

SPEECH BY STEPHEN K. WEST  
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Ladies and Gentleman:

It is an honor to have been asked to share my thoughts with you at the 40th anniversary of the Investment Company Act. Although I can't claim to have worked with the Act for those 40 years I have worked with it and many investment companies for more than half that time. As Matt and the other panelists have suggested the Act as administered by the SEC has done a relatively good job over the years. It has served the public well and permitted imaginative developments and growth. It succeeded in accomplishing its purposes and put a stop to the abuses as they existed and were perceived in 1940.

However, I believe the experience of the industry over these past four decades demonstrates that the time has come to provide for a progressive alternative to the present statutory structure. An alternative that would be to the benefit of the industry and the investing public.

In brief I am proposing that a basic amendment be made to the 1940 Act. My proposal has been suggested from time to time by others and I know that Sid Mendelsohn and his staff have been considering variations of the approach.

The proposed amendment could be considered revolutionary in that it would eliminate the Board of Directors and shareholder voting as such, substantially reduce litigation and, consequently, the role and expense of lawyers. I realize that I may just have lost the support of

two large groups in the audience. Nevertheless, I strongly believe that if some form of the proposal I am about to describe to you is adopted, the investing public would be benefitted and substantial reduction in nonproductive work and costs would occur.

The proposal is to add a new section to the Act which would provide for an optional form of regulatory structure for open end investment companies. For the sake of simplicity I will call this new structure a unitary investment company. It would be a pool of securities managed by its sponsor with the total management fee, economic and investment features set forth in its original organic document. It would eliminate the present almost universal pattern of a fund with its own board of directors linked by a renewable advisory contract with the investment manager. In short it would once again allow, as an alternative, the natural form of an investment pool with a trustee-type sponsor. A structure basically the same as the pioneer open end mutual funds that existed in 1940 such as Massachusetts Investors Trust, and the Keystone Group of Funds. In fact the unitary trust form would be very similar to the present unit trusts permitted by Section 26 of the Act except that it would have a managed rather than a fixed portfolio.

A little bit of history may be of interest here. When the 1940 Act was being put together most of the funds then existing, unlike today, were closed end funds or as they now call themselves publicly traded investment companies. The open end funds were small in comparison and were centered in Massachusetts. The closed end funds were centered in New York. As a result I can graciously say, being a New York lawyer myself, that we can blame any problems of the Act on the New York lawyers. Seriously, it has long been my belief that it was the New York lawyers with their focus on corporate concepts of directors and stockholders as reflected by the corporate form of the closed end funds, who unfortunately had a great deal to do with shaping the concepts in the Act. On the other hand if in 1940 the Boston lawyers had been

given their way with their familiarity with trust concepts and examples of the unitary trust form, we might have had this much more natural structure from the start.

Let me outline the principal features of this proposed unitary structure.

First, it would be an optional choice of a sponsor-manager. It would not change or eliminate present choices of form.

Second, the proposal would be accomplished by adding a fourth type of investment company to the present three types. The three present structures are face amount certificate companies, unit trusts, and management investment companies. The last is the catch-all miscellaneous category and is by far the most common form today. It normally brings with it four important pieces of baggage: A board of directors, stockholders who vote on various matters, annual advisory contracts, and last, but not least, constant shareholder derivative suits. All of these would be eliminated, and in the case of litigation, hopefully reduced.

Third, my suggested alternative would be similar in form to a trust with a corporate trustee, a trust indenture, and investors holding beneficial interests in the trust. The trust indenture would be required to spell out the normal fundamental policies describing the investment nature of the vehicle and most importantly, the management fee. The “trustee” would be the originator, sponsor and investment manager of the investment pool for the life of the trust or until the trustee is removed. In effect the vehicle would be very similar to the Massachusetts business trusts which are in common use today for Massachusetts based funds, but without the corporate superstructure of independent directors, without an advisory contract, and without shareholder voting except for amendatory purposes.

Fourth, the whole protective structure of the Act restraining and limiting self dealing and other potential abuses would remain in place and would apply to a unitary investment company

just as it now applies to investment companies. For instance all the Section 17 prohibitions concerning transactions with affiliated persons would apply. In fact I would go further and prohibit even agency transactions presently permitted by Section 17(e).

Fifth, for reasons that will become apparent when I get to the question of compensation, this proposed alternative unitary investment company would be either a no-load company or a load company with some provision for a refund of the load upon certain types of redemption so that there would be no penalty to the investor if he later disapproved of a change in the funds.

Sixth, is the method by which compensation to the sponsor-investment manager is determined. This is the heart of the proposal. In my opinion in order to achieve the elimination of a corporate superstructure and the resulting benefits, a political tradeoff is necessary and appropriate. That tradeoff concerns the method by which the level of the compensation of the sponsor-manager is set. What I am proposing is a statutory maximum for a fixed expense ratio or manager's fee which can be charged to the investment pool and out of which the manager will pay all the expenses of the pool, with only two exceptions. This expense ratio type management fee would be fixed in the trust indenture and paid to the manager out of the pool. Its structure would be similar to the expense ratio limitations presently set by state blue sky laws with the statutory maximum reflected by the present state maximums. The philosophical objective of this approach is to place the discipline for the compensation arrangements in the hands of the investor and the competitive choice of the market place and remove it from the annual review of the intermediary third party group of the board of directors. As I say all expenses would be paid by the manager; custodial, auditing, legal, advisory, administrative regulatory fees, etc. The investor would know the exact expense override that would reduce the gross investment revenues of the investment pool. Further, the investor unlike the present system will be able to

make exact comparisons among funds of this type of the future cost of overall management. The investment manager on the other hand will have incentive to judiciously control costs within the limits of providing a competitive product based on investment performance, and service to the investor. This I believe will tend to reduce overall costs to the investors.

The two types of expenses that would not be covered in this all-inclusive fee would be those that the sponsor-manager could not price reliably in setting his fee. Namely, extraordinary expenses involving the investment pool itself and the cost of shareholder accounting or transfer agent function. With respect to the transfer agent costs I would require one important difference from current general practice. That is, the costs of shareholder accounting would be required to be charged directly to each shareholder's account and not to the pool. In this manner the cost would be immediately apparent to the investor and most importantly it would retain intact one of the essential features of this proposal. That is, the total future cost of running the investment company will remain fixed and known to and directly comparable by the investor with competing products.

The next key feature to this proposal is that Section 36b would not apply to this form. 36b as you know was the compromise adopted in 1970 to change the federal standard applying to advisory compensation from "gross abuse of trust" to "breach of fiduciary duty". Under my approach this would not be necessary since the whole point is to set the total compensation in a manner easily understood and compared by the investor. The investor would decide whether the fee is excessive and, if it is, vote with his feet by redeeming. Thus, if the costs are too high for his taste he can get out with no penalty and choose another vehicle. In other words in tune with the free market and deregulation trends current today the unitary structure would allow the investor to make a choice, make it clear to him that nobody else is making that choice for him,

and let the sponsor-manager sink or swim in the market place based on the success of his product.

A very good example of where this system might work best and is in fact working now is the money fund. Where income yield is the objective, the total expense ratio is crucial to attracting investors. Competition is immediate and apparent. The role of directors and shareholder voting for money funds is a costly feature which on examination provides few benefits.

Now comes the 64 dollar or 64 million dollar question. How is this gross management fee to be set and how can it be changed if subsequent events make it clearly too high or too low. There are a number of possibilities. My first choice would be a statutory maximum along the lines of present blue sky ratios. This is not a revolutionary proposal. For instance, there is presently a type of statutory maximum adviser fee in the 1940 Act. It is little known and hardly ever referred to and is contained in Section 10(d). There the statutory maximum for the advisory fee alone is 1% of the net assets. This by the way is a section that was developed in 1940 by the Boston lawyers and the open end pools run by the Boston investment advisers for their small accounts. It is amazingly close to what I am proposing in that it allows a fund that meets certain criteria to operate with only one outside director. They almost made it but got left with one director. I would then give the SEC the rule making power to prospectively increase this statutory maximum. The concern that in particular cases or circumstances the maximum would permit "excessive" profits I think is beside the point. The basic discipline here is the investor himself. If he doesn't like the deal he needn't invest in the first place and can always get out. I realize that this philosophical non-regulatory approach to a free market has been an issue since the inception of the Act. It was the subject of much discussion in the legislative activities

leading to the 1970 amendments. However, at that time a different approach to what was perceived to be excessive management fees was adopted. It was thought at that time that the two layers of protection from excessive fees, the board of directors and the shareholder vote, were not working so Section 36b was added. In a sense this present proposal is not contrary to the 1970 solution. Like the 1970 compromise, it also assumes that the board of directors and shareholder voting is redundant and substitutes the market place and a statutory maximum for Section 36b. I believe that on reflection it will be agreed that with a no-load fund, a total expense limitation, a future cost obvious to and comparable by an investor, the ability to challenge the stated fee through 36(b) or in any other manner than redemption by the investor is unnecessary.

There are other possibilities and analogies for limiting the fee. States have always had statutory trustee fees either set or as maximums. The maximum allowed fee could be set by a kind of rate making procedure with the SEC acting as a public utility commission. I don't think the SEC would like that system. I think it would be the worst choice; primarily because we are not dealing with a monopoly situation where rate making might be appropriate. I should also point out that some European jurisdictions have long had a unitary approach of the above type. They have worked very well.

What would be the benefits of this millennium? First and foremost it would conform to the basic reality of how public investment pools are run. They are created, sponsored and stand or fall on the genius of the sponsor-manager. The directors in most cases contribute very little to the limiting and setting of total costs of a fund. With a maximum all-inclusive fee and the present restrictions in the Act it is difficult to see where the abuses would come from short of actual fraud. If there is to be intentional fraud it is unlikely that the directors would find it

anyway. Either the auditor or the SEC has historically fulfilled this function. Perhaps a self-regulatory group as suggested by Chairman Williams yesterday could play a part. In addition to the elimination of directors and stockholder voting the other group whose role would be greatly diminished in this system would be the lawyers. The present system almost demands and certainly encourages constant concern by lawyers of procedures and programs designed to protect against all types of derivative actions based on second guessing of business judgment or conduct of directors and managers. Presently, we have the spectacle of lawyers for the management company, lawyers for the fund, and sometimes lawyers for the outside directors, and around all these circle the plaintiffs' lawyers developing new theories of business practice and constantly testing them in the courts. All this nonproductive work and expense should be substantially reduced with enormous savings of legal fees. I firmly believe this reduction in legal expense will not result in any diminution of the present level of benefits to investors. In fact, I think the unitary structure will result in an increase in those benefits.

Without a board of directors, without stockholders' votes, without layers of lawyers and without the two entity structure linked by an annual contract, and all the time, energy and costs this structure represents, the investment company and its manager would have the alternative and opportunity of getting on with the business at hand. Once again they can concentrate on their basic function and doing what they do best, namely managing the portfolios of the investment company for the benefit of the investing public.