CHAPTER II

THE INVESTMENT COMPANY INDUSTRY

'Thisis a background chapter. It outlines the structural and regula- 'tory context that gives rise to the specific problems discussed in subsequent chapters and 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.

A. WHAT IS AN INVESTMENT COMPANY?

1. *The investment company concept*

In broad terms, an investment company is any arrangement by which a number of persons invest funds in a "company" that is itself (engaged in investing in securities. Most such arrangements are— regardless of their legal nature under local law—investment companies within the meaning of that term as used in the Act,[1] the Special Study and in this report.[2] Within the investment company industry there are a variety of different organizational forms. Most investment companies are corporations, but a significant minority are organized as trusts, including Massachusetts Investors Trust, the second largest investment company in the United States with assets of approximately $2.1 billion on June **30, 1966.**[3] Other organizational forms are also used. For example, the Adams Express Co., which was originally in the transportation business but since 1918 has been an investment company, is a joint-stock company.[4] The range of possible legal forms includes partnerships, agency relationships, and other

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[1] The Act achieves such breadth of coverage by defining "company" in see. 2(a)(8) as "a corporation, a partnership, an association a joint-stock company, a trust, *a fund* or *any* organized group *of persons* whether *incorporated* or *not* * * *" anh by defining "investment company" in sec. 3(a)(1) as "any issuer which * * * is **or** holds itself out as being engaged primarily or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities". (Emphasis added.) The sec. 3(a)(1) definition is supplemented by other tests found in secs. 3(a)(2) and 3(a)(3). See note **9** on p. 34, infra But some arrangements that fall within the broad definitions **of** secs. 3(a) and 2(a)(8) are not subject to regulation under the Act. See pp. 35-37, infra.

[2] This definition is limited to companies which invest in securities. Thus companies formed for the purpose of trading in commodity futures and companies primarily engaged in the business **of** investing and trading in real estate rather than in securities issued by the owners of interest in real estate are not **normally** investment companies within the meaning of the Act. For this reason, real estate investment trusts which qualify as such under the Real Estate Investment Trust Act of **1960** (secs. 856 to **858** of the Internal Revenue Code **of 1954,**,as amended)—though labeled "investment trusts"—are seldom investment companies within the meaning **of** the Act.

[3] The earliest English and Scottish investment companies on which later American companies were modeled were organized as common law trusts. See Bullock, The Story **of** Investment Companies 1–14 (1959). The oldest existing American investment company, the Boston Personal Property Trust, was organized as a trust in 1893 and has adhered to that form of organization ever since. Perhaps because of the prominence of the trust device in the formative era of the investment company industry, investment companies, including those that were organized as corporations, were generally referred to as "investment trusts" prior to 1940. Since **1940** the term "investment company" used in the Act has superseded the earlier generic label of "investment trust." Certain specialized types **of** investment companies are still called 'unit investment trusts." *See* pp. 38, 57–58, infra.

[4] This is a form **of** business organization akin to a partnership in that under the common law the investors are subject to unlimited personal liability **for** the debts **of** the enterprise (except in jurisdictions where the common law rule has been modified by statute, e.g., Mich. Stat. Ann. Sec. **20.92 (1959)**) but akin *to* a corporation in that the capital of the enterprise @ composed **of** freely transferable shares of capital stock. For discussions of the legal attributes of the joint-stock company. see Warren, Corporate Advantages Without Incorporation (1929): 1 Fletcher, Cyclopedia of the Law **of** Private Corporations 64–81 (1963 revised volume). See also ***Hibbs*** **v.** Brown, **190 N.Y. 167, 82 N.E. 1108 (1907).**

arrangements generally not recognized under State law as independent legal entities.[5]

Differences in organizational form can be of some moment to investors. Trusts organized prior to 1940 are still managed by self-perpetuating bodies of trustees rather than by elected boards of directors.[6] Trusts organized since **1940** entail at least a theoretical risk of unlimited liability.[7] So in most instances do joint-stock companies. However, the wide choice of organizational forms has little bearing on the economics of the industry or the regulatory problems that result therefrom and is of no special significance for purposes of this report.[8]

of no special significance for purposes of this report.[8]

2. Statutory exclusions

There are a number of important exclusions from the Act's broad definition of investment company.[9] To begin with, the statutory definition does not extend to many large industrial and other types of holding companies.[10] The Act is also limited to companies in which there is a significant public interest, since it excludes from its coverage a company that has no more than 100 security holders [11] and is neither

[5] At the time of the Act's passage there were several investment companies in existence that did not fit into conventional legal categories. One fairly prominent one was the Alexander Fund. It was neither a corporation, nor an association, nor a trust. The Alexander Fund was merely a descriptive name given to the commingled funds of a group of persons who at first employed W. Wallace Alexander and later his corporate successor, W. Wallace Alexander, Inc., as their agent for the purpose of investing and managing their money. The Alexander Fund was liquidated soon after the Act went into effect.

Investment companies may be created by similar arrangements on the part of insurance companies, banks, and other companies when they establish special accounts for the purpose of investing other persons' funds in securities. Such accounts are significant today. See pp. 35-37, infra.

[6] Although the total absence of investor control over the enterprise under the traditional trust form was a matter of concern in 1940, there was reluctance to impose any serious structural modifications on the numerous existing common law trusts whose indentures did not call for the election of trustees by the beneficiaries. Accordingly, it was determined to permit the continued government of such existing trusts by self-perpetuating bodies but to require elected trustees in the case of new trusts, and to empower the holders of two-thirds of the beneficial interest in pre-1940 trusts to remove those trustees who are natural persons. See Act, sec. 16(b).

[7] The Supreme Judicial Court of Massachusetts, the jurisdiction in which the trust form of investment company is most widespread, has held that a trust instrument empowering the beneficiaries to remove the trustees and to appoint successor trustees creates a partnership, not a trust. *Frost* v. *Thompson*, 219 Mass. 360, 106 N.E. 1009 (1914).

[8] The consequences to the investor of the particular form of organization chosen by a given investment company are, of course, required to be disclosed in its prospectus.

[9] Sec. 3(a) of the Act defines "investment company" as "any issuer which—

"(1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

"(2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or

"(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

"As used in this section, 'investment securities' includes all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority owned subsidiaries of the owner which are not investment companies."

The face-amount certificate business referred to in sec. 3(a)(2) is described at pp. 37-38, infra.

The term "Government securities" in sec. 3(a)(3) refers only to securities issued or guaranteed by the United States (sec. 2(a)(16)). Accordingly, securities issued by the States of the United States, their local governmental subdivisions, and foreign governments are "investment securities." The term "employees' securities companies" in that same subsection relates to companies the securities of which are held by the employees of a single employer or of two or more employers, each of which is an affiliated company of the other (sec. 2(a)(13)).

[10] The Act focuses on companies for which investing in securities is an end in itself rather than a means of controlling and operating businesses. Thus, companies that come within the provisions of sec. 3(a)(3), but are primarily engaged, directly or through a wholly owned subsidiary or subsidiaries, "in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities" are not investment companies for purposes of the Act. Sec. 3(b)(1).

Other companies that come within the provisions of sec. 3(a)(3) may be excluded from coverage under the Act if the Commission finds and by order declares them "to be primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities either directly or (a) through majority owned subsidiaries or (b) through controlled companies conducting similar types of businesses." As to "controlled companies" see sec. 2 (a)(9) and as to "majority owned subsidiaries" see sec. 2(a)(23). For an interpretation of sec. 3(b)(2), see *American Manufacturing Company*, Investment Company Act Release No. 3649 (Mar. 11, 1963).

[11] The 100 security holder test relates to beneficial ownership. Beneficial ownership by a company is deemed beneficial ownership by a single person, except where more than 10 percent of the issuer's out-

making nor presently proposing to make a public offering of its securities.[12] It further excludes companies primarily engaged in the underwriting and distribution of securities;[13] banks; common trust funds maintained by a bank for the exclusive purpose of investing funds contributed to it in its capacity as trustee, executor, administrator or guardian; insurance companies; savings and loan associations and kindred institutions;[14] companies regulated or supervised by the Board of Governors of the Federal Reserve System, the Interstate Commerce Commission, or this Commission under the Public Utility Holding Company Act of 1935;[15] companies primarily engaged in certain types of money lending operations;[16] and certain other classes of issuers.[17] The excluded categories consist for the most part of issuers for whom investment in securities is an activity ancillary to another purpose which is the fundamental object of the enterprise. Moreover, many issuers in those categories are subject to State and/or Federal regulatory statutes. However, if in addition to its normal business activities, such a company creates an investment company, the investment company so created is subject to regulation under the Act.[18]

3. Investment companies created by insurance companies and banks

Certain relatively recent developments in insurance and in banking are very much in point here. The annuity contracts traditionally sold by life insurance companies bind the company to pay a fixed-dollar amount to the annuitant at fixed intervals beginning with a certain year of his or her life. The company has the burden, and bears the risk, of providing the promised sums. Accordingly, the company usually invests most of the premiums it receives in real estate mortgages and debt securities to minimize its risk and assure its ability to make the payments. However, in recent years concern over inflation has led certain insurance companies to search for some device that may afford contract holders an opportunity to benefit from rising market prices for equity securities and thereby protect them against a possible decline in the purchasing power of the dollar. For this purpose the "variable annuity" was developed.

The variable annuity gives the contract holder a varying payment measured by the fluctuating market value of a pro rata share of a portfolio of equity securities. Although variable annuities include a longevity factor, they differ fundamentally from traditional annuity contracts because they: (1) substitute a promise to pay an uncertain amount for a promise to pay a certain amount; and (2) transfer from the insurer to the contract holder the risks inherent in a portfolio of equity securities—a portfolio quite different in nature from the bonds and the mortgages of the traditional life insurance company portfolio. These features of variable annuity contracts, together with the fact that the insurance company segregates the equity securities from the remainder of its holdings, result in the creation of an investment

[12] Both conditions must be satisfied before the exclusion applies. Sec. 3(c)(1).
[13] Sec. 3(c)(2).
[14] Sec. 3(c)(3).
[15] Secs. 3(c)(4), 3(c)(9), and 3(c)(10).
[16] Secs. 3(c)(5) and 3(c)(6).
[17] Among them are charitable, educational, and similar nonprofit companies (sec. 3(c)(12)); employees' stock bonus, pension, or profit-sharing trusts that meet certain conditions imposed by the Internal Revenue Code (sec. 3(c)(13)); voting trusts, the assets of which consist exclusively of the securities of a single issuer that is not itself an investment company (sec 3(c)(14)); and security holders' protective committees that issue no securities other than certificates of deposit and short-term paper (sec. 3(c)(15)).
[18] See sec. 2(a)(8).

company for which the traditional scheme of life insurance regulation is inadequate.[19] The contractual arrangements create a specific, segregated group of securities with respect to which a class of persons has rights and which is therefore a "fund" under the Act.[20] The absence of a legal entity of the traditional type (e.g., a corporation) is of no consequence because the holders of the variable annuities constitute an organized group of persons brought together by, and associated with, the insurance company which initiated the contractual arrangements.[21]

Collective investment accounts created by banks to attract broad investor interest and not formed for traditional fiduciary purposes may also result in the creation of investment companies subject to regulation under the Act. As previously noted, the Act exempts banks and common trust funds maintained by banks for the exclusive purpose of investing the funds of trusts and estates administered by them.[22]

However, when a bank invites customers for whom it is not acting as trustee, executor, administrator, or guardian to contribute to a common fund which the bank will invest in securities,[23] the bank assumes a new function which results in the formation of a statutory investment company sponsored by the bank.[24] This is so whether or

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[19] As Mr. Justice Brennan pointed out in his concurring opinion in *S.E.C. v. Variable Annuity Life Insurance Co.*, 359 U.S. 65, 77–80 (1959), the traditional combination of fixed-dollar obligations running from insurer to insured and state regulation with respect to reserves, solvency, and permissible investments is designed to insulate assureds, including annuitants, from investment vicissitudes. The essence of the variable annuity, on the other hand, is the absence of an obligation to pay a fixed amount and the annuitants' assumption of the risks of equity investment.

[20] See sec. 2(a)(8).

[21] *S.E.C. v. Variable Annuity Life Insurance Co. of America*, 359 U.S. 65 (1959); *Prudential Insurance Company of America v. S.E.C.*, 326 F. 2d 383 (C.A. 3. 1963), *affirming Prudential Insurance Company of America*, Investment Company Act Release No. 3620 (January 22, 1963), *certiorari denied*, 377 U.S. 953; *The Variable Annuity Life Insurance Co. of America*, Investment Company Act Release No. 2974 (February 25, 1960). In *S.E.C. v. United Benefit Insurance Company*, 359 F. 2d, 619 (C.A. D.C. 1966), the Act was held inapplicable to variable contracts that contained a "minimum cash value" provision and also provided for fixed monthly payments during the "payout" period. In the court's view the insurance company had retained a sufficient share of the investment risk to qualify the contract as an insurance contract. The Commission considers this decision erroneous. Its application for a writ of certiorari was granted by the Supreme Court on Oct. 24, 1966. 87 Sup. Ct. 228.

[22] Sec. 3(c)(3).

The common trust fund concept was in origin and remained for many years an adjunct of the banks' performance of their traditional fiduciary functions. It was developed for the purpose of facilitating bank administration of small trusts and estates and permitted portfolio diversification to an extent that would otherwise have been impracticable. See 3 Scott, The Law of Trusts 1683–1693 (2d ed. 1956); Bogue, *Common Trust Fund Legislation*, 5 Law and Contemp. Probs. 430 (1938); Mundheim and Henderson, *Applicability of the Federal Securities Laws to Pension and Profit-Sharing Plans*. 29 Law and Contemp. Probs 795 (1964) The statutory exemption was based on a study of common trust funds made by the Commission in 1939. That study found common trust funds to be purely an adjunct of the trust phase of the banking business. It stated that: "Participation in a common trust fund is restricted to trust estates of which the trustee is the bank or trust institution which sponsors common trust funds. Furthermore, an individual trust estate may be commingled or participate in the common trust fund only if the instruments creating the individual trusts authorize not only the commingling of such trust estate with other trust estates in a single unit, but also permit investment in the type of assets in which the common fund is ultimately to be invested." Investment Trust Study. *Supplemental Report on Commingled or Common Trust Funds Administered by Banks and Trust Companies* (H.R. Doe. No. 476, 76th Cong., 1st sess) 7–8 (1939).

[23] The authority of banks to commingle funds for collective investment purposes has been greatly broadened in recent years by the Comptroller of the Currency Compare 27 Fed. Reg. 9767 (1962), the former regulation governing banks' collective investment activities, with 12 C.F.R. sec. 9.18 (1966 supplement), the revised regulation.

[24] The First National City Bank, the second largest bank in New York City and the third largest bank in the Nation, has established such an investment company known as "First National City Bank—Commingled Investment Account," and the Commission has been informed that a number of other banks also plan to establish investment companies of this character. Participations in First National City's investment company will be available only to customers who invest a minimum of $10,000 in its fund. A petition for review of the Commission's decision to exempt the First National City Bank from certain provisions of the Act (*First National City Bank*, Investment Company Act Release No. 4,538 (Mar. 9, 1966)) is now pending before the Court of Appeals for the District of Columbia Circuit.

A number of banks have already formed and are now managing commingled investment pools consisting of funds deposited with them by self-employed persons who have elected to avail themselves of the benefits of the Self-Employed Individuals' Retirement Act of 1962 (76 Stat. 809, Internal Revenue Code of 1964, secs. 404(a)(1), 404(c)(1)) and by the employees of such persons. Because of this limitation, these existing funds are a specialized type of employees' pension trust. Such funds have been regarded as excluded from the purview of the Act by sec. 3(c)(13). See tbe statement of the Commission's then Chairman in *Common Trust Funds–Overlapping Responsibility and Conflict in Regulation, Hearing Before a Subcommittee of the House Committee on Government Operations*, 88th Cong., 1st sess. 7 (1963). But the question is not free from doubt.

not the formality of requiring a separate account with each person is observed.

4. *Administrative exemptive powers*

When the Act was under consideration, it was recognized that there were and would be investment companies that did not fall under any of the specific exclusions heretofore discussed, but which nevertheless presented peculiar situations rendering it unnecessary or unwise to treat them as investment companies for some or all purposes of the Act. To permit the individualized treatment called for in these and in other circumstances and to avoid undue administrative rigidity, the specific statutory exclusions were supplemented by vesting in the Commission the broad discretionary exemptive powers set forth in section 6(c).[25] Among the exceptional situations in which the Commission has found it appropriate in the public interest and consistent with the protection of investors to grant investment companies complete exemptions from the Act are cases in which public investors held only a minute fraction of the company's outstanding shares,[26] in which the company was formed for the purpose of educating its stockholders rather than that of making money for them,[27] in which the company's dominant aim was the rendition of aid to a foreign country rather than the attainment of normal investment objectives,[28] and those in which foreign nationals held all or almost all of the beneficial interest.[29]

B. TYPES OF INVESTMENT COMPANIES

The Act divides registered investment companies into three classes: (1) face-amount certificate companies; (2) unit investment trusts; and (3) management companies.[30]

1. *Face-amount certificate companies*

Face-amount certificate companies issue so-called "face-amount certificates." These certificates are contracts under which the company is bound to pay a fixed sum at maturity (the face amount of the certificate) to a purchaser who has made a single payment or a series of specified installment payments.[31] Purchasers who fail to continue their installment payments through to the maturity date are nevertheless entitled to receive specified surrender values measured by the amounts actually paid in. During the early years of the certificate's life, however, the surrender value is much lower than the amount of the payments made.[32] Face-amount certificates are fixed-dollar obligations offering an almost entirely predetermined rate of return.[33]

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[25] Tbe section reads in pertinent part:
"The Commission * * * may * * * exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title * * * and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

[26] *The Hutchins Securities Company*, 12 S.E.C. 431 (1942); *Maritime Corporation*, 9 S.E.C. 906 (1941); *The Fitrust Corporation*, 9 S.E.C. 901 (1941).

[27] *Ecclyco Incorporated*, 22 S.E.C. 784 (1946). (The company was organized by a professor and his classes in an advanced economics course at a prominent college as an adjunct to instruction.)

[28] *Israel American Industrial Bunk. Limited*, Investment Company Act Release No. 2526 (May 13, 1957); *Ampal-American Palestine Trading Corporation*, 25 S.E.C. 24 (1947).

[29] *Paribas Corporation*, 40 S.E.C. 487 (1961); *Providentia, Ltd.*, 24 S.E.C. 179 (1946); *Hudson Trading and Investing Corporation*, 9 S.E.C. 220 (1941).

[30] Sec. 4.

[31] Sec. 2(a)(15).

[32] Sec. 28(a)(2).

[33] Face-amount certificate companies do on occasion vote supplemental credits in addition to the interest rate called for by the certificate.

They are debt, not equity securities,[34] and offer a systematic savings program, a higher degree of safety than the ordinary equity security, rates of return lower than those now obtainable from federally insured savings institutions and on United States Government securities,[35] and no prospect of capital appreciation. Moreover, up to one-half of the money that the purchaser pays during the first year of the certificate's life may be deducted for sales compensation.[36]

The face-amount certificate business is now a small segment of the investment company industry. The *six* active face-amount certificate companies that were registered with the Commission on June 30, 1966, had assets on that date of some $1 billion, which was about 2.3 percent of the total assets of all registered investment companies.[37]

2. Unit investment trusts

Unit investment trusts sell redeemable interests in units of specified securities.[38] They are of two types. One type of unit investment trust holds a variety of specific securities. The other type invests all of its assets in a *single* security.

Changes in the underlying securities are seldom made and are usually permissible only on the happening of certain specified contingencies. Hence the trusts' managers have no appreciable discretionary power in the management of the trust assets.[39] Unit investment trusts with diversified portfolios were numerous and popular in the early 1930's. Since that time their importance has dwindled.[39a]

The single security type of unit investment trust, however, is of considerable importance. This type of trust issues "periodic payment plan certificates" which almost always evidence interests in a portfolio consisting solely of shares of a specific investment company. A purchaser of a periodic payment plan certificate[40] acquires an interest in, but not direct ownership of, the underlying investment company's shares. Since the purchaser pays for his interest in fixed monthly installments over a period of years, this type of unit investment trust serves merely as a mechanism for buying investment company shares on an installment payment basis. The aggregate net assets of the 90 unit investment trusts of the periodic payment plan type that were registered with the Commission on June 30, 1966, amounted to about $8.5 billion, approximately 7.5 percent of the aggregate assets of all other registered investment companies on that date.[41]

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[34] Face-amount certificates companies must maintain certain minimum reserves. Sec. 28(a)(2). They must also have at least $250,000 of paid in capital stock. Sec. 28(a)(1).

[35] *Cf.* Act sec. 28(a)(2)(A).

[36] See pp. 247–249, infra.

[37] One of these companies, Investors Diversified Services, Inc., and its wholly owned, subsidiary, Investors Syndicate of America, Inc., account for 95 percent of all the assets of the 6 active face-amount certificate companies.

[38] All securities issued by a unit investment trust must be redeemable. Act sec. 4(2).

[39] For this reason, unit investment trusts were usually referred to as "fixed trusts" prior to the passage of the Act. There was at one time a widespread belief that fixed trusts offered a higher degree of safety than other types of investment companies. See Investment Trust Study, *Supplemental Report on Fixed and Semifixed Investment Trusts*, H.R. Doc. No. 567, 76th Cong., 3d sess. (1940) 24-35.

[39a] Most of the contemporary Unit trusts of this type invest in municipal bonds.

[40] See Act sec. 2(a)(26) for the definition of a "periodic payment plan certificate."

[41] Unit investment trusts of the periodic payment type customarily deduct one-half of the investor's first 12 monthly payments for sales charges. In this respect unit investment trusts of the periodic payment type resemble face-amount certificate companies. For a fuller discussion of the cost of investing in periodic payment plan certificates—commonly referred to as "contractual plans" see pp. 57–58, 223–247, infra.

3. Management companies

Management companies are a residual category.[42] They are investment companies that are neither face-amount certificate companies nor unit investment trusts. The managements of such companies enjoy relatively unfettered investment discretion and within the limitations of investment objectives and restrictions stated in the prospectuses are usually authorized to invest in such securities as they deem proper. Management companies dominate the modern investment company industry. They are far more numerous than either of the other types.[43] On June 30, 1966, management companies had 96.5 percent of the $46.4 billion in assets held by all investment companies registered with the Commission on that date.[44] All subsequent references to "investment companies," unless the context clearly indicates otherwise, will be to management companies.

C. TYPES OF MANAGEMENT INVESTMENT COMPANIES

1. Introduction

Management companies are divided into four mutually exclusive classes by means of two overlapping tests. One test, the diversification test, is functional. It turns on the distribution of a company's portfolio investments among the securities of different issuers.[45] The other, the closed-end versus open-end test, is structural. It turns on whether an investment company is either offering for sale or has outstanding any redeemable security of which it is the issuer.[46] If neither, it is a closed-end company.[47] A security is redeemable if by its terms the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled to receive approximately his proportionate share of the issuer's current net assets or the cash equivalent thereof.[48]

Accordingly, every management company belongs to one—and only one—of the following four classes:

(1) Diversified, open-end.
(2) Non-diversified, open-end.
(3) Diversified, closed-end.
(4) Non-diversified, closed-end.

2. Diversified versus non-diversified

A company is "diversified" for purposes of the Act if it invests—with respect to 75 percent of its total assets—not more than 5 percent of its total assets in the securities of any one company and in securities representing not more than 10 percent of the outstanding voting securities of any one company.[49] Where a failure to meet these

[42] Sec. 4(3).

[43] 528 of the 667 investment companies registered with the Commission on June 30, 1966, were of the management type.

[44] To avoid "double counting" the $3.5 billion of assets held by those unit [illegible] trusts that invest solely in the shares of management investment companies have been excluded.

[45] See Act sec. 5(b).

[46] Act sec. 5(a)(1).

[47] Act sec. 5(a)(2).

[48] Act sec. 2(a)(31).

[49] The Act's definition (sec. 5(b)(1)) is as follows:

"Diversified company" means a management company which meets the following requirements: At least 75 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer."

It will be noted that the foregoing definition divides the assets of diversified investment companies into two segments. One segment, which must amount to at least 75 percent of total assets must be diversified. The other, which may amount to as much as 25 percent of total assets, need not be diversified and may indeed be invested in the securities of a single issuer. This approach permits a diversified company to commit substantial portions of its resources to special situations without losing its diversified status.

requirements results from postacquisition changes in security prices, the company does not lose its diversified status.[50]

Any management company other than a diversified company is classified as a "non-diversified" company by the Act.[51] The diversification of which the Act speaks is not diversification among different. types of securities, such as bonds and stocks, common stock and preferred stock, or relatively speculative as against relatively conservative issues. So far as the Act is concerned a company can be "diversified" even if it confines its investments to bonds or to preferred stocks.[52] Nor is the Act concerned with diversification among industries. Many "diversified" companies limit themselves to investments in a specific

An investment in a diversified company represents an indirect interest in the securities .of numerous issuers, all of which may be—and sometimes are—engaged in one industry. In contrast, an investment in a non-diversified company may represent an indirect interest in the securities of a small group of companies or sometimes of a single company.[54]

There are, however, a number of companies that are "non-diversified" for purposes of the Act because their portfolios do not meet the Act's tests but which nevertheless offer investors a considerable degree of diversification.[55] Non-diversified companies of this type [56] are functionally more akin to the diversified companies than to the highly concentrated type of non-diversified company.

The primary incentive for the maintenance of diversified portfolios stems not from the Act but from the Internal Revenue Code, which treats "regulated investment companies" that meet the Code's diversification tests in a special way. Except for the fact that they apply to 50 percent rather than to 75 percent of a company's assets, the Code's diversification standards are similar but not precisely identical.

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[50] Sec. 5(c) of the Act provides that "a registered diversified company which at the time of its qualification as such meets the requirements * * * shall not lose its status as a diversified company because of any subsequent discrepancy between the value of its various investments and the requirements * * * so long as any such discrepancy existing immediately after its acquisition of any security or other property is neither wholly nor partly the result of such acquisition."

[51] See. 5(b)(2).

[53] A number of diversified companies do so.

[53] The largest of them are Insurance Securities Trust Fund (assets about $1.1 billion on June *30*, 1966). which limits itself to insurance company, insurance holding company, and bank stocks, and Chemical Fund, Inc. (assets approximately *$437* million on June 30, 1966) which invests in the securities of companies engaged in the chemical industry, Both are "diversified" within the meaning of the Act, although neither purports to offer the investor a wide diversification among industries.

In addition, there are a number of investment companies which are registered as "non-diversified" but. which in fact offer investors a considerable degree of diversification among issuers within limits prescribed by the companies' specialized investment policies. Some investment companies of this latter type offer geographical specialization, .Examples are **Eurofund, Inc.** (June *30*, 1966, assets about *$25* million), which invests in European securities, the Japan Fund, Inc (June 30, 1966, assets about $28 million) which has over 90 percent of its assets invested in Japanese common stocks, and Israel Development Corp. (June *30*, **1966,** assets about *$20* million) which concentrates on Israeli securities.

Although these specialized mvestment companies are sometimes called "specialty funds," many of them are not mutual funds.

[54] Coca-Cola International Corp. (assets approximately $448 million as of June 30,1966) is an example of this type of non-diversified company. Coca-Cola International holds approximately 6½ million shares of the common stock of the Coca-Cola **Co.** which, except for a small amount of cash on hand and some short-term U.S. Government securities, is its only asset. Christiann Securities Co., the second largest of all registered investment companies (assets approximately **$2.6** billion on June 30, 1966), is another non-diversified company of this type. Christiana's substantial holdings of the common and preferred **stocks of E. I.** du Pont de Nemours & Co. account for over 97 percent of its total **assets.** Coca-Cola International and Christiana are investment companies because the former does not manage Coca-Cola nor the latter **Du** Pont. Act sec. 3(b)(1). They are non-diversified management companies rather than unit investment trusts because: (a) they issue shares of then' own stock whereas unit mvestment trusts issue certificates of beneficial interests in the securities that they hold; and (b) they are corporations whereas unit investment trusts are noncorporate units which have no boards of directors.

[55] For example, a company that commits 35 percent of its assets to the, securities of a single issuer but places the **remaining** 65 percent in relatively small holdings of the securities of numerous issuers offers an appreciable measure of diversification, although the size of its commitment to the single issuer precludes it from being considered "diversified" under the Act.

[56] **Oppenheimer Fund,** Inc. (assets approximately **$75 million** as **of June 30,** 1966) is such a "non-diversified" **company.**

to those of the Act.[57] Generally speaking, registered investment companies that do not meet the diversification tests of the Code enjoy no special tax advantages.[58] Their income is usually taxed in the same way and at the same rates applicable to other corporations.[59] Companies that are diversified for purposes of the Code, on the other hand, enjoy a signscant tax advantage over other corporations. In fact, few of them ever pay any Federal corporate income tax.

Such special Federal income tax treatment allows diversified investment companies to pass their pretax ordinary income on to their shareholders. It also enables diversified investment companies and their shareholders to avoid double taxation on net long-term capital gains realized by the companies. To obtain this favorable Federal income tax treatment, a diversified investment company, however, must distribute at least 90 percent of its ordinary income in the form of dividends.[60] Thus, these tax advantages are obtainable only by sacrificing the right to add substantial portions of the company's earnings to its capital. Most diversified companies choose the tax advantages. Hence they distribute all or substantially all of their ordinary income to their shareholders.[61] Most of these companies also distribute all or substantially all of their net long-term capital gains to their shareholders even though there is no special tax reason for so doing. The pertinent provisions of the Internal Revenue Code are discussed in somewhat more detail in the appendix to this chapter.

Diversified companies hold more than 80 percent of all management investment company assets. In terms of numbers of shareholders, the preponderance of the diversified investment companies is especially striking. On December 31, 1965, the ten largest diversified companies had about 2,686,000 shareholder accounts, while the corresponding total for the ten largest non-diversified companies was only about 120,000.[62]

3. Open-ends and closed-ends.

As has been pointed out, the distinction between an open-end company and a closed-end company is the presence of a redeemable security in the open-end company's capital structure.[63]

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[57] Compare sec. 851(b)(4) of the Internal Revenue Code of 1954 with sec. 5(b)(1) of the Act.

[58] The use of the phrase "special tax advantages" is not meant to imply that the Commission disagrees with or questions the treatment that the Internal Revenue Code now gives diversified investment companies.

[59] Internal Revenue Code, sec. 851(b)(4). Joint-stock companies and associations are treated as corporations for Federal income tax purposes. Internal Revenue Code, sec. 7701(a)(3).

However, some non-diversified companies enjoy a tax position even better than that of the diversified companies. These are former public utility holding companies that chose to transform themselves into non-diversified investment companies in order to comply with the Public Utility Holding Company Act of 1935. Some such companies, among them the United Corp. (approximate June 30, 1966, assets $145 million), Electric Bond & Share Co. (approximate June 30, 1966, assets $219 million), Standard Shares, Inc. (formerly Standard Power & Light *Corp.*) (approximate June 30, 1966, assets $56 million), and Abacus Fuud, Inc. (formerly International Hydroelectric System (approximate June 30, 1966, assets $42 million), hold quantities of utility stocks acquired during the 1920's at prices considerably in excess of those now prevailing. Sales of these high cost utility shares generate losses in excess of income. Hence these companies have no earnings or profits and pay no Federal corporate income taxes. Under sec. 316 of the Internal Revenue Code, the amounts that they distribute to their stockholders are not dividends which are taxable to the recipient as ordinary income. but tax-free returns of capital.

[60] If any of the remaining 10 percent of their ordinary income is retained by such companies, it will be subject to corporate income tax.

[61] Many of the companies offer programs pursuant to which shareholders can invest their dividends and capital gain distributions *in* new shares. Because substantial numbers of shareholders have chosen to avail themselves of these programs, much of the money that the companies distribute to their shareholders finds its way back to their treasuries in exchange for new shares issued to existing shareholders.

[62] These figures show aggregates of shareholder accounts and thus include some persons who own shares in two or more iuvestment companies. To some extent that cannot be determined with precision: the raw figures understate the number of shareholders in the uon-diversified companies. This is so because much lion-diversified stock is held in the names of nominees. In a non-diversified company shares of record held by a single nominee may be owned beneficially by a number of persons. In the diversified companies (especially in the open-end diversified companies, and the ten largest diversified companies are all of the open-end type) there is much less divergence between record ownership and beneficial ownership. See note 82, on page 44, infra.

[63] *See* p. 39, supra.

Since a closed-end company is under no obligation to redeem, that is, buy back its own shares, its capita3 structure is much like that of companies in other areas of the economy.[64] Equity capital contributed by the public is viewed as permanently committed to the enterprise. Shareholders who wish to sell must find buyers on a securities exchange or in the over-the-counter market.[65] The selling price is determined by market forces and is seldom identical to net asset value. Similarly, investors who wish to buy most normally buy from existing shareholders, not from the company itself. The company is not engaged in a continuous quest for new equity capital.

Closed-end companies can make continuous offerings of their own securities. But very few of them actually do so. Indeed, established closed-end companies seldom make new public offerings of any sort except through reinvestment programs under which existing stockholders can reinvest their dividend and capital gain distributions in new shares and through rights offerings pursuant to which existing stockholders can purchase new shares. In recent years shares of closed-end companies generally have tended to sell at discounts from net asset value.[66] Under these circumstances a new offering of a closed-end company's shares would have to be made at a price that would dilute the interests of existing shareholders.[67]

An open-end company is under a legal duty to redeem its shares at their approximate current net asset value. Shareholders who wish to dispose of their shares usually sell to the issuer rather than resort to the securities markets, as there is only a small trading market for open-end shares.[68] Since there will always be some shareholders who

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44 In the case of closed-end companies, however, the extent of the permissible debt component is limited by sec. 18(a) of the Act..

65 Closed-end companies can repurchase their own securities, but. are "der no obligation to do so. A closed-end company's decision to repurchase its own shares is a busmess judgment voluntarily arnved at, not a legal obligation.

The repurchase practices of closed-eiid companies are governed by sec. 23(c) of the Act, which requires that such repurchases he made either: (1) in the open market, in which event notice of intention to repurchase must be given to the affected class of security holders; or (2) pursuant to tenders made to all holders of securities of the class to be purchased; or (3) by such other fair and nondiscriminatory procedures as the Commission may by rules and regulations permit.

The repurchase programs of closed-end mvestment companies and of other companies whose securities are traded on exchanges and m the over-the-counter market raise questions under the antimanipulation and the antifraud provisions of the Securities Exchange Act of1934 (see pp. 61–62 infra). Because of these questions and also because extensive repurchases would result in a material shrinkage in the repurchasing company's size, closed-end investment companies have seldom elected to repurchase substantial quantities of their own stock.

66 See table II–1 at p. 44, infra.

67 Under sec. 23(b) of the Act, such an offering would require the consent of a majority of the existing shareholders or the approval of the Commission.

68 Unlike the redemptiou feature of open-end companies' shares, the continuous offering feature is a voluntary management decision. A few open-end companies have ceased to make continuous public offermgs of new shares. Examples are State Street Investment Corp. with assets of approximately $347 million on June 30,1966, and the Laeard Fund, Inc., whose assets amounted to about $92 million on that date., When an open-end company stops selling new shares, mvestors who wish to buy its shares cannot obtam them from the issuer. To satisfy that demand, an over-the-counter trading market has developed in these shares. Thus, shareholders who wish to sell need not exercise thew right to redeem. Among the open-end companies that do not make continuous offerings of their own shares are the so-called "exchange funds." Such companies issue shares in exchange for other securities and permit investors to obtain an indirect interest in the company's diversified portfolio of securities in exchange for holdings of the securities of a single issuer or of a small number of issuers. Exchange funds usually refuse to accept contributions of securities the aggregate market value of which is below a certain minimum figure. The amount of this minimum, varies, but $25,000 is a frequent figure. After an initial offering period, exchange funds do not issue additional shares, although they are obligated to redeem share already issued. Exchange funds appeal primarily to investors who wish to dispose of securities in which there has been substantial price appreciation without having to pay an immediate capital gains tax. Their attractiveness to this class of investors stems from the fact that transactions with exchange funds have until recently been deemed non-taxable under sec. 351 of the Internal Revenue Code, which provides that gain or loss shall not be recognized when property is transferred to a corporation solely in exchange for stock and securities and where the transferors of such property are in control of the corporation immediately after the exchange. (See Chirelstein, "Exchange Funds," 75 Yale L.J. 183(1965)). In July of 1966, however, the Internal Revenue Service proposed to amend its regulations so as to make transactions with exchange funds taxable events. Proposed Treas. Reg. & 1.351–1, 31 Fed. Reg. 9549 (July 14,1966). The ensuing uncertainty as to the tax status of exchange funds brought the formation of new funds of this type to a temporary halt. The tax status of these funds has now been clarified by sec. 203 of the Foreign Investors Tax Act of 1966 (Pub. Law 89–909, 80 Stat. at 1577). That statute, enacted on November 13, 1966, provides that certain types of transfers to exchange funds, if made on or before June 30, 1967, are non-taxable.

want to sell, an open-end company must comply with continuous demands for cash from selling stockholders. To offset the resulting cash outflow, and because of the strong incentives for growth created by the structure of the industry, the managers of virtually all open-end companies vigorously promote sales of new shares at all times.

Open-end investment companies are commonly referred to as "mutual funds." Indeed, this term has become a synonym for open-end investment companies.[69]

Today, mutual funds dominate the industry. They have for many years been able to sell new shares at a rate far in excess of the rate at which outstanding shares are redeemed.[70] Because of this excess of sales over redemptions there has been a continuous flow of money into open-end companies. Their growth through new money inflow has been striking.

The growth of closed-end companies, however, has been quite different. As has been noted, closed-end companies do not continuously issue new shares; and since the tendency of their shares to sell at a discount from net asset value normally precludes them from publicly offering new shares, infusions of new capital are rare.[71] Moreover, most corporations that grow from within do so through the retention and reinvestment of earnings. This form of internal growth is not as significant to closed-end companies since, for tax considerations peculiar to investment companies, closed-end companies as well as mutual funds tend to distribute all or almost all of their earnings.[72] Hence the only significant source from which an established closed-end company can grow is appreciation in the value of the securities that it holds.

The "discount" in the trading markets for shares of closed-end companies deters the formation of new closed-end companies. Few have been formed, except as an incident of public utility holding company reorganizations,[73] or for the purpose of investing in foreign securities[74] and in the relatively unmarketable securities of small businesses.[75]

The present dominance of the mutual funds is a complete reversal of the situation that prevailed in earlier years. During the 1920's mutual funds were few and small, while there were many large closed-end companies which held most of all investment company assets.[76] After **1929,** closed ends lost much of their former favor with investors,[77]

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[69] The Act does not refer to "mutual funds," a term which came into vogue during the mid-1940's but ha[illegible] been used to some extent during prior years. See Bullock, The Story of Investment Compani[illegible] 73 (1959[illegible] See also *Hearings on S. 3580 Before a Subcommittee of the Senate Committee on Banking and Cu[illegible]y*, 76t[illegible] Cong., 3d sess. 452 (1940). These, the hearings on the bill that eventually became (with modifications) the Investment Company Act, are hereinafter cited as "Senate Hearings".

[70] During 1965 total sales amounted to about $5.2 billion as against redemptions of approximately $2 billion, for a net new money inflow of roughly $3.2 billion.

[71] The market discount for closed-end shares (see table II-1 at p. 33, infra) is a phenomenon that did not always exist In the pre 1929 era, market quotations for closed-end shares were often appreciably above net asset value Such an excess of market price over net asset value was and still is called a "premium "

[72] *See* p. 23, supra.

[73] See note 59 on **p. 41,** supra.

[74] E.g., Eurofund, Inc., the Japan Fund, Inc.

[75] As of June 30, 1966, 57 active small business investment companies with total assets of $343.2 million were registered with the Commission as closed-end investment companies. These companies were organized under the Small Business Investment Company Act of 1958 to supply capital to small business enterprises.

[76] Investment Trust Study, pt. 2, 3336, 46-56, 375.

[77] The substantial premiums at which closed-end shares had previously sold gave way to substantial discounts. By the close of 1929 the aggregate market value of investment company shares was approximately 35 percent below the actual value of those companies' assets. Investment Trust Study, pt. 3, 1021. During the 1930-35 period, stockholders of closed-end companies declined by 17,000, while stockholders of open-end companies increased by 154,000. Mutual funds were able to sell new securities during the depression years. But closed-end companies found it impossible to do so. See Investment Trust Study, pt. 2, 375-376.

but not until **1944** did the aggregate assets of mutual funds exceed those of the Closed-end companies.[78] By June **30, 1966,** the assets of mutual funds were almost *six* times those of the closed-end companies. On that date there were **379** mutual funds registered with the Corn-mission, with total assets of approximately **$38.2** billion, as against **149** active closed-end companies with total assets of about **$6.6** billion. The open-ends not only hold more assets than the closed-ends,'* they have many more security holders,

The open-end, segment of the mdustry consists almost entirely of diversified companies. Its closed-end segment, on the other hand, is largely non-diversified.[80] When the diversified companies in both segments of the industry are compared to each other, we see that the assets of the diversified closed-end companies are valued at about **$2** billion, approximately one-nineteenth of the assets of the mutual funds. And the 10 largest open-end diversified companies have about **2,686,000** stockholder accounts,[81] more than **10** times the number of stockholder accounts (about **244,000)** in the **10** largest closed-end diversified companies.[82]

Tables II-1 and **11-2** present the data in tabular form.

TABLE *11-1.— The 10 largest diversified closed-end investment companies on June SO, 1966*

Name	Gross assets (millions)	Yet assets per share	Selling price	Percent premium or (discount)	Number of share-holders of record [a] (thousands)
1. Tri-Continental Corp	$535.5	$32.25	$23.63	(26.7)	[b] 47.3
2. The Lehman Corp	439.3	55.49	30.63	(13.7)	36.1
3. Madison Fund, Inc	231.3	20.47	22.63	10.6	66.7
4. U.S. & Foreign Securities Corp	133.0	40.17	29.00	(27.8)	7.9
5. The Adams Express Co	117.8	30.72	29.00	(5.6)	19.5
6 General Public Corp	95.3	6.69	6.00	(10.3)	'37.9
7 Niagara Share Corp	3	22.26	18.50	(16.9)	7.9
8 Consolidated Investment Trust	2	1260	d9.75	(22.6)	11.2
9 General American Investors Co., Inc	8	37.57	34.63	(7.8)	[e] 8.2
10 Investors Securities Corp.	4	19.99	15.25	(23.7)	[g] 1.3
Total	$1,895.0				244.1

[a] Shareholders as of Dec. 31, 1965.
[b] Includes 3,200 holders of preferred stock and 2,900 holders of common stock purchase warrants.
[c] As of March 29, 1966.
[d] Based on published hid and offer quotations in the over-the-countermarket.
[e] Includes 400 holders of prefered stock.
[f] Formerly known as International Holdings Corp.
[g] As of March 1.1966.

[78] Bulloek, The Story of Investment Companies, 98 (1959).

[79] Two diversified open-end companies, Investors Mutual, Inc., with June 30, 1966 assets of about $2.8 billion, and Massachusetts Investors Trust, with assets of about $2.1 billion on that date, each have resources in excess of the aggregate resources of all diversified closed-end companies.

[80] One non-diversified closed-end company, Christians Securities Co. (June 30, 1966 assets about $2.6 billion) holds approximately 39 percent of all closed-end assets although it has only about 10,000 shareholders.

[81] Figures as to numbers of stockholder accounts are as of Dee. 31,1965.

[82] Contrast this 243,000 figure with the roughly 435,000 shareholders of the largest open-end company, Investors Mutual Inc., and with the roughly 363,000 stockholders of the third largest open-end company, Wellington Fund, Inc.

Because much closed-end stock is held in the names of nominees, the number of beneficial holders of closed-end shares is understated to some extent. One of the larger closed-end companies has stated that the number of its beneficial shareowners exceeds the number of its shareholder accounts of record by about 50 percent. Mutual fund shares, on the other hand, are generally held of record in the names of their actual owners. See note 61 on p. 41, supra.

The aggregates in the text relate to shareholder accounts, not to numbers of individuals. Since there is an unknown number of persons who hold shares in two or more investment companies, these figures overstate to some extent the total number of individuals involved.

TABLE II-2.—*The 10 largest diversified open-end investment companies on June 30, 1966*

Name	Net assets (millions)	Number of shareholders [a] (thousands)
1. Investors Mutual, Inc		435.3
2. Massachusetts Investors Trust		217.8
3. Wellington Fund, Inc	1,920.6	[b] 363.4
4. Investors Stock Fund, Inc	1,730.0	[b] 346.3
5. The Dreyfus Fund, Inc	1,539.8	[b] 324.3
6. Affiliated Fund, Inc	1,256.6	202.3
7. United Accumulative Fund	1,245.4	[b] 273.8
8. Fundamental Investors, Inc	1,163.3	[b] 186.0
9. Insurance Securities Trust Fund	1,061.0	191.0
10. Massachusetts Investors Growth Stock Fund, Ine	931.0	[c] 145.3
Total	$15,775.5	2,685.5

[a] shareholders are as of Dec. 31, 1965.
[b] Includes holders of periodic payment plans
As of Nov. 30,1965.

The reasons for and the questions raised by the phenomenal growth of the funds can best be understood by examining the structure of the mutual fund industry.

D. MUTUAL FUND STRUCTURE

1. Introduction

Most mutual funds eontract out their principal functions to other organizations that work for them on a fee basis. This "externalization of management" is the most striking feature of the industry's organizational pattern. The following description of the way in which the funds' most important functions—the selection of investments, the sale of new shares, and the execution of portfolio transactions—are performed delineates the special characteristics of mutual fund structure and paves the way for the more detailed examination found in subsequent chapters.

2. Selecting and supervising investments

All mutual funds operate within the limitations imposed by the fund's fundamental investment policies [83] and certain other guidelines stated in the prospectus.[84] The fundamental policies must be set forth when the company registers with the Commission and cannot be changed without shareholder approval.[85] Most funds invest mainly in common stocks. Some of them aim primarily at capital appreciation and are prepared to assume a relatively high degree of risk in pursuit of that aim. Others place more stress on the conservation of capital and the minimization of risk. Some funds are called "balanced" funds because they maintain relatively balanced portfolios containing common stocks, preferred stocks, and bonds. A few funds limit their portfolios to bonds or a combinntion of bonds and preferred stocks. And, as has previously been noted, most funds aim

[83] The term "fundamental policies" relates to the relatively narrow list of topics enumerated in sec. 8(b)(1) of the Act regarding (1) the statutory classification into which the particular company falls; and (2) its policies with respect to the borrowing of money, the issuance of senior securities, the underwriting of securities issued by persons other than the company itself, the concentration of investments in particular industries or groups of industries, the purchase and sale of real estate and/or commodities and the making of loans to other persons.

[84] These guidelines relate to a broader range of subjects than the fundamental policies. They embrace such matters as emphasis on capital appreciation as against emphasis on income, and stress on safety of principal as against stress on maximum current income.

[85] Act sec. 13.