



SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

JAN 16 1970

Honorable John E. Moss, Chairman
Subcommittee on Commerce and Finance
Committee on Interstate and Foreign Commerce
Room 2125, Rayburn House Office Building
House of Representatives
Washington, D. C. 20515

Dear Mr. Moss:

In his testimony before the Subcommittee on November 13, 1969, Mr. Robert L. Augenblick, president of the Investment Company Institute, while acknowledging that the Institute had agreed with the Commission not to oppose the management-fee provisions in H.R. 11995 and S. 2224, which impose judicially enforceable fiduciary obligations on investment company managers with respect to their compensation, suggested that this be augmented by "self-regulation." Thereafter, senior members of our staff had several meetings with industry representatives and staff members of your committee to discuss the proposal. In my testimony before the Subcommittee on December 11, 1969, I pointed out a number of the very complex and difficult problems presented by this proposal. Since then, our staff, representatives of the Investment Company Institute and of the NASD have met again with the staff of the Committee to consider the matter further. Every effort was made in these extended sessions to ascertain exactly what the Investment Company Institute had in mind, how its proposal would work, and whether a scheme compatible with H.R. 11995 could be developed.

In essence it appears that the Institute proposes to tack on at the end of the Bill a new section drawn largely--almost verbatim--from the Maloney Act (Section 15A of the Securities Exchange Act of 1934), to include in this a provision exempting all members of the proposed self-regulatory association from

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the proposed Section 36(b) dealing with the fiduciary obligations of investment company managers, and to delete certain provisions of the Maloney Act which are obviously inapplicable to the investment company industry as distinct from the securities industry. At this point the ICI does not know what type of rules would be developed except that these would have to be "intricate," or how the association would be organized, financed or managed, or what part of the industry would choose to join it, or the impact of this self-regulation on other provisions of the 1940 Act.

After careful consideration, we do not believe that this proposal is an appropriate addition to H.R. 11995 and S. 2224. In view of the unique structure of externalized management in the investment company industry, self-regulation in the advisory fee area does not appear to be workable or desirable under the present statutory scheme. And it does not seem to us possible to work out a responsible alternative scheme in a one-section supplement to the pending bill. That bill is responsive to existing problems in the industry within the framework of existing regulation, and has commanded the attention of the Commission and the Congress for about three years. A simplistic self-regulatory proposal made at the eleventh hour of this consideration does not do credit to the concept of self-regulation, a complex subject.

The difficulties with the proposal that lead us to this conclusion may be summarized as follows:

1. In advancing the self-regulation proposal, the ICI concedes that a prime objective is elimination of shareholder actions and actions by the Commission. These are two of the principal means by which Congress has provided for the enforcement of the Federal securities laws and the protection of injured investors. There is no sound policy reason to support making an exception to protect investment advisers against those for whom they are fiduciaries. With the support of the Commission, the courts have also consistently implied private rights of action under the Federal securities laws, especially under the 1940 Act. These long-standing policies ought not be reversed now. As the Supreme Court stated in Petroleum Exploration, Inc. v. P.S.C., 304 U.S. 209 at 222 (1938), "... the expense and annoyance of litigation is 'part of the social burden of living under government.' "

The insulation of the advisory companies from stockholder litigation would mean that this would be the major incentive for anyone to join the organization. This does not seem to be an adequate reason for supporting such an organization from the viewpoint of the funds or their directors, particularly since proposed Section 36(b) would insulate fund directors from suit unless they also were the recipients of compensation challenged under the section.

2. Self-regulation is effective in areas of common concern between the industry and the Commission. For example, in my speech of September 4, 1969, I discussed the need for greater self-regulatory effort in the context of various problem areas which clearly are of common concern to the securities industry generally. The difficulty with the self-regulation proposal in the area of advisory fees, however, is that in this area, the industry has steadfastly maintained that there is no problem. In effect, we fear it would amount to self-protection for a group as closely knit as the ICI, which has only some 115 management companies as members. Indeed, we understand that ten mutual fund management companies control about 52 per cent of the net assets of the industry and that 15 of them control about 65 per cent, or nearly two-thirds. This would not be self-regulation by the funds--it would be self-regulation by this small group of management companies.

3. Under the present proposal, in order for any adviser to join the organization, the funds under its management would be required to join. The dues structure would probably result in the funds paying substantial or even the major costs of the organization. This is an anomaly in that the purpose of the organization would be to insulate advisers from shareholder's suits. Further, viable self-regulation must carry with it meaningful sanctions for noncompliance, including expulsion. The ICI proposal contemplates this. Thus, the proposal embodies the possibility of the added anomaly of a fund being expelled from the organization supported by its dues for misconduct--not of itself--but of its adviser.

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4. In order to engage in this self-regulatory activity, the association would require an exemption from the antitrust laws. In the light of the present externalized management structure which is prevalent in the industry, we cannot possibly support such a request as being in the public interest.

5. Particularly in view of the problems presented by this species of self-regulation, the Commission would have to assume a very active role in the performance of its oversight possibilities. This would probably have to be more complete and thorough-going than the existing oversight under the Securities Exchange Act and would almost certainly wind up by involving the Commission in "rate-making." The Commission does not want and should not be forced to be a rate-making body in the advisory fee area.

6. The ICI proposal contemplates an "objective" industry-wide standard which would encompass not only ordinary mutual funds but even the separate accounts of insurance companies. We understand that the present thinking of ICI envisions a schedule of specific permitted total expense ratios keyed to fund size. Such a standard would also have to take into account such factors as relative costs of different services performed by the advisers for each fund, and their differing value to shareholders from fund to fund. To do this, the ICI admits, an "intricate" rule is required which they have not yet worked out. We have serious reservations whether such a rule could be devised. Further, effective Commission oversight of such a rule would require rate-making on the part of the Commission, which, as indicated, the Commission has opposed.

Investment advisory expenses and services and their value vary significantly from fund to fund and from complex to complex, reflecting the wide diversity of investment company objectives and policies and the multiplicity of means used to achieve those objectives and policies. To encompass all this within a single objective rule which would operate fairly to all concerned and under all circumstances seems to us difficult, if not impossible. Another problem exists under this objective rule. Investment company complexes vary greatly in terms of the incidental services in addition to investment advice and

management which are paid for out of the fee. Consequently, the ICI contemplates that the objective rule would be keyed not to the management fee itself but rather to placing ceilings on the permissible expense ratios of the funds. This would intensify the conflict of interest of the advisers by providing an incentive to skimp services in order to maximize the fee component of the total allowable expense.

7. The ICI contemplates that brokerage received by an affiliated broker would not be taken into account in determining reasonableness of the advisory fee under their rule. It has consistently been the Commission's position that all compensation, specifically including brokerage received by the adviser or its affiliates, should be taken into account in determining the reasonableness of advisory fees. To do otherwise would discriminate in favor of advisers with broker-dealer affiliates inasmuch as brokerage commissions are not included in computing expense ratios.

8. In shifting regulation of sales loads from the NASD to the new organization, the ICI proposal would fragment and dilute the role of the NASD. Further, in the area of sales loads charged by broker-dealers, the "self-regulation" would be determined by an association in which broker-dealers would have little or no voice.

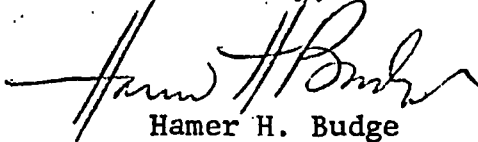
9. The ICI suggestion to create an entirely new self-regulatory mechanism for investment advisory fees is something entirely different from adding to the existing functions of the NASD in the regulation of charges in the over-the-counter market and the new function of regulating sales loads in the mutual fund field as contemplated by H.R. 11995. The NASD is a large, well-established organization with a substantial staff and thirty years of experience in regulating sales charges. Moreover, unlike management fees, sales charges, either for mutual fund shares or for over-the-counter securities, lend themselves much more easily to a regime of objective ceilings and that is the general manner in which the NASD has proceeded in the past.

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The foregoing does not mean that we are opposed to self-regulation per se, or even that we are unalterably opposed to it for every aspect of the investment company industry. So far as the area of advisory fees is concerned, the proposal submitted to us is not compatible with the legislation pending before the Committee. It is our experience that self-regulation can be successful only when it is in the interest of the self-regulators that self-regulation be vigorous and effective. Generally speaking, with some exceptions at various times, this has been true of the exchanges and the NASD. In the area of investment advisory fees, effective self-regulation cannot be expected without other major changes in the Investment Company Act, so that self-regulation in this regard would not be dominated by those who receive such fees and have a vested interest in insulating them from effective control. We therefore hope that Congress will act upon the pending legislation in its present form, which is the product of over ten years of study and which, until recently, represented a consensus between the Commission and the industry, leaving to some future time the consideration of major changes which would be necessary to provide a climate for successful self-regulation in this industry.

Sincerely,



Hamer H. Budge
Chairman

Duplicate Originals:

Robert L. Augenblick, Esq., President
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and General Counsel
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