperly in this respect, the shareholders may take appropriate legal action in the courts for redress.

As your constituent is aware, the management or advisory fee is usually computed at an annual rate of 1/2 of 1% of the net assets of the fund, although the amount of the fee varies with individual companies. In the case of Massachusetts Investors Trust, to which he made specific reference on the assumption that the 1/2 of 1% fee would be applicable, the management of the company is not delegated under contract to an investment advisory firm. Instead, the company is managed directly by the trustees, with the advice and assistance of an advisory board and a directly employed research staff. For the year 1957, when the company had average net assets of about one billion dollars, the trustees and advisory board received compensation totalling $1,041,795, which was computed on the basis of a declining scale of percentages of net assets and gross earnings. In addition, the expense of the research department and general office amounted to $556,552. The total expenses of the company, including the foregoing amounts, amounted to $2,304,209, or about .21% of average net assets for the year.

The question whether the amounts paid by investment companies for advisory and management fees may be excessive is one which has been of concern to the Commission and its staff for some time. While we are considering this problem in order to ascertain whether it would be appropriate to take any action under the Investment Company Act as now in effect or to recommend any changes in legislation with our limited staff, it is difficult to say when we can complete the necessarily extensive studies required in this area.

In this connection, it is hoped that useful information may be obtained from a study of the size of investment companies which was recently undertaken by the Securities Research Unit of the Wharton School of Finance and Commerce, University of Pennsylvania. The Wharton School was retained by the Commission to make this study pursuant to the authority contained in Section 14(b) of the Investment Company Act. The principal objectives of this study, as set forth in Section 14(b), are to determine the effects of increasing size of investment companies on the investment policies of such companies, on security markets, on concentration of control of wealth and industry, and on companies in which investment companies are interested. In studying the effect of size on the management policies of investment companies, the relationship between the amount of investment advisory fees paid by investment companies, the nature of the advice received, and the costs of the services performed may be pertinent and efforts will be made to have the study encompass this question.

Your constituent also suggests that affiliated persons of the management or advisory company should not be permitted to serve as officers and directors of the investment company. We doubt that it would be necessary or appropriate to adopt such a requirement. The Commission, however, has made recommendations to the Congress, which are now pending before the appropriate committees of the House of Representatives and the Senate, for strengthening the requirements that at least 40% of the board of directors of an investment company shall be composed of persons who have no pecuniary interest, other than their fees as directors, in the management or operation of the company.