PAINE WEBBER INCORPORATED
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Richard Breeden, Esq.
Task Group on Regulation of
Financial Services
Department of the Treasury
15th Street and Pennsylvania Ave., N.W.
Washington, D.C. 20220

Dear Mr. Breeden:

We understand that the Task Group is considering the problems of the regulatory scheme to which mutual funds are subjected as well as means of redressing these problems and providing a simplified pattern of regulation. We believe that this objective can be achieved without forfeiting meaningful protection of public investors.

Because we understand that the Task Group does not intend to propose a comprehensive overhaul of existing securities regulation, we shall limit our comments to our paramount concerns.

The first is section 36(b) of the Investment Company Act of 1940 (the “Act”). This provision has spawned and inspirited an excessive and wasteful body of management fee litigation. Such litigation results in no benefit to shareholders, saps enormous resources of both advisers and mutual funds and enriches only the lawyers. Defendants are bludgeoned into settlements by the costs, time constraints and risks of litigation regardless of likelihood of ultimate success.

Most suits brought under section 36(b) end in settlements. As a result, the scope and nature of the “fiduciary duty” standard of the section remains undefined. This vagueness permits plaintiffs’ lawyers to continue to raise such questions in frequently successful attempts to force settlements from advisers who for the most part are charging no more than is being charged by most others in the marketplace for similar services.

The Investment Company Institute (“ICI”) has proposed that section 36(b) be amended by substituting for the “breach of fiduciary duty” test the business judgment of independent directors. We believe this approach represents a reasonable solution to the issues that section 36(b) was intended to address. This approach is also consonant with the increasing regulatory reliance on independent directors to resolve issues involving disparate interests of advisers and funds.

A second concern is a provision of the Act which we believe serves little, if any, regulatory purpose, and in addition impedes the ability of securities firms to raise capital. Section 12(d) (3) makes it unlawful for any registered investment company to ". . . purchase or otherwise acquire any security issued by or any other interest in the business of any person who is a broker, a dealer, is engaged in the business of underwriting, or is either an investment adviser of an investment company or an investment adviser registered under title II of this Act . . . ."

The Commission reads section 12(d)(3) broadly. Although the section does not by its terms prohibit the purchase of securities of an issuer such as Paine Webber Incorporated, the corporate parent of a company engaged in the specified activities, the Commission views the provision as nonetheless applicable. The staff recently determined section 12(d)(3) applied to the purchase of securities of Sears, Roebuck and Company since that company controls Dean Witter. While the staff has promulgated an exemptive rule, it contains many restrictions that make it unwieldy and, moreover, are unnecessary for the protection of investors.

At the time of the adoption of section 12(d)(3) most broker-dealers were organized as partnerships. Thus until recent years, an investment in a broker-dealer involved direct negotiation, a private placement and the close inter-relationship between investor and issuer which these imply. Such a close relationship — more entrepreneurial and like that of joint venturer rather than investor in the public market — might indeed create the potential for abuse of position with which Congress was apparently then concerned.

We see no reason, however, for the continued existence of section 12(d)(3). Many broker-dealers are now publicly owned. Perhaps more important, there are other provisions in the Act that adequately protect against self-dealing, e.g. section 36(a). Any benefit that may have existed at the time of adoption is extant no longer and is clearly outweighed by the impediment of the provision to the efforts of securities firms to raise capital. We recommend strongly that section 12 (d)(3) be repealed.

Yet another concern is section 17(d) of the Act. Section 17(d) as written is far from lucid and leaves mutual funds no choice but to resolve uncertainties by seeking exemption requests for specific transactions — or to refrain altogether from any transaction which may fall within its purview. The latter course is typically chosen since the Commission will not issue exemptive orders under the section without the very costly and time consuming exercise of reviewing and approving every facet of the proposed transaction. We believe that exercise is more properly in the bailiwick of the board of directors of the fund. The disinterested directors of a fund should be perfectly capable of protecting the interest of shareholders and section 36(a) can provide a swift remedy to any wrongdoing. Accordingly we believe section 17(d) should be amended to achieve that result.

Finally, there is a serious problem with the Commission's troublesome foray into legislation: rule 12b-1. Rule 12b-1 set up an elaborate scheme for funds to follow to authenticate payment to advisers for distribution expenses — something that section 12 itself never prohibited.

Section 12(b) prohibits a mutual fund from acting "as a distributor of securities of which it is the issuer, except through an underwriter, in contravention of (SEC) rules and regulations" (emphasis added). The exception for funds which offer their shares "through an underwriter" clearly limits the Commission's authority under section 12(b). Agreements with underwriters are regulated by section 15 of the Act.

The rule has as its premise that a fund is bearing distribution expenses indirectly if an underwriter sells the fund's shares for a fee. However, the history of section 12(b) makes it clear that Congress never intended that result. Saying that a fund hiring an external underwriter to distribute the fund's shares is itself deemed to be an "underwriter," is like saying that a person who retains a lawyer to prosecute a lawsuit is deemed to be a lawyer.

We believe section 12 should be amended to permit fund directors to enter into fund distribution arrangements they deem appropriate in the exercise of business judgment. Once again, section 36(a) would serve to remedy any abuses.

If it would be helpful for us to expand these comments or respond to questions, please let us know.

Very truly yours,

Sam Scott Miller

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