In only one instance in 1958 did an open-end company or group own a majority stock interest in a portfolio company, and in only one case was there evidence of an open-end company acquiring stock for the purpose of obtaining control over a portfolio company.[120] Nevertheless, there were, at a minimum, some 39 holdings that were large enough, sometimes in combination with interlocking personnel, to have the potential for influencing portfolio company managements. These include the 34 instances of open-end company group holdings of 10 percent or more of the voting shares of portfolio companies (including 1 case in which an officer-director holding pushed the group interest over 10 percent) and 5 cases in which a group holding of between 5 and 9.9 percent was accompanied by 1 or more portfolio company interlocks.[121]

Among the 34 cases of holdings of 10 percent or more, 6 (5 of which were owned by the Axe-Houghton group) exceeded 20 percent of the voting stock of the portfolio companies. Of the 28 holdings of 10 to 19.9 percent, 3 were accompanied by an interlocking officer, director, or advisory board member, between the investment company and portfolio company; and 25 holdings of 10 to 19.9 percent were associated with no interlock.

Of the 39 holdings with the greatest potential for control or significant influence over portfolio companies, only 1 was owned by 1 of the 3 systems with assets exceeding $600 million (MIT), and only 5 were owned by 1 of the 10 systems with assets of between $300 and $600 million (3 by the Parker Corp. group; 1 by the Boston Fund, and 1 by United Funds). Thirty-one of these 39 large holdings were held by 4 companies with assets of between $150 and $300 million—21 by Insurance Securities Trust Fund, 8 by the Axe-Houghton group, 1 by TV-Electronics, and 1 by State Street Investment Corp. The Bernhard (Value Line) group and Gas Industries Fund (now Colonial Energy Shares) in the $50 to $150 million class each held 1 of the 39 control holdings.[122]

The pattern of large holdings in both 1952 and 1958 was very much dominated by the numerous large holdings of a single company, Insurance Securities Trust Fund, of Oakland, Calif. This large company, with assets of $299 million on September 30, 1958, was strictly limited by its trust agreement to acquiring no more than 10 percent of the voting securities of any portfolio company. On September 30, 1958, it had pushed exactly to this limit in the case of 21 different portfolio companies, and held between 5 and 9.9 percent of the voting stock of an additional 32 insurance companies. Insurance Securities Trust Fund thus held 5 percent or more of the voting stock of 53 portfolio companies in 1958. It accounted for 32 percent of all open-end company holdings of 5 percent or more, and virtually all (21 of 24) holdings of 10 percent or more of portfolio company shares. With holdings consolidated on a group basis, Insurance Securities Trust accounted for 29 percent of all group holdings of 5 percent or over and 64 percent of all group holdings of 10 percent or more.[123]

Second in importance only to the Insurance Securities Trust Fund as an owner of very large holdings of portfolio company shares was the Axe-Houghton group, which was also a member of the $150 to

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[120] See pp. 410, 427–428.
[121] See pp. 406–408, 410–411, 416–417.
[122] See pp. 409–411.
[123] See pp. 409–410.

$300 million size class in 1958. This 5-company system held 5 percent or more of the voting shares of 12 different portfolio companies in 1958, of which 4 were between 5 and 9.9 percent, 3 holdings were of 10 to 19.9 percent, and 5 were 20 percent or over. The largest holding of this group (in terms of percentage of voting shares held) was 55 percent of the voting common of Katzenbach & Warren, held entirely by the Axe-Houghton Stock Fund.[124]

It should be noted that while the largest systems do not have many very large holdings, they own many sizable holdings which may have control significance. Although members of the Investors Diversified Services group had no holdings as large as 10 percent, they had 30 between 5 and 9.9 percent in 1958; and although the MIT group had no holdings as large as 10 percent and only 4 between 5 and 9.9 percent, the 2 members of the group had a total of 113 portfolio company holdings of between 1 and 4.9 percent, and MIT had interlocks with 9 portfolio companies in which it owned at least 1 percent of the voting shares. National Securities Series had 113 large holdings and 18 between 5 and 9.9 percent in 1958; the Parker Corp. group owned 64 large holdings and 10 of 5 percent or over.[125]

Despite the growth of large holdings of mutual funds, outright control of portfolio companies by these organizations is a rarity and is confined mainly to small companies, as envisaged by the authors of the act of 1940. Mutual funds with large holdings undoubtedly exercise varying degrees of influence with portfolio companies, but as of late 1958 neither the extent nor character of their influence appeared to be such as to warrant serious concern.

Institutional investors, including mutual funds, have been criticized frequently in recent years for precisely the opposite failing—namely, for failing to function as active and independent stockholders, and for tending to lend uncritical support to existing management. Considering the importance of their holdings in many portfolio companies, open-end investment companies have been relatively inactive stockholders. This has been due in large part to the decision made by the managements of many companies to concentrate on investment management and avoid entanglements with portfolio companies that might involve the investment company in portfolio company operating decisions or potential conflicts of interest in investment decision making. Following this approach, most open-end company managements have evidenced approval or disapproval of portfolio company management and policies primarily by buying or selling portfolio company securities rather than by attempting to organize or participate in a movement for reform.[126] This position appears to be consistent with the objective of optimizing the interests of the fund shareholders. Since the prime responsibility of the management of a mutual fund is the supervision of an investment portfolio, substantial diversion of effort from this activity, or retention of a holding in a company whose management had proven a disappointment, would be difficult to justify in terms of the purported function of this institution.

This is not to deny the possibility that some open-end companies may have carried this policy of nonparticipation or uncritical cooperation with management to extremes, or that management groups

[124] See p. 410.
[125] See pp. 409–410.
[126] See pp. 417–420.

controlling mutual funds often could serve more effectively as portfolio company shareholders with relatively minor cost. It should be noted, however, that many open-end companies have on occasion voted against management stock option plans and opposed by vote and direct communication new security issues or proposed alterations in voting or preemptive rights, which would be disadvantageous to them (and other shareholders).[127] This activity has been particularly characteristic of the larger open-end company systems. Moreover, they do exert their influence through extensive contacts maintained with managements of portfolio companies and through the impact on the price of securities of their decisions to buy and sell.

Many open-end companies, especially the larger ones, attempt to maintain more or less continuous personal contact with the managements of portfolio companies, for the purpose of obtaining information of investment value. These contacts are maintained by frequent visits, telephone calls, correspondence, and occasional get-togethers at the annual meeting of the portfolio company or at the offices of the investment company.[128] These personal contacts undoubtedly affect the behavior of a number of open-end companies as stockholders. However, they are also important as an avenue of communication that not only provides the investment company with information, but affords a means whereby investment company opinion must inevitably be made known to portfolio company managements. Since this contact policy is widely used, this channel of communication appears to be an environmental fact of some importance in shaping investment company policies as portfolio company shareholders, and portfolio company management thinking on matters important to open-end investment companies.

INVESTMENT ADVISERS OF MUTUAL FUNDS

The 1960 survey of investment advisers of mutual funds dealt with a total of 163 advisers who supervised 232 open-end investment companies with total assets (end of 1960) of $15.6 billion. Eight of these one hundred and sixty-three advisers also managed closed-end investment companies, and 60 had clients other than investment companies. The other assets supervised by these advisers brought the aggregate of managed assets up to $30.1 billion. The management of open-end company assets was found to be fairly concentrated, with the five largest advisers, each managing more than $600 million in assets, supervising 43 percent of all open-end company assets subject to adviser control.[129]

Seventy-three of the 163 advisers were independent advisers, adviser-underwriters, or members of multiple-adviser systems, that confined their activity largely to supervising (and in some cases wholesaling the shares of) mutual funds. Thirty-six advisers were investment counselors or their subsidiaries; 27 were broker-dealers or their subsidiaries; 5 were subsidiaries of underwriters of investment company shares; 4 were banks or trust companies; 4 were subsidiaries of insurance companies; 4 were subsidiaries of diversified holding companies; and 10 were subsidiaries of miscellaneous other organizations.[130]

[127] See pp. 419, 425, 428.
[128] See pp. 421–424.
[129] See pp. 440–444.
[130] See pp. 435–436.

The diversity of type of investment advisers has been increasing in recent years because of the greater variety of entrants into the business, including various individuals as well as companies. In an increasing number of cases new advisers have been established by preexisting systems to handle the affairs of a new investment company. This has resulted in the establishment of at least nine multiple-adviser systems.[131]

There have been three principal and interrelated sources of income and other benefits that accrue to investment advisers and affiliated persons maintaining effective control over mutual funds: (1) advisory and management fees; (2) payments for selling activities in the wholesale and retail distribution of mutual fund shares; and (3) brokerage commissions for the purchase and sale of portfolio securities for the account of the investment company. There are other financial interests deriving from the operation of mutual funds, but they are of lesser importance in terms of revenue and potential source of conflict of interest between shareholders and the controlling management group.

Advising mutual funds was the prime source of gross income to almost one-half of the 163 advisers (77, or 47.2 percent), and one of the three most important sources of gross income to almost nine-tenths of the advisers (144, or 88.3 percent). The distribution of mutual fund shares was second in importance as a source of gross income to investment advisers, constituting the largest source for 32 advisers (19.6 percent) and one of the three most important income sources for 60 advisers (36.8 percent). Advising other clients was the most important source of income to 28 advisers (17.2 percent), and aggregate brokerage income was next in importance, being the largest source of income to 11 advisers (6.7 percent).[132]

Since income from selling mutual fund shares and from mutual fund brokerage business was frequently obtained by persons controlling or otherwise affiliated closely with the adviser, an attempt was made to estimate incomes from these sources in 1960 for controlling management groups, as well as for advisers alone. Adjusting for selling and brokerage incomes received by organizations closely affiliated with the investment adviser, advising mutual funds was still the most important source of income in the greatest number of cases (57, or 35 percent), distribution of mutual fund shares was the largest source of gross income in 48 instances (29.4 percent), advising other clients was still third, constituting the main source of income of 28 advisers, and brokerage was the largest source of gross income for 15 advisers (9.2 percent).[133]

Turning now to the question of the fee rates charged open-end companies by their advisers for advisory and administrative services, in four out of five cases these rates were fixed and did not vary with changes in the size of the fund.[134] The effective fee rates charged open-end companies tended to cluster heavily about the traditional rate of 0.5 percent per annum of average net assets, with approximately half of the advisers charging this rate.[135] This concentration around the one-half of 1 percent level occurred more or less irrespective of the

[131] See pp. 436–437.
[132] See pp. 437–438.
[133] See pp. 438–440.
[134] See pp. 480–481.
[135] It may be noted that in a sample of 87 open-end companies the median ratio of advisory fees to investment income of the mutual fund—presumably the main source of income under conditions of stable capital markets—was 16.3 percent in fiscal 1960–61.

size of open-end company assets managed by investment advisers. Thus, 3 of the 5 advisers supervising $600 million or more of mutual fund assets, and 22 of the 40 advisers managing assets of $50 million or over, charged an effective fee rate of approximately one-half of 1 percent.[136] This was true despite the fact that operating expenses of the adviser were generally lower per dollar of income received, and also lower per dollar of assets managed, with increases in the size of assets under the adviser's control.[137]

Advisory fee rates charged mutual funds tended to be substantially higher than those charged by the same advisers to the aggregate of their clients other than investment companies, for comparable asset levels. In 45 percent of the cases examined of mutual fund advisers with other clients, the effective fee rate charged mutual funds was two or more times that of the aggregate of other clients.[138] Advisory fee rates of mutual funds also tended to exceed substantially the effective management costs of open-end companies without advisers. Adviser rates to open-end companies were also found to be less flexible in relation to size of assets managed than rates charged other clients (as well as the effective management costs of companies without advisers).[139]

The relatively high rates commonly charged open-end companies by investment advisers do not appear to be a consequence of extensive services rendered to, or expenses incurred on behalf of, mutual funds. This is indicated, first, by the fact that fee rates charged open-end companies were frequently relatively high even where the expenses absorbed by the adviser were small.[140] And even where those advisers with other clients were examined who carried out extensive record-keeping and administration for these clients, or who had as many as 100 or more other clients presumably requiring individual portfolio attention, other client rates still tended to fall well below the rates charged mutual funds.[141]

A second reason for questioning whether exceptional administrative services and expenses explain the relatively high fee rates charged mutual funds is the fact that, with comparable services provided to mutual funds without investment advisers, management costs tended to be lower.[142]

More decisively, an analysis of the financial statements of investment advisers indicated that the expenses involved in advising mutual funds are less than those incurred in advising other clients. Expense ratios were found to be sharply higher for those advisory firms which received income from both investment company and other clients. Moreover, expense ratios increased with increases in the proportion of total income received from noninvestment company clients for most size classes of assets managed.[143] The strength of these relationships varied between specific expense items, but the relationships held in general when comparisons were made on a per-dollar-of-income-received basis and a per-dollar-of-assets-managed basis. In general,

[136] See pp. 482–485.
[137] See pp. 500–504, 508.
[138] See pp. 488–489.
[139] See pp. 485–487, 489–491.
[140] See pp. 491–492.
[141] See pp. 492–494.
[142] See pp. 494–495.
[143] It may be noted that only in those cases where the investment company assets managed were less than $300 million did the income received by the adviser from noninvestment company clients account for a significant part of total advisory income.

the salaries of personnel other than officers and directors were a prominent item in cases where the proportion of income received from non-investment company clients **was** large.[144]

It was noted earlier that higher management fee rates for open-end companies were not a function of superior performance. It is also interesting to observe that in spite of the great importance of performance to investor welfare, there appear to be very few, if any, instances of boards of directors giving serious consideration to changing investment advisers or merging their fund into one with a clearly superior performance record.

These findings suggest that the special structural characteristics of this industry, with an external adviser closely affiliated with the management of the mutual fund, tend to weaken the bargaining position of the fund in the establishment of advisory fee rates. Other clients have effective alternatives, and the rates charged them are more clearly influenced by the force of competition. Mutual fund shareholders do not pay higher management fee rates than they would incur through other institutional investment channels (which, however, normally do not involve a substantial sales charge), but they do not generally benefit from the lower charges that the volume of their pooled resources might be expected to make possible. Mutual funds without advisers have relatively lower and more flexible advisory costs, apparently at least in part as a consequence of conventional limitations on salary incomes (as opposed to payments to external organizations).

Although returns on net worth are of limited significance in the service trades,[145] it is of interest that they were highly variable among investment advisers. In a sample of 43 advisers having corporate form and engaging solely in advisory activities, the rates of return on net worth after taxes and after payment of directors' and officers' salaries ranged from 469.5 percent to a loss of 326 percent. Seven firms realized returns greater than 100 percent and 23 firms realized between 10 and 50 percent. The median rates of return on net worth on a before-tax and after-tax basis respectively were 29.5 and 17.3 percent. The distributions of rates of return were not uniform for all classes of advisers, but higher rates of return were more likely to be realized in the management of larger aggregations of assets. Of the six advisers supervising assets of $600 million or more, three had after-tax rates of return in excess of 100 percent, and two had rates under 20 percent. Six of the nine firms reporting losses were in the size classes with assets under $10 million. The median size of assets managed by the nine firms reporting losses was $1.3 million. No adviser with assets of $150 million or more reported losses.[146]

The sale of shares of open-end investment companies has been a major concern of the control groups that have managed them. Selling shares has been the principal means of expanding the volume of assets managed, and such increases automatically bring with them higher management fees (with four out of five advisers charging flat management fee rates) and more brokerage business to distribute. Moreover, in recent years selling shares has been the principal source

[144] See pp. 498–509.
[145] See p. 517.
[146] See pp. 419–422.

of gross income to the control groups of almost one-third of the investment advisers of mutual funds (29.4 percent in 1960).[147]

In the case of 110 (67.5 percent) of the 163 advisers, some income was obtained directly in 1960 by the controlling management group from the underwriting of open-end company shares, and 68 of these groups also derived income from the retailing of mutual fund shares. In 68 instances the adviser itself performed the underwriting function and obtained income from this activity, and in 34 of these cases the adviser also sold a substantial volume (10 percent or more) of mutual fund shares at retail.[148] The performance of the underwriting function by affiliated persons does not appear to be related to group size, but retailing shares is definitely more important as a direct source of income to the smaller systems. However, where the larger groups are as important as they are in the mutual fund industry, it is of interest that two of the very largest systems, Investors Diversified Services and Waddell & Reed, sell directly all or most of the shares of their constituent mutual funds. The control groups of two other substantial systems, Hamilton Management Corp. and F.I.F. Management Co., also sell directly the bulk of the shares of their affiliated open-end companies.

Intensive sales effort has been one of the important characteristics contributing to the expansion of mutual funds. Of the 156 companies responding to the first questionnaire, 5 were not selling their shares, 18 were no-load companies, and the remaining 133 companies sold their shares through wholesale and retail distribution channels at some positive selling charge. Over half of the companies had a sales charge of 8 percent and over, and slightly more than three-fourths had a charge of 7 percent or more of the selling price of the shares.[149] There was a statistically significant positive relationship between company or group asset size and the size of the loading charge. This was due in considerable part to the concentration of no-load funds in the smaller size classes. However, it also reflects the emphasis which many of the larger systems place upon selling investment company shares. They have found that high retail commissions, which induce greater selling effort, tend to increase the rate of sales of investment company shares.

The question may be raised whether there may not be a conflict of interest between mutual fund shareholders and their investment adviser in respect of the effort that should be devoted to selling shares.[150] The benefits to the adviser of more or less indefinite growth by intensive selling are fairly obvious. Without a scaled management fee rate the advantage of such growth to the shareholders in the form of cost reductions is sharply restricted. A priori it has been argued that shareholders benefit from increased diversification or risk and the ability of the adviser to afford more substantial facilities and able personnel; but it has been pointed out on the other side that small or moderate-sized portfolios contribute to flexibility of portfolio adjustments in the light of changing circumstances. Since neither average performance nor variability of performance has been significantly related to size of fund, neither of these considerations appears to have

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[147] See pp. 439–440.

[148] See pp. 471–472.

[149] See pp. 469–471.

[150] Similar questions can of course be raised as regards the interests of owners and management groups in other sectors of the economy.

been decisive. It is worthy of note in this connection that a financial analysis of 37 advisers who also served as principal underwriter for their controlled mutual funds revealed that underwriting is not only more expensive than advising per dollar of gross income received, but that in a substantial number of cases the underwriting expenses (mainly selling outlays) were subsidized out of advisory income.[151]

The disposition of brokerage business by mutual funds has also been a source of controversy regarding possible conflicts of interest between controlling management groups and shareholders. In the case of 26 of the 163 advisers examined in 1960 the controlling management group was closely affiliated with a broker, and in these instances the affiliated broker tended to do a large part of the brokerage business of the mutual fund.[152] It is commonly asserted that this is costless to the fund since the commissions involved are standardized in any case. This disregards the fact that valuable services can be obtained by means of the judicious use of brokerage, and that when it is absorbed by the controlling management group a quid pro quo to the fund shareholders need not be forthcoming.

The allocation of mutual fund brokerage is also influenced by the provision of investment advice by brokers, daily quotations and wire services, exchange membership and the desire for efficient execution, and a variety of other factors.[153] However, given the fact that a high proportion of transactions can be executed equally well by a large number of brokers, the sale of mutual fund shares by broker-dealers is the most important factor affecting the brokerage allocations of the numerous open-end company groups selling their shares in volume through independent dealers.[154]

An analysis of the relationship between sales of investment company shares made by New York Stock Exchange firms that were among the 20 largest dealers in the shares of each of 59 mutual fund groups, and the brokerage received by such dealers, indicated that a 1-percent increase in the sale of shares of investment companies by these firms tended to be associated with receipt of a 0.87-percent increase in brokerage commissions. For the larger funds the relationship was stronger, with a 1-percent increase in sales yielding roughly a 1-percent increase in net brokerage commissions.[155] This approximates a formula frequently applied in the industry, whereby a $100 increase in sales elicits a $1 increase in commission.[156] The apparently larger rewards to dealers by the larger systems may result in part from the fact that they are surplus brokerage systems; i.e., groups with brokerage commissions available for their disposition after the acquisition of necessary services from brokerage firms. The smaller funds are less likely to have surplus brokerage, and they more often sell their own shares directly, with or without a loading charge. They also

[151] It has sometimes been maintained that the higher fee rates charged mutual funds are a result, at least in part, of the need to offset losses incurred by advisers in selling mutual fund shares. While this might be an argument of merit in some cases, it has no application to the substantial number of advisers who do not participate in the selling of shares. And while this might be a consideration for new and small funds, it would hardly seem applicable to those that have achieved large size. It should also be noted that a large proportion of adviser-underwriters managing assets of over $50 million reported net profits in the underwriting function. See pp. 514–517.

[152] See pp. 473–475.

[153] See pp. 527–536.

[154] A further increase in the use of secondary offerings in the future might reduce the relative importance of sales of mutual fund shares in affecting brokerage allocations.

[155] See pp. 535–537.

[156] See pp. 534–535.

tend to be more influenced by affiliations in the allocation of their brokerage business.

Give-up transactions, in which executing brokers are instructed to credit other brokers with some fraction of brokerage commissions received, are used by a sizable minority of open-end companies, mainly as a means of rewarding dealers for sales of mutual fund shares. Give-ups are more important for the larger (surplus brokerage) companies that frequently employ a few selected principal brokers for purposes of secrecy and economy in trading. In these cases 60 percent of the brokerage is commonly viewed as at the disposal of the investment company management, since price concessions are limited by the regulated price structure for brokerage services. The larger companies, unable to absorb this surplus brokerage directly, use it to acquire various services: and as these surpluses become substantial the spillover is apparently largely in the direction of rewards to dealers.[157]

The extensive use of brokerage for rewarding dealers in mutual fund shares, as in the case of the diversion of brokerage to affiliated brokers, raises the question of whether there is a return of value to the shareholders in this type of arrangement. The widespread use of give-up transactions also suggests that the structure of regulated commission rates on brokerage transactions may be significantly lacking in flexibility.

Views as to appropriate remedies for potential conflicts of interest between controlling investment advisers and mutual fund shareholders depend on an appraisal of the importance of these conflicts to investors and the public, and the adequacy of existing mechanisms for protecting shareholder and public interests, including the required provision of information to shareholders, shareholders' voting rights, the legal obligation to select independent directors, limitations on principal transactions by affiliated persons, and competition. No attempt will be made here to evaluate the importance of these potential conflicts; they clearly exist, and they raise questions concerning the efficacy of some of the shareholder protections incorporated into the Investment Company Act of 1940.

With respect to the information requirements of the Investment Company Act, shareholders receive considerable factual data in mutual fund prospectuses and reports, and in whatever information is provided them by mutual fund salesmen. Whether this provides them with an adequate basis for evaluating performance, management fees, and the disposition of brokerage business,[158] in the absence of some framework for appraisal (including comparative information) is an open question. It is also possible that in spite of the information provided, mutual fund shareholders are led by the structure of formal relationships into supposing that their fund is a truly independent organization, whose officers and directors negotiate at arm's length on their behalf with the investment adviser in fixing fees, deciding on brokerage allocations, continuing his services based on an appraisal of the adequacy of performance, etc. If mutual funds are, in fact,

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[157] See pp. 537–539.

[158] In many cases information concerning the existence and extent of brokerage allocations to dealers in mutual fund shares is disclosed in prospectuses but not in reports regularly submitted to shareholders. A question can be raised whether this constitutes adequate disclosure to shareholders who entered the fund before the initial insertion of this information in the fund's prospectus or where there has been a substantial change in brokerage allocations.

corporate shells, serving as controlled instrumentalities of investment advisers, it is possible that the preservation of these forms, and the manner in which the associated facts are presented to him in prospectuses and reports, leave the shareholder inadequately informed concerning the central facts of power and responsibility in his fund. Shareholders may also be persuaded that they need pay little attention to most of these matters on the ground that they are fully protected from abuse by Government regulation under the Investment Company Act and other securities legislation.

On the other hand, shareholders may be well aware of the relevant facts; they may regard the mutual fund as a corporate shell and view themselves as really buying a package sold by a controlling management group, including management fees, brokerage allocations, sales effort, and performance, which yields a net result that they accept. It is also possible that shareholders either approve of the present handling of these matters, or at least do not regard the issues involved in areas of potential conflict of interest as of sufficient importance to warrant serious attention. If we could assume adequate investor knowledge in these areas, the question might be raised whether, if shareholders are insufficiently concerned about certain issues (such as the level of management fee rates) to make any substantial protest or to elicit an important competitive response in the industry, they have sufficient importance to warrant special attention.

It should be noted that shareholder acceptance of a situation without serious protest need not indicate an absence of investor interest in or desire for change. Quiescence may reflect the recognition of absence of power, or it may reflect the fact that these issues, though recognized as relevant to investor welfare, appear too marginal in importance to command serious investor attention, particularly in a period of rising stock prices. Furthermore, shareholders may accept the actions of a fund management which are validated by the fact of widespread and conventional usage, although the practices in question may be objected to from other standpoints.

Some salient characteristics of existing machinery for protecting mutual fund shareholder interests through legal provision of voting rights and the requirement of independent directors were discussed earlier. Shareholder voting rights appear likely to be of limited value in this industry as a consequence of the wide distribution and low level of concentration of mutual fund shares, ease of withdrawal from the fund assured by the redemption privilege, and the fact that the most important part of the package acquired by an investment in a mutual fund may be regarded as the services of the specific management group exercising control.

It was also concluded that the independent director requirement may be of restricted value as an instrument for providing effective representation of mutual fund shareholders in dealings between the fund and its investment adviser. This was inferred from the fact that independent directors are selected by the controlling management group, that the definition of "affiliated director" in the Investment Company Act is narrow, and from the accumulated evidence concerning the level and behavior of fee rates and the typically minor role of the board of directors and independent directors in mutual fund affairs.

This does not deny that shareholder voting rights and the independent director requirement have value as potential checks in the event of major abuse; nor should we rule out the possible improvement in these protective devices by means such as attempting to stimulate the activity of independent directors through greater publicity regarding their responsibilities, and perhaps increasing the proportion and tightening the definition of unaffiliated directors.

One of the most important and powerful shareholder protections incorporated into the Investment Company Act was the section 17 limitation placed upon sales and purchases of securities and other properties between investment companies and affiliated persons. This has virtually eliminated several classes of transactions that were associated with major abuse in the preceding several decades. (It may be noted that these problems were of importance prior to the period when mutual funds were a major factor in the investment company business.)

Competition among mutual funds has provided investors with a wide range of choice as to fund type, loading charge, etc. It has stimulated efforts to achieve outstanding investment performance since fund sales, at least to some extent, have been positively correlated with fund performance. Competition in promoting sales directly as well as indirectly through winning and stimulating dealer sales efforts with respect to particular funds has been an important characteristic of the mutual fund industry. Thus competition in the mutual fund business has assumed the principal nonprice forms—variety of product, product quality, and sales promotion—but for the most part it has involved price, at the investor level, only insofar as size of sales charge has become a competitive factor as between the principal funds in the industry and the no-load companies, which still constitute a relatively small fringe of the business. Management fee rates and the allocation of brokerage business have not as yet elicited important competitive responses for a major part of the industry.

There are several other approaches to handling potential conflicts of interest, which could be considered if these conflicts were deemed serious. One type of approach, suggested by the shell theory of the mutual fund, and by the analysis of management fee rates in chapter VIII, would be to eliminate the shell and require a direct relationship between shareholders and controlling managers. This could be brought about either by requiring each open-end company to be internally managed (i.e., excluding investment advisers), or by eliminating the investment company shell between the adviser and shareholder by requiring advisers to sell shares directly in a fund explicitly managed and controlled by them. This type of approach might provide a closer alignment of power and fiduciary responsibility, but it also would be a disruptive action with consequences that must be regarded as speculative. A second approach would be direct regulatory controls and limitations on selling charges (including those levied in front-end load contractual plans) and the imposition of a required maximum structure of management fee rates scaled by asset size (with, perhaps, allowance for performance differentials). Here, again, the regulation of selling charges and fee rates would be disruptive, and would, in addition, raise extremely difficult problems of equitable rate fixing.

The widespread use of brokerage commissions in the form of "give-ups" to reward dealers for the sale of mutual fund shares, and the absorption of brokerage by persons closely affiliated with fund control groups, may be deserving of special attention. Insofar as the rewards to dealers are encouraged by the limited scaling of brokerage commission rates, some attention might be given to the possibilities of increasing flexibility in this area. In principle, a desirable solution to the question of the proper disposition of brokerage business might be to provide means whereby some share of surplus brokerage could be channeled directly to the mutual fund.[159]

[159] This might be achieved either by mutual funds obtaining seats on the exchanges, which is at present restricted by exchange rules, or by broker-advisers sharing the surpluses with mutual fund shareholders indirectly via reduced management fee rates.