

CHAPTER I  
BACKGROUND, SCOPE, AND SUMMARY

A. INTRODUCTION

This report is submitted pursuant to section 14(b) of the Investment Company Act of 1940 ("Act") which authorizes the Securities and Exchange Commission ("Commission") "at such times as it deems that any substantial further increase in size of investment companies creates any problem involving the protection of investors or the public interest to make a study and investigation \* \* \* and from time to time to report the results \* \* \* and its recommendations to the Congress."

The Act has not been materially amended since its passage in 1940. Although the Commission's annual reports to Congress have given considerable attention to the investment company industry, this is the Commission's first report to the Congress pursuant to section 14(b). This report describes the dramatic growth of and the substantial changes in the investment company industry since 1940 and discusses the major public policy implications of that growth and of those changes. It examines the extent to which the Act meets the needs of today and the probable needs of tomorrow, and presents the Commission's program, including recommendations for legislation, to enhance the effectiveness with which the Act's provisions implement its fundamental policy: to "mitigate, and so far as is feasible, \* \* \* eliminate \* \* \* conditions \* \* \* which adversely affect the public interest and the interest of investors."<sup>1</sup>

In this report the Commission finds that on the whole the investment company industry reflects diligent management by competent persons. The flagrant abuses which prevailed prior to 1940 and prompted the enactment of the Act have to a significant extent been eliminated. Under the guidelines established by the Act the investment company industry has acted responsibly to provide a useful and desirable means for investors to obtain diversification of investment risks and professional investment management. Thus, this report should not impair public confidence in investment companies. However, the growth and change in the investment company industry, particularly during the past decade, raises important questions of public policy, including, among others, the cost to investors of participation in the securities markets through mutual funds. To a large extent these questions are attributable to the unique structure of the mutual fund industry which interferes with the ability of fund managements to resolve them in the interest of mutual fund shareholders.

No attempt has been made in this report to assess the merits of investment company securities relative to other types of securities

<sup>1</sup> Act, sec. 1(b) (concluding paragraph).

or to analyze the securities of particular investment companies.<sup>2</sup> That is not the purpose of this report. Its primary purpose is to describe and assess the growth of the investment company industry, particularly its mutual fund sector, and to present recommendations for changes in the Federal law applicable to investment companies that will, the Commission believes, assure fairer treatment to the millions of Americans—most of them of modest means—whose appraisal of their own needs and circumstances has led them to invest many billions of dollars in those companies.

#### B. INVESTMENT COMPANY GROWTH

In little more than a quarter of a century American investment companies have become an investment medium of major significance. At the end of 1940, investment company assets were about \$2.1 billion. By June 30, 1966, they had increased to \$46.4 billion. Particularly striking has been the growth of the open-end sector of the investment company industry—the so-called mutual funds whose shares are redeemable by shareholders at net asset value. Mutual fund net assets have grown from about \$450 million at the end of 1940 to about \$38.2 billion on June 30, 1966. Although the assets of the funds increased by about eight times between 1940 and 1952, their growth has been even more striking in recent years. Mutual fund assets, which were only about \$4 billion at the end of 1952, had more than tripled by the end of 1958 when they stood at \$13.2 billion. And from the end of 1958 to mid-1966, the assets of the funds almost tripled again, so that mutual fund assets in the middle of 1966 were more than nine times their size at the end of 1952.

The growth of mutual funds has been accompanied by a dramatic increase in the number of mutual fund investors. In 1940 there were slightly less than 300,000 mutual fund shareholder accounts. By the end of 1965 this figure had grown to over 6.7 million.<sup>3</sup> More than 3.5 million investors now hold mutual fund shares.<sup>4</sup> The present economic importance of the mutual fund industry can be gauged from the fact that in 1965 mutual funds raised almost \$5.2 billion through the issuance of new shares, more than double the \$2.3 billion in new stock sold for cash in the United States during that year by all corporations other than investment companies. The growth of the industry as a whole has been exceeded in many instances by that of individual funds. In mid-1966 there were 19 mutual funds each of which held assets greater than those of the entire mutual fund industry at the end of 1940.

#### C. BACKGROUND OF THE REPORT

##### 1. *The Wharton Report*

The report that the Commission now makes had its genesis in 1958 when the investment company industry was much smaller than it is today and when its mutual fund sector grew from \$8.7 billion at the beginning of the year to \$13.2 billion—a little more than

<sup>2</sup> The Commission has traditionally regarded this type of analysis as being outside the scope of its responsibilities. Cf. Report of the Special Study of the Securities Markets, 2d. Doc. No. 95, 88th Cong., 1st sess. ("Special Study"), p. 1, IV.

<sup>3</sup> Source: Investment Company Institute.

<sup>4</sup> Source: Investment Company Institute.

The number of mutual fund shareholder "accounts" is almost double the number of mutual fund "shareholders" because many investors hold shares in two or more funds.

one-third its present size—at the end of the year. In that year the Commission authorized the Securities Research Unit of the Wharton School of Finance and Commerce of the University of Pennsylvania to make a study pursuant to section 14(b) of the Act and to submit a report to the Commission. The Commission originally asked for a report concentrating on mutual funds that would “be primarily directed to the question of the effects of size on investment policies and comparative performance of investment companies and, to the extent possible, to the effects of size of investment companies on the securities markets and on the policies of portfolio companies.”<sup>5</sup> It soon became clear, however, that the effects of increases in the size of investment companies could not be fully understood without a study of the relationships between mutual funds and their investment advisers, principal underwriters, and portfolio brokers. Accordingly, when the original part of the Wharton Report was nearing completion, the Commission asked that it be expanded to include an analysis of these areas.

The Wharton Report was delivered to the Commission in August of 1962 and was submitted to the Congress at the end of that month. It was the most comprehensive analysis of the mutual fund industry since the Commission’s Investment Trust Study,<sup>6</sup> which led to the enactment of the Investment Company Act of 1940. The Wharton Report presented much factual material about mutual funds and identified areas in which problems appeared to exist. It concluded that “the more important current problems in the mutual fund industry appear to be those which involve potential conflicts of interest between fund management and shareholders, the possible absence of arm’s length bargaining between fund management and investment advisers, and the impact of fund growth and stock purchases on stock prices.”<sup>7</sup>

## 2. *The Special Study*

In September 1961, while the Wharton Report was being prepared, Congress added section 19(d) to the Securities Exchange Act of 1934, authorizing and directing the Commission “to make a study and investigation of the adequacy, for the protection of investors, of the rules of the national securities exchanges and national securities associations.” A detailed study of the securities business and the securities markets followed, which resulted in a report that was submitted to Congress in five parts during 1962 and 1963.<sup>8</sup> That report has become known as the “Special Study.”

The Special Study treated aspects of the mutual fund industry which fell outside the scope of the Wharton Report. The Special Study’s examination of the mutual fund area was primarily concerned with the way in which mutual fund shares are sold and with the special problems involved in the sale of so-called “contractual plans” for the acquisition of mutual fund shares. It also examined the factors that influence the way in which the brokerage commissions paid by the funds for the purchase and sale of portfolio securities is allocated and the potential conflicts of interest arising from “insider” trading in securities being purchased or sold by the funds.

<sup>5</sup> Wharton School of Finance and Commerce, *A Study of Mutual Funds*, H. Rept. No. 2274, 87th Cong., 2d sess. 1 (1962) (hereinafter referred to as the “Wharton Report”).

<sup>6</sup> SEC Report on Investment Trusts and Investment Companies (1938-40).

<sup>7</sup> Wharton Report p. X.

<sup>8</sup> See note 2, *supra*.

### 3. Commission Review

The Wharton Report was a report to the Commission, not by the Commission. It was an analytical study that made no recommendations for legislative or administrative action. The Special Study, on the other hand, did make recommendations; but those were the recommendations of the staff which prepared the Study, not of the Commission. It remained for the Commission to evaluate the Special Study's recommendations against the background of the basic questions posed by the Wharton Report and of its own experience in administering the Federal securities statutes.<sup>9</sup> The Commission transmitted the Wharton Report to the Congress, stating that it would evaluate the public policy questions raised by the report "as part of a comprehensive program of study with a view to determining and formulating such legislative, rule, and enforcement proposals, if any, as may be desirable and thereafter reporting to the Congress."<sup>10</sup>

To aid it in this task, the Commission directed its staff to make further inquiries. In these subsequent studies, the Commission's staff sought to test the conclusions of the Wharton and Special Study Reports by an intensive firsthand examination of a cross section of the investment company industry. The group of companies selected for this purpose reflected varying patterns of organization within the industry and consisted of 33 companies with total assets on June 30, 1966, of more than \$13 billion—over 27 percent of all investment company assets on that date.<sup>11</sup> The staff also studied the operations of small mutual funds that were not associated with large investment company groups and interviewed the managements of other investment companies, officers of other financial institutions as well as broker-dealers who sell mutual fund shares and who handle portfolio transactions for investment companies and other institutions.<sup>12</sup>

Extensive use has been made of information in the Commission's files.<sup>13</sup> Statistics derived from that source<sup>14</sup> have been supplemented by additional data obtained from the Investment Company Institute ("ICI")<sup>15</sup> and from the Association of Mutual Fund Plan Sponsors, Inc. The Commission is most appreciative of the cooperation and assistance that it has received from both of these organizations and from many persons in the investment company and securities industries.

<sup>9</sup> When the Commission forwarded the Special Study to the Congress it said in its letter of transmittal: "The examination of the securities markets and the writing of the report have been done by a group designated the Special Study of Securities Markets. The Special Study was given freedom to analyze and point out problems as they appeared to it: \* \* \* the judgments, analyses, and recommendations in this report are those of the Special Study and not the Commission. However, the Commission has worked very closely with the study throughout and has gone over every section of the report. We believe that the report is a thoroughly responsible document. We do not embrace every recommendation as our own but we do accept them as a sound point of departure for proposals to the Congress for rulemaking by the Commission and by the self-regulatory agencies and for discussions with the industry. Like the study, we at the same time recognize the complexities and subtleties of the problems presented." Special Study, pt. 1, IV-V.

<sup>10</sup> Wharton Report VII.  
<sup>11</sup> Twenty of these investment companies were typical mutual funds charging a sales load, five were unit investment trusts issuing contractual plans, two were no-load funds, two were closed-end investment companies, two were exchange funds, and two were face-amount certificate companies. For discussion of these types of investment companies, see pp. 37-459, infra.

<sup>12</sup> A number of special staff inquiries into the functioning of the securities markets, made after the completion of the Special Study, were also germane to the investment company area and to this report.

<sup>13</sup> On Jan. 25, 1965, the Commission revised and broadened the annual reports that most registered investment companies are required to file with it. (See Investment Company Act Release No. 4151, Securities Exchange Act Release No. 721.) This new reporting form, known as Form N-1R has supplied the Commission with much information that was previously unavailable to it on a regular basis.

<sup>14</sup> Except where otherwise noted, statistical material in this report is based on the Commission's public files. June 30 net asset figures come from annual reports filed with the Commission by each registered investment company.

<sup>15</sup> ICI members hold about 93 percent of all mutual fund assets.

## D. SCOPE OF THE REPORT

This is not a report on every phase of the investment company industry. It focuses primarily on the areas where the mutual fund industry's growth raises questions as to the present adequacy of the regulatory pattern fashioned in 1940. Relatively little attention is given to the many areas in which that pattern still works well and as to which the Commission sees no need for additional legislation at the present time. Thus, little mention is made here of the problems with which this Commission was most concerned when it made an exhaustive inquiry into the investment company industry during the late 1930's. On the abuses which plagued the investment company industry prior to 1940, the Act has been and continues to be an effective check. The investment company industry that the Commission has been examining has grown to a size unforeseen in 1940. That growth, especially the phenomenal growth of the mutual funds—raises issues of significant public concern.<sup>16</sup> This is for the most part a report on public policy implications of investment company growth.

Problems presented by small business investment companies, exchange funds and other specialized types of investment companies are not treated in detail. To the extent that major public policy issues have arisen in these areas they concern matters largely outside the range of this Commission's responsibilities. For example, the regulation of small business investment companies is primarily the responsibility of the Small Business Administration. And the legislative question with respect to exchange funds is one of tax policy rather than one of investor protection. In the investor protection area for which this Commission is responsible there is no present need for extensive amendments to the Federal securities statutes so as to make special provision for these types of companies.

One of the most striking characteristics of the investment company business is its unusually dynamic character. Its history has been marked by rapid and far-reaching change, and the pace of change is especially swift at the present time. Accordingly, this report discusses recent noteworthy trends, some of which did not appear significant until the report was nearing completion. One such development is the formation of investment companies for the purpose of investing in the securities of other investment companies. Another is the growing stress of a sizable number of mutual funds on aggressive short-term trading rather than the more traditional objective of long-run investment, a phenomenon that has been accompanied by the increasing use of mutual fund shares as vehicles for speculation rather than as media for investment.

The implications of other recent developments are as yet too uncertain to permit extensive discussion. Noteworthy in this connection are the questions raised by the entry into the investment company industry of conglomerate corporations whose primary business interests lie in nonfinancial fields." Control of an investment company or of a group of investment companies—even a company or a group that is quite small by the standards of today's invest-

<sup>16</sup> Wharton Report X.

<sup>17</sup> Mutual funds with assets of over \$800 million are now controlled by industrial companies. And other nonfinancial corporations never previously involved in the mutual fund field or in the securities business have from time to time given serious consideration to the acquisition of control over existing or the hunching of new mutual funds. *See* n. 93 on p. 46, *infra*.

## 6            IMPLICATIONS OF INVESTMENT COMPANY GROWTH

ment company industry—carries with it control of a sizable pool of investment capital. The owners of that capital are the investment company's shareholders. But it is the company's managers who decide how the shareholders' capital is to be used. When this power of decision is held by a corporation for whom investment management is ancillary to the direct operation of business enterprises, that corporation may be tempted to use the resources of its controlled investment company to further its noninvestment company interests. For example, the controlling corporation may cause the investment company to acquire a substantial block of the securities of a principal supplier to or an important customer of one of its operating divisions. Of course, such an acquisition can be motivated by bona fide investment judgment. But it can also be motivated by the controlling company's desire to obtain assured sources of supply, lower prices, a captive market or other benefits for the operating divisions that are of primary interest to it.

As yet, the involvement of conglomerate corporations in the investment company field is limited. And nothing has come to the Commission's attention to indicate that the industrial corporations that have acquired investment company interests have in fact deployed the companies' resources so as to promote their own interests in other businesses at the expense of investment company shareholders.

The recent and sometimes sudden emergence of trends such as this makes it impossible to foresee with certainty at this time whether industry change and growth will lead to regulatory problems other than those discussed in this report. The Commission, therefore, will evaluate on a continuing basis the implications of change in this growing and very important segment of the securities industry. Should new developments call for further revision of the Act, the Commission will communicate its views and the reasons on which they are based to Congress.

### E. OUTLINE OF THE REPORT

The report consists of nine chapters. This chapter describes its background and scope and summarizes its contents. Chapter II outlines the industry structure and the regulatory framework that give rise to the specific matters discussed in subsequent chapters. It describes the investment company industry, the background and provisions of the Investment Company Act, and the pertinent findings of the Wharton Report and Special Study.

Chapter III discusses the management function and its cost. It deals with the question of whether the Act's controls over managerial compensation are adequate in view of the present size of the mutual fund industry and of its probable future growth. Chapter IV discusses questions raised in connection with the execution of investment company portfolio transactions, including those arising out of the allocation of mutual fund portfolio brokerage, close affiliations between investment companies and the brokers through whom the companies buy and sell securities, distributions of realized capital gains and transactions by persons affiliated with investment companies in securities being bought or sold by such companies. Chapter V evaluates mutual fund sales charges and their fairness to investors.

Chapter VI examines the relationship between mutual fund *size* and performance. Chapter VII considers the impact of mutual fund

growth and of the increasing importance of other institutional investors, particularly pension funds, on the securities markets. Chapter VIII discusses questions relating to investment company relationships with portfolio companies, with stress on those raised by the recent emergence of mutual funds which invest primarily in the securities of other investment companies. Chapter IX discusses the need for a number of changes in the Act in areas, which though important, are narrower than those treated in earlier chapters.

#### F. SUMMARY OF THE REPORT

##### 1. Chapter II.—*The Investment Company Industry*

###### (a) *The coverage of the Act*

The basic definitions of an investment company under the Act include most arrangements by which persons invest funds in a company which itself invests in securities.<sup>18</sup> However, not every company which falls within these definitions is regulated under the Act. Thus, the Act is inapplicable to companies for whom security ownership is a means of controlling and operating businesses and which are not primarily engaged in investing in securities. Companies that have no more than 100 security holders and are neither offering nor proposing to offer their securities to the public are specifically exempted.<sup>19</sup>

Other categories of business enterprises that meet the basic statutory definitions but are specifically excluded from regulation under the Act are banks, savings and loan associations, insurance companies and certain other types of companies most of which are subject to State or Federal regulation under statutes other than the Act. An excluded company can however create, and some insurance companies and banks have created, or propose to create, investment companies subject to regulation under the Act.<sup>20</sup>

The Congress has given to the Commission broad exemptive powers that enable it to deal with exceptional situations in which regulation under the Act is inappropriate.<sup>21</sup>

###### (b) *Types of investment companies*

The Act divides regulated investment companies into three types: (1) face-amount certificate companies; (2) unit investment trusts; and (3) management companies.

(i) *Face-amount certificate companies.*—Face-amount certificate companies issue certificates obligating the companies to pay at maturity fixed sums (the face amounts of the certificates) to purchasers who have made single payments or a series of installment payments.<sup>22</sup> Rates of return on the certificates are almost entirely predetermined.

(ii) *Unit investment trusts.*—Unit investment trusts sell redeemable interests in fixed portfolios of specified securities. At one time most such trusts held diversified—but predetermined—portfolios. Today, most unit investment trusts are simply mechanisms for selling the shares of a management investment company on an installment payment basis.<sup>23</sup>

<sup>18</sup> Note 1 on p. 33, *infra*.

<sup>19</sup> Pp. 34-35, *infra*.

<sup>20</sup> Pp. 35-37, *infra*.

<sup>21</sup> Pp. 34-37, *infra*.

<sup>22</sup> Pp. 37-38, *infra*.

<sup>23</sup> P. 38, *infra*.

(iii) The management companies.—The Act classifies as a management company any investment company that is neither a face-amount certificate company nor a unit investment trust. Since management companies cover a wide spectrum of the investment company industry, and since they are far more numerous and their assets far greater than the face-amount certificate companies and the unit investment trusts, this report is principally about them.<sup>24</sup>

There are four kinds of management companies: (1) diversified—open-end, (2) non-diversified—open-end, (3) diversified—closed-end, and (4) non-diversified—closed end.<sup>25</sup>

Diversified companies invest in the securities of many different issuers, while non-diversified companies invest in the securities of relatively small numbers of issuers or indeed of a single issuer.<sup>26</sup>

Diversified companies are able to pass their income on to their shareholders free from any Federal corporate income tax.<sup>27</sup> The diversified companies hold more than 80 percent of all management investment company assets and have many more shareholders than the non-diversified companies.

Open-end companies, commonly referred to as “mutual funds,” issue “redeemable” securities—i.e., securities whose holders have a right to obtain from the company their proportionate share of the companies net assets or the cash equivalent. Open-end shares normally are bought from and redeemed by the company through its principal underwriter. Almost all open-end companies offer and sell new shares of their own stock on a continuous basis.

A company that has not issued—and is not offering to issue—a redeemable security is a “closed-end” company. In contrast to the open-ends, closed-end companies neither redeem outstanding securities nor engage in the continuous sale of new securities. They operate with relatively fixed supplies of capital. In other respects the diversified closed-end companies are quite similar to mutual funds. The shares of closed-end companies are normally bought and sold on securities exchanges and in the over-the-counter securities markets.

#### (c) Mutual fund structure

Although a few mutual funds are managed along conventional corporate lines by their own officers and directors, most of them are formed, promoted, and managed by external organizations that are separately owned and operated. These separate organizations are usually designated as “investment advisers.”<sup>28</sup> The advisers select the funds’ investments and operate or supervise most other aspects of their business. In return for their services they receive an advisory fee. The fee is almost always a percentage of the value of the fund’s net assets, fluctuating upward or downward as the value of the portfolio changes.<sup>29</sup>

Often a single adviser organizes and manages a group of funds—a “fund complex.” Through the complex, one adviser can appeal to a broad cross-section of investors with differing investment objectives. Thus the same adviser may manage a balanced fund, i.e., one whose portfolio includes bonds and preferred as well as common stocks; a

<sup>24</sup> P. 39, *infra*.

<sup>25</sup> *Ibid.*

<sup>26</sup> Pp. 39–40, *infra*.

<sup>27</sup> Pp. 40–41, 79–82, *infra*.

<sup>28</sup> P. 46, *infra*.

<sup>29</sup> *Ibid.*

common stock fund stressing capital appreciation; and a third fund stressing current income.<sup>30</sup>

The function of selling new fund shares generally is contracted out to an organization called a "principal underwriter" which in most cases is either the adviser itself or a close affiliate.<sup>31</sup> Since mutual funds are constantly buying and selling securities for their portfolios, they incur substantial brokerage costs. Fund adviser-underwriters often allocate substantial portions of this brokerage to their affiliated brokerage firms or to securities dealers who sell fund shares.<sup>32</sup>

*(d) Distribution of mutual fund shares*

Most purchasers of mutual fund shares pay a sales charge or "sales load"—usually 8.5 percent of the total purchase price, which amounts to 9.3 percent of the net amount actually invested—when they buy fund shares.<sup>33</sup> The sales load, which is by far the most important expense incident to a mutual fund investment, does not go to the fund itself but to its principal underwriter, retail dealers and salesmen who sell fund shares. It pays only for selling effort. Of course, where sales of fund shares exceed redemptions additional costs are sustained when the new money is invested in portfolio securities. Investors in the so-called "no-load" funds—of which there are about 60 at the present time—pay no sales charge of any kind in connection with their purchases of mutual fund shares.<sup>34</sup>

Principal underwriters use two different distribution techniques. Some confine themselves to wholesaling and leave the actual selling to independent retail dealers. Others have their own retail sales organizations called "captive sales forces." In either case, the growth of the funds through the sale of new shares increases the advisory, the underwriting and, in an appreciable number of instances, the brokerage income of those who control them.<sup>35</sup>

*(e) The pattern of Federal regulation*

Apart from the Investment Company Act, three other Federal statutes—the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Advisers Act of 1940—apply to the investment company industry.<sup>36</sup> However, those statutes are concerned primarily with disclosure and the prevention of fraud. Because the relatively liquid, mobile, and readily negotiable assets of investment companies afforded unusual opportunities to the unscrupulous, Congress determined that the earlier statutes were inadequate to meet the problems which had been revealed in the Commission's reports and passed a special regulatory statute—the Investment Company Act.<sup>37</sup> In the exhaustive study of the industry which preceded passage of the Act it was found that, in many instances, investment companies had been operated in the interests of their managers rather than in the interests of their shareholders.

In the areas where abuses then were most acute and the need for corrective action most pressing, the Act provides specific and rigorous controls designed to eliminate outright dishonesty, managerial self-dealing in securities and other types of property, unsound finan-

<sup>30</sup> Pp. 47-48, *infra*.

<sup>31</sup> P. 54, *infra*.

<sup>32</sup> Pp. 50-51, *infra*.

<sup>33</sup> P. 52, *infra*.

<sup>34</sup> P. 52, *infra*.

<sup>35</sup> Pp. 55, 59-60, *infra*.

<sup>36</sup> Pp. 59-63, *infra*.

<sup>37</sup> Pp. 63-66, *infra*.

cial structures, and immunity from liability for misconduct. It also establishes machinery for shareholder participation in investment company affairs. Although attention was given to managerial compensation, sales charges and brokerage commissions, they were on the whole of secondary importance in the relatively small investment company industry of 1940.<sup>38</sup>

The Act specifically prohibits transactions in which investment companies lend money to, sell property to, buy property from, or engage in joint transactions with, their affiliated persons unless the Commission first finds the proposed transaction fair and reasonable.<sup>39</sup> With limited exceptions it does not, however, impose analogous controls on compensation for services—sales loads, managerial compensation, and brokerage commissions. In these areas fund managers retain a large measure of discretion subject, however, to what were referred to at the time that the Congress was considering the Act as “a few elementary safeguards,” mainly, approval by shareholders and by directors unaffiliated with management.<sup>40</sup>

The Wharton and Special Study Reports questioned the adequacy of the protections afforded investors in the advisory fee, sales compensation, and brokerage commission areas.<sup>41</sup> The Wharton Report concluded that the potential conflicts of interests in these areas were among the “more important current problems” in the mutual fund industry.<sup>42</sup> and suggested that they might be attributable to an industry structure under which the funds are managed by external service organizations.<sup>43</sup>

## 2. Chapter III—The Management Function and Its Cost

### (a) Contracting out the management junction

Most mutual funds are managed by external investment advisory organizations which are controlled by the funds' organizers or by their successors.<sup>44</sup> Mutual fund advisory organizations often manage large pools of capital, but it is not unusual for them to employ relatively few people and require relatively little capital of their own.<sup>45</sup>

The adviser's fee is usually a percentage of the fund's net assets.<sup>46</sup> Although most funds receive some nonadvisory services from their investment, advisers in return for the advisory fee, the extent of such services varies greatly. Stock transfers, dividend disbursing, and custodial services, the most substantial nonadvisory services required by mutual funds, are usually not paid for by the advisory fee.<sup>47</sup> Sometimes advisory fees pay solely for investment management, and the fund pays its adviser or a close affiliate of the adviser an administrative fee based on a percentage of net assets in addition to the advisory fee.<sup>48</sup>

### (b) The cost of management

Beyond a certain point increases in an investment company's assets do not lead to commensurate increases in the cost of furnishing it with investment advice and other managerial services. Hence,

<sup>38</sup> Pp. 66, 69, *infra*.

<sup>39</sup> Pp. 68-69, *infra*.

<sup>40</sup> Pp. 69-71, *infra*.

<sup>41</sup> Pp. 72-75, *infra*.

<sup>42</sup> P. 72, *infra*.

<sup>43</sup> P. 73, *infra*.

<sup>44</sup> P. 87, *infra*.

<sup>45</sup> Pp. 87-88, *infra*.

<sup>46</sup> P. 89, *infra*.

<sup>47</sup> Pp. 90-92, *infra*.

<sup>48</sup> Pp. 92-94, *infra*.

there are considerable economies of size to investment company managers. In large measure these economies reflect the fact that the management of a small security portfolio requires much the same general economic and market forecasting, analyses of various industry groups and evaluations of particular securities—the basic elements in the investment advisory process—as does the management of a large one.<sup>49</sup>

The Wharton Report found that as of 1960 most investment advisers were not sharing the economies of size with the funds and their public shareholders. In approximately four out of every five cases mutual fund advisory fee rates were fixed and did not vary with the size of the assets managed. Annual fees “tended to cluster heavily around the traditional rate of 0.50 percent of average net assets.”<sup>51</sup>

The 0.50 percent annual advisory fee rate was still prevalent in the mutual fund industry during 1965. Among the 57 externally managed funds with net assets of more than \$100 million on June 30, 1965, the median fee rate was 0.48 percent of average net assets and the mean fee rate was 0.45.<sup>52</sup>

The 1965 expenses of the larger externally managed funds were almost double those of investment companies of comparable size which are managed by their own officers and staff, i.e., the internally managed companies. They are also substantially higher than the fees that banks charge for managing the investments of pension and profit sharing plans.<sup>53</sup> While the managerial services required by the two investment media differ somewhat, these differences do not adequately explain the extent of the disparity between pension and mutual fund advisory fee rates.

Publicly held, externally managed mutual funds pay substantially higher advisory fee rates than registered investment companies which are operated exclusively as equity investment vehicles for banks and other institutions.” Mutual fund advisory fee rates also are substantially higher for comparable asset levels than the rates that private individuals pay for investment advice.<sup>55</sup>

Publicly held mutual funds require certain services that are not needed by other purchasers of investment advice. For example, an adviser to a publicly held mutual fund assumes special responsibilities arising from the fund's relationship to its shareholders and from the necessity of complying with the recordkeeping and the reporting requirements of State and Federal law.<sup>56</sup> But the internally managed investment companies pay for those very same services. Yet their aggregate management costs are much lower than those of the externally managed companies.<sup>57</sup> Thus, the higher management expenses of the externally managed funds cannot be attributed solely to cost factors. That hypothesis is confirmed by the fact that advisers' profit margins are higher on their mutual fund accounts than on nonfund accounts.<sup>58</sup>

<sup>49</sup> Pp. 95-96, *infra*.

<sup>50</sup> P. 96.

<sup>51</sup> Pp. 96-97, *infra*.

<sup>52</sup> Pp. 97-100, *infra*.

<sup>53</sup> Pp. 102-118, *infra*.

<sup>54</sup> Pp. 118-119, *infra*.

<sup>55</sup> Pp. 119-121, *infra*.

<sup>56</sup> Pp. 116, *infra*.

<sup>57</sup> Pp. 102-108, *infra*.

<sup>58</sup> Pp. 119-121, *infra*.

## (e) Existing restraints on management compensation

Mutual funds are unique among large purchasers of investment management because neither cost considerations nor other competitive factors influence a fund's choice of advisers. This is so because mutual funds are formed by, and generally remain under, the effective control of their advisers.<sup>59</sup>

The disclosure requirements of the Federal securities laws apply to management compensation in the investment company industry.<sup>60</sup> But disclosure is a less effective restraint on managerial compensation in this industry than it is in other industries.<sup>61</sup>

Congress supplemented disclosure with additional regulatory provisions for advisory fees.<sup>62</sup> However, those provisions, which mainly require approval of advisory contracts by shareholders and unaffiliated directors, have rarely operated to provide fund shareholders with an adequate share of the economies of size in many cases.

The Act's requirement that shareholders approve new advisory contracts gives them only the choice of approving the contracts proposed by management, or of rejecting them and creating uncertainty for the funds' operations.<sup>63</sup> The Act's requirement that renewals of advisory contracts be approved by a majority of the fund's directors who are unaffiliated with its adviser, in many instances, has not been effective in meeting the needs of mutual fund investors. The ability of unaffiliated directors to bargain at arm's length is seriously hampered because they are seldom free as a practical matter to terminate a long established management relationship solely because of differences over fee rates. Under these circumstances, the essential element of arm's length bargaining—the freedom to terminate negotiations and to bargain with other parties—is lacking.<sup>64</sup>

Because of the absence of competition, the limitations of disclosure, the ineffectiveness of shareholder voting rights and the difficulty of effective action by unaffiliated directors, advisory fee rates did not decline as the funds grew. With some exceptions, it was the pressures generated by the publication of the Wharton Report and the pendency of shareholder litigation that led to such departures as there have been from the traditional flat fee rate of 0.50 percent. These departures have seldom been substantial.<sup>65</sup>

Many of the fee seductions were made in connection with the settlement of shareholder suits attacking as excessive the advisory fees paid to 18 advisory organizations serving most of the larger funds in the industry.<sup>66</sup> This litigation, however, has done little to reduce, or to stimulate reduction of, advisory fees. The courts have held that since the contracts under which the fees were paid had been ratified by shareholders and by unaffiliated directors, the plaintiffs had to bear the burden of proving affirmatively that the fees were so grossly excessive that payment thereof constituted a "waste" of corporate assets.<sup>67</sup>

The shareholder protections created by the Act have been construed under State law as precluding judicial inquiry into the reasonableness

<sup>59</sup> Pp. 126-127, *infra*.

<sup>60</sup> P. 127, *infra*.

<sup>61</sup> P. 128, *infra*.

<sup>62</sup> Pp. 127-128, *infra*.

<sup>63</sup> Pp. 128-130, *infra*.

<sup>64</sup> Pp. 130-132, *infra*.

<sup>65</sup> P. 132, *infra*.

<sup>66</sup> *Ibid.*

<sup>67</sup> Pp. 132-141, *infra*.

of advisory fees. This anomaly results from the Act's failure to provide an express, readily enforceable standard of reasonableness. Such a standard of reasonableness already is in the Act and operates effectively for transactions between investment companies and their affiliated persons that involve the lending of money or the purchase or sale of securities or other properties. If the Act is to be effective in the area of management compensation, it must make clear that the standard of reasonableness also extends to that sphere.<sup>68</sup>

(d) *The Commission's recommendations*

Accordingly, the Commission recommends that the Act be amended to provide expressly that:

(1) All compensation received by any person affiliated with a registered investment company (including investment advisers, officers, directors, and trustees, any person serving as its principal underwriter and any affiliated person of such persons) for services furnished to the investment company be reasonable;

(2) The standard of reasonableness be applied in the light of all relevant factors, including the fees paid for comparable services by other financial institutions engaged in administering pools of investment capital of like size and purpose such as pension and profit sharing plans, insurance companies, trust accounts, and other investment companies; the nature and quality of the services provided; all benefits directly or indirectly received by persons affiliated with an investment company and the affiliated persons of such persons by virtue of their relationship with the investment company; and such competitive or other factors as the Commission may by rule or regulation or, after notice and opportunity for hearing, by order, determine are appropriate and material in the public interest;

(3) The application of this standard be unaffected by either shareholder or directorial approval of advisory contracts or other arrangements for management compensation;

(4) Recoveries in actions to enforce the statutory standard of reasonableness be limited to that portion of the compensation deemed excessive which has been paid or accrued within two years of the date on which the action is instituted; and

(5) The Commission be empowered to institute actions to enforce the statutory standard of reasonableness and to intervene as a party in any private action brought to enforce that standard.<sup>69</sup>

The proposed statutory standard of reasonableness would not preclude investment advisers and other persons affiliated with investment companies from realizing profits on the various types of services they provide to such companies. However, the standard of reasonableness would make clear that persons who derive benefits from their fiduciary relationships with investment companies can charge them no more for their services than if they were dealing with them on an arm's length basis. Under this standard, a determination of the amount of compensation would include all benefits directly or indirectly received by investment company managers by virtue of their relationship with the companies.<sup>70</sup>

<sup>68</sup> Pp. 142-143, *infra*.

<sup>69</sup> Pp. 143-144, *infra*.

<sup>70</sup> Pp. 145-146, *infra*.

In the Commission's view, the adoption of an express statutory standard of reasonableness for managerial compensation is the most feasible way of improving shareholder protection with a minimal disruptive effect on industry structure. The Commission has considered other proposals in this area. These range from proposals to strengthen disclosure, shareholder voting rights and the position of unaffiliated directors to proposals for requiring the internalization of the management function. Proposals with respect to disclosure, voting and unaffiliated directors were rejected as wholly unrealistic. On the other hand, proposals calling for internalization were viewed as too sweeping to be warranted at this time.<sup>71</sup>

(e) *Sales of management organizations*

Sales of the assets of, or controlling blocks of stock in, adviser-underwriter organizations have caused funds to change managers. Since the management organization's control of a fund often is an exceedingly valuable asset, the price paid for its stock or its assets reflects the expectation that the buyers will be able to succeed to the advisory, brokerage and underwriting revenues obtainable from this control relationship.<sup>72</sup>

Sales of management organization are of paramount importance to the fund and its shareholders. The conflict of interests involved usually is a striking one. It is in the interest of the retiring manager to obtain for himself the highest price for this relationship. The interest of the fund and its shareholders, on the other hand, is to obtain the best available management at a reasonable cost.<sup>73</sup>

Although the Act requires that the new advisory relationship be approved by the holders of a majority of the fund's shares, this safeguard has not adequately protected the shareholders' interest in all cases.<sup>74</sup> In the Commission's view, transfers of the management relationship that are adverse to the interest of the funds and its shareholders should be prevented. The Commission believes that this objective can be achieved without discouraging fund managers who are unable or unwilling to continue serving in that capacity from terminating their relationship and without depriving them of an opportunity to obtain a fair return from their efforts in organizing and developing the investment company.<sup>75</sup>

Accordingly, the Commission recommends that the Act be amended to prohibit sales of management organizations if the sale or any express or implied understanding in connection with the sale imposes additional burdens on the investment company or its shareholders or limits its future freedom of action.

3. *Chapter IV — Portfolio Transactions*

(a) *The securities markets*

The substantial brokerage costs that investment companies pay are an increasingly important source of revenue to the securities industry. In 1965, these charges amounted to more than \$100 million for the mutual fund sector alone.<sup>76</sup>

<sup>71</sup> Pp. 147-149, *infra*.

<sup>72</sup> P. 149, *infra*.

<sup>73</sup> P. 151, *infra*.

<sup>74</sup> P. 152, *infra*.

<sup>75</sup> Pp. 152-153, *infra*.

<sup>76</sup> P. 155, *infra*.

Portfolio holdings of investment companies tend to be heavily concentrated in securities listed on the New York Stock Exchange.?? While most investment company transactions are executed on that exchange, the companies also can buy and sell NYSE-listed securities on seven regional exchanges<sup>78</sup> and in the so-called "third market" segment of the over-the-counter market.<sup>79</sup> Investment companies also are important holders of securities that are traded only in the over-the-counter market, and a few companies invest principally or exclusively in such securities.<sup>80</sup>

Charges for the execution of transactions in the over-the-counter market are subject to negotiation.<sup>81</sup> In the exchange markets, however, brokerage commissions are governed by exchange minimum commission rate schedules which do not provide for a volume discount. The exchange commission on an order for 10,000 shares of a given security is exactly 100 times the commission for a 100-share order.<sup>82</sup>

Hence, though exchange members compete vigorously among themselves, with members of other exchanges and with nonmember broker-dealers for investor patronage in exchange-traded securities, they do not do so on the basis of direct price competition.<sup>83</sup> Nonexchange members who operate in the third market, however, are not bound by exchange commission rate schedules. Often they are able and willing to handle orders for institutional customers in NYSE-listed securities for less than exchange members have to charge.<sup>84</sup>

(b) *Allocation of mutual fund brokerage*

Exchange members also are willing to execute and clear exchange transactions for mutual funds and other large institutional customers for a fraction of the commissions they must charge them.<sup>85</sup> They allow mutual fund managers to allocate a substantial portion of the brokerage to other brokers who had nothing to do with the execution of the transaction on which the brokerage is earned.<sup>86</sup>

Some of this brokerage is allocated to broker-dealers for nonsales services, including investment research, investment recommendations, private wire and teletype connections, pricing of fund securities portfolios and, in a few instances, custodial services.<sup>87</sup> However, the managers of most dealer-distributed funds which are not closely affiliated with brokerage houses use a substantial portion of the funds' brokerage to pay dealers extra compensation for sales of fund shares.<sup>88</sup> The amount of brokerage available for sales depends upon a variety of factors, but generally the larger funds and fund complexes are able to use a much greater percentage of their brokerage for sales than are the smaller ones.<sup>89</sup>

The simplest way to reward broker-dealers for nonbrokerage services is to place brokerage orders with them. However, placing orders with substantially all of the member firms that sell fund shares and

<sup>77</sup> P. 157, *infra*.

<sup>78</sup> Pp. 157-158, *infra*.

<sup>79</sup> Pp. 159-161, *infra*.

<sup>80</sup> P. 158, *infra*.

<sup>81</sup> Pp. 158-159, *infra*.

<sup>82</sup> Pp. 156-157, *infra*.

<sup>83</sup> P. 157, *infra*.

<sup>84</sup> Pp. 159-160, *infra*.

<sup>85</sup> Pp. 162-163, *infra*.

<sup>86</sup> P. 163, *infra*.

<sup>87</sup> Pp. 161-163, *infra*.

<sup>88</sup> Pp. 164-165, *infra*.

<sup>89</sup> Pp. 165-167, *infra*.

provide other services would impose burdens on fund trading departments and on the ability of fund managers to acquire or dispose of portfolio securities in the most efficient and inexpensive way.<sup>90</sup> Most fund managers, therefore, attempt to distribute fund brokerage to a large number of dealers who sell their shares by using the "customer-directed give-up." They direct the broker who executes an order and receives the commission to ("give up" portions of that commission to one or more designated brokers who have no connection with the transaction.<sup>91</sup> Because of the profitability of fund commission business, many NYSE members are willing to give up as much as 60 percent of the commissions on such orders—some will give up 70 percent or even more.<sup>92</sup>

NYSE rules prohibit members from sharing with nonmembers commissions on transactions executed on that exchange.<sup>93</sup> Fund managers, therefore, place orders for NYSE-listed securities traded on regional exchanges with brokers who are members of both the NYSE and one or more regional exchanges in order to channel give-ups to dealers in fund shares who are members only of a regional exchange. Regional exchanges also have competed with the NYSE for mutual fund business by fashioning rules that allow give-ups of brokerage income to dealers who sell fund shares but who are not members of any exchange. Increases in regional exchange trading volume in recent years are largely due to the use of regional exchanges by the funds.<sup>94</sup> Mutual fund transactions on regional exchanges often are "crosses" of orders that have been arranged and negotiated elsewhere and later brought to the floor of the exchange for formal execution.<sup>95</sup>

(c) *Impact of mutual fund reciprocal and give-up practices*

Although reciprocity—doing business with people who do business with you—is an accepted custom of the business world, in the mutual fund industry it takes on a unique character. The use of the funds' brokerage commissions as extra compensation to retail sellers of fund shares primarily benefits their adviser-underwriters rather than the funds and their shareholders.<sup>96</sup>

Under existing commission rate structures, mutual fund shareholders could derive greater benefits from their brokerage commissions if the give-up portions of the commissions were transmitted to the funds themselves or their adviser-underwriters for the purpose of reducing management costs. However, in the face of competitive pressures managers of the dealer-distributed funds have not used brokerage for this purpose.<sup>97</sup>

The increasing importance of brokerage as compensation for sales of fund shares presents a potential for harmful effects on fund management. The need to allocate brokerage for sales may tempt fund advisers to skimp on the allocation of brokerage for investment advice or other nonsales services of greater benefit to the funds than the accelerated sale of new shares.<sup>98</sup> Even more important, it creates pressures for ("churning," i.e., frequent sales and purchases of

<sup>90</sup> Pp. 167-168, *infra*.

<sup>91</sup> Pp. 169-170, *infra*.

<sup>92</sup> P. 170, *infra*.

<sup>93</sup> *Ibid.*

<sup>94</sup> Pp. 170-171, *infra*.

<sup>95</sup> Pp. 171-172, *infra*.

<sup>96</sup> P. 172, *infra*.

<sup>97</sup> Pp. 172-173, *infra*.

<sup>98</sup> Pp. 173-174, *infra*.