December 10, 1969

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION
ON H. R. 14737 TO THE COMMITTEE ON INTERSTATE AND
FOREIGN COMMERCE, HOUSE OF REPRESENTATIVES

This memorandum, prepared in response to a request by the Committee, sets forth the Commission's views on H.R. 14737, introduced by Congressman W. S. ("Bill") Stuckey in the House of Representatives on November 6, 1969, to amend the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933 and the Securities Exchange Act of 1934.

In many respects, this bill is identical to H.R. 12867, which was introduced by Congressman Stuckey on July 15, 1969 and which was the subject of our memorandum of November 5, 1969. addressed to the Committee. To the extent that these bills are similar we adhere to the comments made in our November 5, 1969 memorandum opposing adoption of that bill. We comment in detail on H.R. 14737 only to the extent that it differs from H.R. 12867.

The discussion below generally is organized to follow the catagories of matters referred to in our memorandum of November 5, 1969 on H.R. 12867. The Commission strongly opposes the adoption of H.R. 14737 since, as we indicated in our comments on H.R. 12867, it would in many important respects be contrary to the Commission's major legislative recommendations for improving investor protection and in some cases, would significantly reduce present standards of investor protection under the Investment Company Act.

Investment Advisory Contracts

Section 8(b) of H.R. 14737, like H.R. 12867, provides for outright immunity from suits brought under Section 36(b) of the Investment Company Act to question management fees, if the management contract is approved by all of the unaffiliated members of the board of directors and by two-thirds of the shareholders of a mutual fund, if no more than 50 percent of the board are interested persons.[1/] H.R. 12867 did this by raising a "conclusive presumption" that fees were fair and equitable if the required approvals were obtained, without mentioning Section 36(b). H.R. 14737 takes a slightly different approach by explicitly making Section 36(b) (imposing a fiduciary duty on the investment adviser with respect to the receipt of compensation for securities) inapplicable to a contract approved as specified in Section 15(b) of the Act as amended by H.R. 14737. H.R. 14737 goes on to provide that if such contract receives the requisite approvals, the fee would also "be presumed to be both fair and equitable and not in breach of any fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature." Although this presumption would not be "conclusive" as in H.R. 12867, the substantive result would probably be the same as under H.R. 12867.

1/ Our objections to the substantially identical provision in H.R. 12867 are expressed in our memorandum of November 5, 1969 (see pages 3-5).

Moreover, Section 8(b) of H.R. 14737 might achieve the following anomalous result in suits against advisers, officers, and directors of funds for breach of fiduciary duty involving personal misconduct under Section 36(a) of the Act, as amended: It would raise a presumption that an advisory fee is fair and equitable even though a breach of fiduciary duty involving personal misconduct was committed by an officer, director, or investment advisor in connection with negotiating or otherwise setting the management fee.

The provision that a fee be presumed fair and equitable for the purposes of Section 36(a), as well as the provision for immnuity under certain conditions from suits under Section 36(b) of the Act would not only fail to provide the protections for investors intended to be secured by S. 2224 and H.R. 11995, but would even go so far as to negate the present common law prohibition against an investment adviser, or an officer, or director of an investment company receiving or approving a management fee amounting to waste or fraud and vitiate the gross abuse of trust provision of present Section 36 of the Act, in so far as it relates to fees.

H.R. 14737 thus removes existing protections and effectively insulates fund managers from actions relating to unreasonable or excessive fees--or even from suits charging waste. It erodes the present gross abuse standards of Section 36 in the fee area. Nothing in the record before this Committee justifies such a cutback in investor protection.

With respect to advisory fees based on performance, H.R. 14737, as does H.R. 12867, deletes the amendment in Section 24(a) of S. 2224 and H.R. 11995 to Section 203(b) of the Investment Advisers Act of 1940 requiring registration under that Act of investment advisers whose only clients are investment companies. However, H.R. 12867 deletes the amendment to Section 205 of the Investment Advisers Act contained in Section 25 of S. 2224 and H.R. 11995, which would permit a performance fee for an investment adviser only if the fee increases or decreases proportionately on the basis of investment performance against an appropriate index of securities prices or other appropriate measure of performance. H.R. 14737 also abandons the modification of this amendment contained in Section 25 of H.R. 12867, which we opposed in our memorandum of November 5, 1969 (see pages 5-7). The effect of this deletion, together with its deletion of Section 24(a) of S. 2224, would be to continue to permit investment advisers to investment companies to receive compensation on the basis of a share of the capital gains or capital appreciation or any portion of the funds of the client.

We are opposed to these deletions from S. 2224 and H.R. 11995 and reaffirm our support for the approach taken in those bills. As the Report of the Senate Banking and Currency Committee points out, S. 2224 provides protection for shareholders of investment companies against arrangements which give investment advisers special incentives to take undue risks but which would permit limited performance fee arrangements determined on a reasonable basis. 2/

Sales Loads

Section 8 of H.R. 14737 would exempt sales loads from regulation under Section 22(b) of the Act if the underwriting contract specifying such load were approved by all of the unaffiliated members of the board of directors and two-thirds of the shareholders, if no more than 50 percent of the board members are interested persons. Our opposition to substantially the same proposal in H.R. 14737 was expressed in our memorandum of November 5 at pages 8-10 and the reasons for such opposition are equally applicable here. Section 8 in H.R. 14737 differs from Section 8 of H.R. 12867 to the extent that it also provides for a presumption, rather than a "conclusive" presumption, that a sales load is fair and equitable if the requisite approval is secured, but we believe the substantive effects would be the same.

Section 12(a) of H.R. 14737 would require that the NASD, in setting sales loads should allow for "reasonable profitability for brokers and dealers, and underwriters." Section 12(a) of S. 2224 and H.R. 11995 provides for "reasonable compensation" for these persons. We are opposed to the profitability standard

2/ Senate Rep. No. 91-184, 91st Cong., 1st Sess. (1969) ("Senate Committee Report") p. 45.

because it would place profitability of fund sellers above investor protection.

Then Chairman Cohen in his supplementary statement to your Subcommittee on October 24, 1967, put it very well when he said,

> "Selling mutual funds is an easy occupation to enter. Almost anyone not found guilty of a serious crime can become a mutual fund salesman. And since fund salesmen are, with rare exceptions, compensated on a pure commission basis, another salesman adds little to the employer's costs. Any sales that the new salesman makes (no matter how few or small) produce income for the employer. It is a case of the more, the merrier. There is a typical pattern. Each new salesman makes--or tries to make--sales to his friends and relatives. Carrying his selling efforts beyond that is more difficult. Prospects aren't that numerous because the ratio of salesmen to prospective investors is so high. In this connection, I might point out that Mr. Cornelius Roach of Waddell & Reed, Inc., estimated before this Committee that there are about 90,000 people selling mutual funds. Since there are approximately 4,000,000 mutual fund share-holders, there is, by Mr. Roach's estimate, a mutual fund salesman for every 44 existing mutual fund shareholders. Even if one were to estimate that there are only 50,000 mutual fund salesmen, there would be a mutual fund salesman for every 80 mutual fund investors. So it is inevitable that many full-time salesmen find it very hard to earn a good livelihood solely from the sale of fund shares. When a salesman does manage to unearth somebody who could invest in a mutual fund, he often finds that one of the army of part-time salesmen or a full-time salesman from a large New York Stock Exchange firm has already made the sale. Hence the turnover rate among salesmen is very high.

In few other areas of the American economy does the labor force rotate at a comparable rate. New recruits who believe--or who are led to believe--that selling mutual funds is an open road to riches, or at least a dignified way in which to add a meaningful supplement to an income primarily derived from some other source, are offset by equal numbers of dropouts who have found that it isn't quite as easy to make money selling mutual funds as the recruiter said it was.

Just as it is relatively easy to become a mutual fund salesman, it is not difficult to become a mutual fund dealer. All it takes is $2,500 which can be borrowed. Many salesmen, who tire of sharing what they produce with their employers, venture into business for themselves. But the same obstacles that the proprietors of these new mutual fund retailing firms faced as salesmen still confront them and their sales recruits. Hence the high entry rate among mutual fund dealers is counterbalanced by a high departure rate.

The essential question thus becomes whether federal law should continue to insulate mutual fund sales organizations, which have probably grown oversized and inefficient in terms of production, from both price competition and price regulation.

The Commission is not insensitive to the legitimate needs of the mutual fund salesman and of the small mutual fund dealer for compensation. Indeed, as I have pointed out, the present system provides the seed for such failure. However, we must also consider--indeed, we must give priority to--the interests of some 4 million investors, most of whom are far from affluent themselves.

All of us are interested in minimizing unemployment. But investors should not have to combat unemployment by paying artificially high prices--prices protected by law, not produced by market forces--for mutual fund shares. . . ." (emphasis added).3/

3/ House Hearings on H.R. 9510 and H.R. 9511 before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, 90th Cong., 1st Sess., pages 701-702.

Section 12(a) of H.R. 14737 would also add a provision to Section 22(b) to grant the Commission authority upon application or otherwise to give "smaller companies. . .subjected to relatively higher operating costs," qualified exemptions from rules made.

This provision appears to be superfluous in view of the Commission's broad exemptive authority under Section 6(c) of the Act. (See page 9 of this memorandum which discusses a similar provision.)

Front-end Loads

Section 16(a) of H.R. 14737 would modify the corresponding Section in 16(b) of S. 2224 and H.R. 11995 by reducing the time during which the purchaser of a contractual plan may surrender his certificate and obtain a refund of sales charges from three years to one year. It also changes the refund from the excess over 15 percent to the excess over 20 percent of the gross payments made by the holder.

Section 16(a) of H.R. 14737 also changes the times at which contractual plan holders must be sent notice of surrender and payment rights after payments have been missed to conform to the reduced refund period.

H.R. 14737 also reduces from 60 to 30 days the period of time during which a contractual plan holder has a right to withdraw and get back all sales and loading charges. The bill also adds language to the effect that SEC rules prescribing reserve requirements be "reasonable" and "reasonably necessary" to carry out the refund and withdrawal provisions. It also provides that no reserve requirement specified by Commission rules shall be taken into account in computing "net capital" of any one investment company issuing periodic plan certificates under Commission rules and regulations.

We oppose these changes from the reasons given in pages 11-12 of our memorandum of November 5, 1969.

H.R. 14737 also would delete Section 16(a) of S. 2224 and H.R. 11995 that Section would repeal present Section 27(b) of the Act under which the Commission has authority to relax the requirements of Section 27(a) in the case of smaller investment companies. In this connection, the Senate Committee Report points out:

> "Since there is no evidence that the operating costs of the smaller contractual plan sponsors are any higher than those of their larger competitors, it is hard to see how the Commission could ever properly grant a 27(b) application for permission to charge higher loads. If in an unusual case such an application were to be supported by a substantial showing of merit, your committee directs the Commission to grant such application by exercising the exemptive authority under Section 6(c) of the Act. Section 27(b) is therefore surplusage and it is recommended that it be deleted.[4]

We agree with the judgment of the Senate on this provision.

4/ Senate Committee Report, p. 20.

Restrictions on Commission Officers and Employees

Section 2 of H.R. 14737 is identical with Section 2 of H.R. 12867. Our opposition to this proposal is expressed in our memorandum of November 5, 1969, at pages 12-14.

Suits Against Mutual Funds and Other Matters Affecting the Jurisdiction of the Commission

Section 19(b)(7) of H.R. 14737 is identical with Section 20(b)(7) of H.R. 12867 which we discuss in our November 5, 1969, memorandum at pages 12-15.

Investment Advisers Act

H.R. 14737 deletes the provision in Section 25 of H.R. 12867 (which provides that Section 205 not be construed to apply to advisory contracts with non-U.S. citizens and residents nor to prohibit registered investment advisers from having incentive contracts with unregistered investment companies). Therefore, the discussion on Page 16 of our November 5, 1969, memorandum is not applicable to H.R. 14737.

Oil and Gas Funds

H.R. 14737, as does H.R. 12867, deletes Section 3(b)(5) of S. 2224 and H.R. 11995 and therefore retains the present exemption in the Act for any investment company all of whose business is holding oil, gas or other mineral royalties or leases. As indicated in Chairman Budge's testimony of ~~November~~ December 11, 1969 we would not object if Section 3(b)(5) of H.R. 11995 is deleted, since we now plan with oil and gas industry co-operation, to try to work out a separate statute for submission to Congress to regulate oil and gas funds in a reasonable manner consistent with the protection of investors.

Administrative Procedure Act

H.R. 14737 deletes the provision in Section 12(a) of H.R. 12867 which would have specified that the Administrative Procedure Act ("APA") would be applicable in a Commission rule-making proceeding to limit excessive sales loads pursuant to Section 22(b) of the Act. We commented in our November 5, 1969 memorandum that since Commission rule-making is presently subject to the APA, no specific reference to the APA is necessary.

Section 19 of H.R. 14737, however, retains the requirement in corresponding Section 20 of H.R. 12867 that the Commission afford "the defendant a fair opportunity to comply in accordance with the Administrative Procedure Act (5 U.S.C. 558)," before it can institute court proceeding to enforce a breach of fiduciary duty involving personal misconduct. Our comments opposing this provision appear on pages 20-21 of our November 5, 1969, memorandum.

Face-Amount Certificates

H.R. 14737 completely deletes Section 17 of S. 2224 and H.R. 11995, which would provide investors in face-amount certificates greater protection by limiting the sales loads on future sales of face-amount certificates to 20% during the first three years and 10% in the fourth certificate year. The effect of H.R. 14737 would be to continue present law allowing up to 50% of the first year's payments to be deducted for sales charges.

As your Committee is aware, Chairman Moss has introduced H.R. 13754 to eliminate the front-end load and equivalent surrender charges on future sales of installment face-amount certificates, as a supplement to S. 2224 and H.R. 11995. On November 12, 1969, Chairman Budge testified in favor of H.R. 13754 before your Subcommittee on Commerce and Finance. He pointed out that our recent study conducted at the request of the Senate Banking and Currency Committee 5/ reconfirmed our original conclusion contained in our December, 1966 Report that front-end load charges on face-amount certificates are contrary to the public interest and the interests of investors. As Chairman Budge pointed out in his testimony:

> "We found that the investment yield on face-amount certificates held to maturity is less than that realized on other savings programs and that the majority of purchasers of installment face-amount certificates do not continue payments under the plans to their stated maturity dates. A large portion of those people who buy face-amount certificates lose money and their losses are caused by the deduction of the front-end load from early years' payments. For example, more than 55 percent of those persons who purchased the most popular 20-year face-amount certificates scheduled to mature from 1965 through 1968 lost money, by redeeming prior to break-even point, and more than 84 percent (by face-amount) failed to reach maturity as scheduled."

In view of these facts, it would be a setback to future investors in face-amount certificates if H.R. 14737 were enacted since it fails to adopt even the minimal improvements provided by Section 17 of S. 2224 and H.R. 11995.

5/See our memorandum to your Committee dated October 22, 1969 which supports the passage of H.R. 13754 and discusses this report.

Attendance at Directors' Meetings

Sections 8(c) and 17 of H.R. 14737 would delete the amendments provided by Sections 8(c) and 18, respectively, which would require that the voting requirements of Sections 15(a), (b), (c) and 32(a) of the Act for approval and renewal of advisory and underwriting contracts and for the selection of independent auditors can be satisfied only by directors who are personally present at a meeting at which their votes are taken. In our 1966 Report on the Public Policy Implications of Investment Company Growth, we found that in some investment companies absentee approval by board members is not uncommon. [6/]

The purpose of these amendments is to "assure informed voting on matters which require action by the board of directors of registered investment companies," [7/] which is a practical necessity if unaffiliated directors are to effectively protect the interests of shareholders.

H.R. 14737 also achieves the somewhat inconsistent result of requiring advisory and underwriting contracts and the selection of independent accountants to be approved by a majority of the disinterested members of the board but not requiring that such

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6/ Public Policy Implications of Investment Company Growth, pp. 334-335.

7/ Senate Committe Report, page 39

directors be present at the meetings when these votes are taken. This would erode an important potential safeguard for shareholders.

Securities Exchange Act of 1934

Section 28 of H. R. 14737 would amend the Securities Exchange Act of 1934 to provide that no flat fixed minimum commission charged by a national securities exchange by its members on all transactions on such exchange and adopted in accordance with the procedures of the Act shall be considered in violation of the antitrust laws, provided that the commission rate is reasonable and further provided that the exchange provides reasonable access and commission rate differentials for bona fide nonmembers.

On May 28, 1968 the Commission announced the institution of public hearings to give extensive consideration to various aspects of the commission rate structures of the registered national securities exchanges. These hearings were initiated in July 1968 and thus far involve approximately 5,000 pages of testimony plus numerous extensive written submissions on matters including (i) commission rate levels for exchange members (intra-member rates) and for non-members, (ii) the services for which such commission rates pay and the costs allocated thereto, (iii) give-ups and reciprocal practices among different categories of members and non-members, (iv) membership by financial institutions, (v) economic access to exchange markets by non-member broker-dealers, (vi) competition among exchanges and among exchanges and other markets, and (vii) the necessity for restrictions on access of exchange members to the third market. These issues are before the Commission in connection with its oversight responsibility, provided in Section 19(b)(9) of the Exchange Act to assure that commission rates fixed by national securities exchanges are reasonable.

The issues to which the provisions of Section 28 of H.R. 14737 relate -- reasonable access and commission rate differences for bona fide non-members, reasonable fixed minimum commission rates and the applicability thereto of the anti-trust laws are matters which are involved in this proceeding and now under active consideration by the Commission. The matter of reasonable commission rates is most complex and is bound up withthe important related issues of public ownership of member firms, institutional membership, non-member access and competition among markets.

While the Commission has reached no conclusions on the merits of these questions, it does believe that existing Section 19(b) of the Exchange Act provides an adequate framework for balancing the anti-trust and other issues of public policy. We urge that the Commission be given an opportunity to complete its inquiry and attempt to resolve the issues pursuant to its powers under Section 19(b) of the Exchange Act before any attempt is made to enact further legislation in this area. Such legislative action at this juncture would be premature and disrupt the present proceedings being conducted pursuant to our authority under the Exchange Act.

Other Matters

The provisions of H.R. 12867 on which we commented under this subject heading in our November 5, 1969, memorandum have been substantially conformed to S. 2224 and H.R. 11995 by H.R. 14737. However, H.R. 14737 does contain a number of other modifications which would remove needed investor safeguards and add needless procedural complications or unnecessarily limit Commission discretion. We will not discuss all these modifications in detail, since all of them are summarized in the comparative table attached to this memorandum. However, three examples of these changes are:

(1) Section 19 of H.R. 14737 would add a requirement that derivative suits under Section 36(b) of the Act, as amended, is brought by shareholders "acting in good faith and with justifiable cause." This is similar to the requirement in paragraph (7) of Section 36(b) of the Act, as proposed to be amended by H.R. 14737, which would impose federal criminal penalties on any person who knowingly acts as attorney or agent in connection with any judicial, administrative or other proceeding matter involving any party subject to the jurisdiction of the Commission, if he acts "without justifiable cause." Although a shareholder would not be subjected to criminal penalties by Section 19 of H.R. 14737, we believe that this requirement would impose a needless obstruction to derivative suits. As we stated in our November 5, 1969, memorandum,

we believe that any disadvantages of allowing shareholders full access to the courts are far outweighed by the protections such access gives against abuses which otherwise would find no remedy.[8/]

(2) Section 19 of H.R. 14737 provides that the Court may award relief "as may be reasonable and appropriate in the circumstances" in Commission suits brought under Section 36(a) of the Act, as amended, for breach of fiduciary duty involving personal misconduct. This changes the language in corresponding Section 20 of S. 2224 and H.R. 11995 which provides that a court may award relief which "in its discretion deems appropriate in the circumstances." The grant of discretion in S. 2224 and H.R. 11995 closely follows the language of present Section 36 of the Act with respect to injunctive relief. We do not believe that Section 19 of H.R. 14737 enunciates a substantive standard any different from the equivalent provision in the latter two bills, but the difference in language would tend to set the stage for needless arguments on the extent of the courts' discretion in framing relief.

(3) Section 8(a) of H.R. 14737 deletes the requirement specified in Section 15(a)(1) of the Act, that investment advisory contracts "precisely" describe compensation to be paid thereunder. Section 8(a) of S. 2224 and H.R. 11995 retain the

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8/ See additional comments in our November 5, 1969, memorandum at pages 14-15.

present requirement that such compensation be precisely described. We believe that H.R. 14737 in this respect would represent a significant weakening of an essential disclosure requirements, which the Congress in enacting the Investment Company Act of 1940 deemed necessary to permit the independent directors and shareholders of mutual funds to make an informed and intelligent decisions when considering approval of the contract.

Conclusion

As the foregoing makes clear, and as we stated with respect to H.R. 12867, H.R. 14737 would in fact substantially cut back the protections now offered by the Investment Company Act of 1940. The voluminous record already adduced before your Committee, as well as the Commission's own studies and reports fully support the proposition that present regulation must be augmented, at least to the extent contemplated by S. 2224 and H.R. 11995. H.R. 14737 is not only inadequate in this regard, but seriously erodes present protections.

In our opinion, the enactment of H.R. 14737 would represent a substantial setback for fund shareholders which might have the effect of undermining vital shareholder confidence in the mutual fund industry--without which the industry could not long survive in its present state. As we have previously informed your Committee, the Commission supports S. 2224 and H.R. 11995 because, despite the revision of our original recommendations, they still represent a major improvement in existing mutual fund regulation in meeting the needs of investors in the critical areas of concern indicated by the Commission's study of the fund industry.

There is no reason to substitute for S. 2224 and H.R. 11995, the products of such long negotiation, which have passed the Senate without opposition, a bill which so substantially lessens key elements of mutual fund shareholder protection.