H.R. 9510

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

May 1, 1967

The President of the Senate
The Speaker of the House of Representatives

Sir:

I have the honor to transmit legislative proposals unanimously recommended by the Securities and Exchange Commission with the hope that they will be introduced and enacted in this first session of the 90th Congress. They would provide additional protection for mutual fund shareholders in areas where the tremendous growth of the industry since enactment of the Investment Company Act of 1940 has created needs which were either unanticipated or of secondary importance at that time. Between the end of 1940 and June 30, 1966, investment company assets increased from about $2.1 billion to $46.4 billion. Most of this growth was accounted for by mutual funds, whose net assets increased from $450 million at the end of 1940 to about $38.2 billion at June 30, 1966. By the end of 1965 there were more than 3,500,000 mutual fund investors as compared with less than 300,000 in 1940.

The Commission's proposals are the outgrowth of studies made by or for the Commission pursuant to Congressional direction, primarily that contained in Section 14(b) of the Investment Company Act of 1940 which authorizes the Commission if it finds "that any substantial further increase in the size of investment companies creates any problem involving the protection of investors or the public interest, to make a study and investigation" and to report the results to the Congress.

The first of these studies, which commenced in 1958 pursuant to Commission direction, was made by the Wharton School of Finance and Commerce of the University of Pennsylvania. That report submitted to the Congress in August of 1962 found that the more important current problems in the mutual fund industry involved potential conflicts of interest between the fund management and shareholders and the impact of fund growth and purchases on stock prices. The Wharton School Report was followed by the Report of the staff of the Commission's Special Study of the Securities Markets, which, insofar as

mutual funds were concerned, examined sales of mutual fund shares including sales practices and the special problems raised by the so-called front-end load in the sale of periodic payment plans for the accumulation of such shares.

Neither the Special Study nor the Wharton Report was a report by the Commission. Following publication of these reports the Commission undertook to evaluate the public policy questions that they raised as part of an extensive study of its own and to report its recommendations to the Congress. The results of that study are found in the Commission's Report on the Public Policy Implications of Investment Company Growth which was transmitted to the Congress on December 2, 1966 and published as House Report No. 2337, 89th Cong., 2d Sess. The legislative proposals transmitted herewith are designed to carry out the recommendations contained in that report.

Areas of primary concern in the report included the costs of management and sales charges. Mutual funds, although ordinarily organized either as corporations or as business trusts, usually are managed and operated not by their own officers and employees but by separate entities which provide management and advisory services under contract with the fund. Traditionally these contracts have provided for compensation on the basis of a percentage of the assets of the fund. As the funds have grown in size the amounts of management fees have likewise grown and the Commission's report concluded that economies of scale in the costs of managing large pools of assets have seldom been shared equitably with investment company shareholders. The proposed legislation would expressly require that management fees be reasonable and make this standard enforceable in the courts. However, any person attacking the reasonableness of a management fee which had been approved by the fund's directors as required by the Investment Company Act would have the burden of proving that the fee was unreasonable. A requirement that the fee be reasonable would appear inherent in the fiduciary relationship between investment company shareholders and an investment advisory organization which is in effective control of the fund. The existing provisions of the Investment Company Act, however, provide no adequate means by which such a requirement may be enforced.

The proposed legislation would also place a 5% ceiling on charges for mutual fund sales, subject to a power in the Commission to grant exceptions where appropriate. This proposed maximum charge would

still be substantially greater than the sales charges generally prevailing in the securities markets such as stock exchange commissions or over-the-counter markups for securities of comparable quality. As a result, in part, of the resale price maintenance scheme provided in Section 22(d) of the Investment Company Act, which the mutual fund industry regards as important for the preservation of the existing pattern of distribution of such shares, competition has not operated to reduce sales loads. Rather the sales charges paid by the average or small investor have tended to increase as investment companies competed for the favor of dealers and their salesmen.

Of particular concern are the sales charges paid by those investors, generally small investors, who accumulate mutual fund shares by monthly payments over a period of years. Under the existing provisions of the statute, up to 50% of the first year's payments may be deducted for sales charges. The Commission's study as well as the Special Study showed that a substantial portion of such investors are unable or unwilling to complete their plans, with the result that up to half of the money that they pay in goes for sales costs. The proposed legislation would eliminate the front-end load feature and require that sales charges be spread equally over all payments, thus reducing the undue risk of loss suffered by those investors who do not complete their plans, as well as making sure that a greater proportion of the money paid by an investor is invested for his benefit.

The proposed legislation would also contain other provisions which are designed primarily to facilitate the administration and enforcement of the Investment Company Act, to eliminate certain anomalous situations, and to update and correct certain provisions.

These legislative proposals recognize as did the Commission's report that on the whole the investment company industry reflects diligent management by competent persons, that the industry has provided a useful and desirable means for investors to obtain diversification of investment risks and professional investment management and that drastic changes in the Investment Company Act of 1940 are not required. We believe, however, that enactment of these proposals would assure fairer treatment for the millions of Americans, including many of modest means, who have chosen to investment many billions of dollars in investment company securities.

The Bureau of the Budget advises that enactment of legislation along the lines of this Bill would be in accord with the program of the President.

By direction of the Commission.

Manuel F. Cohen
Chairman

Enclosure