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assets on a per share basis. Applicants have retained an outside expert to assure that the funds have systems to compute net asset values accurately.

The third area addressed is whether investors receive information enabling them to understand a multiple class arrangement and make informed investment decisions. Certain disclosures have been required, *e.g.*, that salespersons' compensation depends upon which class is sold and differences in the yields and total returns for the respective classes.

The Division recommends that the Commission adopt a rule permitting funds to issue multiple classes of shares in a single underlying portfolio. We intend to re-examine the conditions imposed on applicants, with a view towards streamlining them. A more general rule would simplify the procedure for creating multiple classes, saving time and reducing expenses. Multiple class funds are a useful structure that can increase investor choice, result in economies of scale and certain efficiencies in the distribution of fund shares, and allow fund sponsors to tailor products more closely to the needs of investors.

#### **IV. The Unified Fee Investment Company: An Alternative**

As the foregoing discussion suggests, mutual fund fee structures have grown increasingly complicated in the last two decades. The array of fees and loads now available to investors does increase investor choice, but may also impede price competition. The Division believes that price competition might be improved if, ironically, still *another* form of investment company were permitted -- one with a simplified fee structure and low barriers to exit by dissatisfied shareholders.

Accordingly, the Division recommends that the Commission propose legislation to permit the introduction of a new investment vehicle, which we term a unified fee investment company ("UFIC"). The UFIC would have a single, fixed fee set by the vehicle's "investment manager" and no separate sales charges or redemption fees. All UFIC expenses, except brokerage commissions on the fund's own portfolio transactions and extraordinary costs, would be paid from the single fee or from the manager's own resources. Rule 12b-1 would not apply. The level of the fee would be prominently displayed on the cover page of the prospectus and in all sales literature and advertising. To protect investors should competition not restrain fee levels for the UFIC, the Act would prohibit "unconscionable or grossly excessive" unified fees.

The UFIC would have a board of directors to police operational conflicts and approve a variety of operational activities, just as do other funds. The UFIC's board also would be charged with approving the investment manager's contract with the fund, and ensuring that the level of the single fee is not unconscionable

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or grossly excessive. Short of protecting shareholders against such fees, however, the board would not be responsible for negotiating the level of the fee, nor would the board be required to scrutinize the fee provisions of the fund's investment advisory contracts. The board also would oversee the level of services provided to the UFIC through review of all material service contracts. Shareholders would elect directors in accord with section 16(a) of the Act. Two-thirds of the directors would be independent; and, once initially selected by the UFIC sponsor, the independent directors would be self-nominating.

The UFIC's shareholders would not vote on issues related to fees or contracts. Thus, they would not vote to approve or terminate the management contract, any investment advisory contract, or any other contracts for fund services. Their authorization would not be needed to increase the rate of the unified fee. Rather, after reviewing advance notice of a fee increase or contractual change, shareholders would have the opportunity to accept or reject the increase or change by remaining in the fund or redeeming their shares. The shareholders would have all other voting rights mandated for shareholders of open-end companies.

The UFIC's single fee would be reflected in the vehicle's performance figures and could be readily compared with the fees charged by other UFICs. Without sales loads as barriers to exit, dissatisfied UFIC investors could redeem freely. This ready ability to exit should focus managers on keeping expense levels low and investors satisfied.

Regulatory provisions imposed by the 1970 amendments to the Investment Company Act to counteract the ineffectiveness of competitive forces on fee levels would not apply to the UFIC. Thus, section 36(b) would not apply to the fee paid to the UFIC's investment manager. In addition, section 22(b) would not apply to the fee or any portion thereof.

It appears likely that no-load funds would use the UFIC first. Many long-term bond or stock funds that distribute their shares through commissioned sales forces likely would have to restructure their sales compensation arrangements in order to operate as UFICs. A few broker-dealers have already reformulated sales compensation from large up-front payments to streams of payments, which would be more compatible with the UFIC structure. Given the flexibility of the UFIC, if investor demand for a simplified fee product is strong, we expect that the industry would use its creativity to devise distribution methods acceptable to commissioned sales forces that would allow long-term bond and stock funds to use the UFIC.

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## A. Rationale for the Unified Fee Investment Company

Investors today appear to have a heightened awareness of fund expenses and their effect on investment return, but at present bond and equity funds do not appear to compete on the basis of expenses, perhaps because of several factors that inhibit market pressure. This increased investor awareness is likely due partly to Commission actions in the past twenty years to relax restrictions on advertising generally by investment companies and to develop standards for disclosing and advertising fund performance.<sup>175</sup> These actions permitted the evolution of an information industry that tracks funds. Specialized newsletters are published by a host of organizations, and many financial and general interest publications provide extensive coverage and analysis of mutual funds, including periodic rankings of performance and fund expense ratios.

As a result of these changes, funds that have low expenses have enjoyed substantial growth,<sup>176</sup> and market forces appear to be a more effective restraint on expenses today than they were in the 1960's. The degree of restraint, however, varies among the three major fund types: money market funds, bond funds, and stock funds. Two factors appear to explain the variations. First, where the costs of owning mutual fund shares are clear-cut and there are few barriers to exit, investors have greater incentive to leave, and, consequently, fund sponsors must be vigilant about paring expense levels. Second, where expenses directly and substantially affect short-term performance, investors focus on expense levels; the less expenses affect short-term performance, the less investor scrutiny they receive.<sup>177</sup>

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<sup>175</sup>See Chapter 9.

<sup>176</sup>For example, assets under the management of the Vanguard Group, the lowest-cost producer in the mutual fund industry, grew twentyfold during the 1980's, from \$2.4 billion to over \$50 billion, twice the rate of the industry as a whole. SANFORD C. BERNSTEIN AND Co., **THE FUTURE OF THE MONEY MANAGEMENT INDUSTRY** 60 (1990) [hereinafter **BERNSTEIN REPORT**].

<sup>177</sup>The level of expenses, of course, varies widely among fund types. According to one fund group:

[Costs] tend, for example, to be higher in equity-oriented funds (where they are easy to overlook on any short-term basis), and lower in money market funds (where they account for substantially all of the difference in yield). The costs of taxable and tax-exempt bond funds fall between this range.

Vanguard Money Market Reserves, 1990 ANNUAL REPORT ii (1990). One writer contrasts the expenses of bond funds with those of stock funds by noting that "[bond funds usually have lower expense ratios than stock funds because they are not managed as aggressively." Carole Gould, **High Expenses: Sign of Weakness**, **N.Y. TIMES**, Mar. 4, 1990, at F-28.

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These factors converge for money market funds and consequently market forces appear to exert great downward pressure on money market fund expenses. Investors accurately perceive that the money market fund is a relatively homogenous product for which yield is a major purchase criterion. The typical money market fund has no sales loads, either front-end or contingent deferred, and either no or low rule 12b-1 fees and thus simple, intelligible expenses and no barriers to a dissatisfied shareholder's exit from the fund. To attract and retain investors, money market fund sponsors actively compete on yield. Expense differentials may account for as much as three quarters of the variation in money market fund yield and almost one half of the difference between the highest- and lowest-yielding money market funds.<sup>178</sup> Investor focus on money market fund expense levels is sharpened by advertising and media coverage, which provide significant information to facilitate yield comparisons, and emphasize that the level of fund expenses is a major determinant of yield. Substantial fee waivers by money market fund sponsors have been common in recent years, and further emphasize the relationship between expenses and yield.<sup>179</sup> In fact, the fee waivers are usually styled as the manager absorbing all fund expenses beyond a certain level (e.g., twenty-five basis points), resulting in a fixed, single fee.

There is less market pressure on the levels of fees with bond and stock funds than with money market funds. The variety of charges and operating and

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<sup>178</sup>See IBC/DONOGHUE'S MONEY FUND REPORT 1 (Aug. 10, 1990); BERNSTEIN REPORT, *supra* note 176, at 12. The effect of expenses on yield is likely to be further enhanced, as the recent amendments to rule 2a-7 (17 C.F.R. § 270.2a-7) have tightened the conditions of the rule relating to portfolio quality, maturity, and diversification, so that money market funds' portfolios (and rates of return) are likely to become increasingly fungible. See Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 18005 (Feb. 20, 1991), 56 FR 8113.

<sup>179</sup>Carole Gould, *One Way Funds Can Inflate Yields*, N.Y. TIMES, June 23, 1991, at III-10 ("More and more funds are absorbing some expenses as part of marketing strategies intended to attract investors by inflating yields -- the amount that funds earn in interest after the expense charges are subtracted. As of April 30, [1991,] 7 of the 10 top-yielding money funds were subsidizing at least part of their expenses by charging investors less than the total amount spent to run the funds. And, on average, 7 of the 10 top money funds have done so for the last year . . .").

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distribution expenses of bond and stock funds are difficult to aggregate, cannot be readily compared among funds," and cause investor confusion?" Today, bond and stock funds typically operate under an unbundled fee structure: they pay multiple fees for separate services provided under separate contracts. Of further confusion to investors, fees with the same label pay for different services. For example, some advisory contracts provide for portfolio management only. Other advisory contracts also provide for administrative, shareholder accounting, and transfer agency services. Compounding the labeling problem, particular fees are obscured by their placement in either the fund or the shareholder account, or by shifting their timing among point of purchase, investment period, and point of exit. Moreover, the sales loads (contingent or otherwise) and redemption fees charged by many bond and stock funds are perceived by investors as a penalty for taking one's money elsewhere and, as barriers to shareholders' exit, discourage competition for investors' dollars. Consequently, the competitive pressures on these funds appear to be less than on money market funds.

In addition, the relative investment performance of stock funds and, to a lesser degree, bond funds is not as significantly affected by expenses, at least in the short run, as is the performance of money market funds.<sup>182</sup> As a

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<sup>180</sup>Contributing to this difficulty, rule 12b-1 distribution fees currently are treated as an annual fund expense that is automatically included in annual return computations, while front-end loads and contingent deferred sales charges are sometimes included in calculations of total return and at other times are not included. For example, rule 482 (17 C.F.R. § 230.482) permits mutual funds to advertise performance data that do not reflect sales loads or other nonrecurring fees, provided that the funds disclose that the performance data do not reflect their deduction, and that, if reflected, the loads or fees would reduce the performance quoted. Rankings of fund performance issued by various publications often do not reflect such charges.

<sup>181</sup>With the 1988 amendments to Form N-1A (see *Inv. Co. Act Rel. 16244, supra* note 85), the Commission required mutual funds to consolidate expense data in a fee table located near the front of each prospectus and to include additional disclosure regarding rule 12b-1 plans. These disclosures improve investor understanding of fund expenses and sales charges, but the different kinds of costs still frustrate direct comparisons.

<sup>182</sup>Bond funds' expense differentials account for a lesser, although still significant, proportion of the overall yield and total return variation than do those of money market funds. Bond fund yields are subject to greater variation than yields of money market funds because bond fund portfolio managers are not bound by the limits on portfolio quality and maturity mandated by rule 2a-7 and accordingly, their portfolios are not as homogenous. The expenses of bond funds, however, have different effects on yield than on total return. A bond fund's total return usually differs from its yield because the value of its portfolio varies with changes in the general level of interest rates and changes in the credit quality of the issuers whose securities it owns; the impact of interest rate and credit quality changes on portfolio value and on total return are greatest for bond funds with portfolios of long-term or low-quality bonds. Correspondingly, expenses have less effect on the total return of these funds, at least in the short run.

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consequence, investors appear to focus less on the expense levels of these funds than they do for money market funds.<sup>183</sup>

For these reasons, the Division has concluded that a new type of open-end investment company that has readily determinable and comparable expenses and minimal barriers to exit, like money market funds, would appeal to investors because of the simplicity of its fee and would foster competitive pricing among bond and stock funds. Accordingly, the Division recommends that the Commission propose amendments to the Act to permit the UFIC, an alternative type of mutual fund with a single fee. The UFIC would be subject to a lesser degree of fee regulation, and its simple fee structure would benefit both investors and sponsors. Fee disclosures for UFICs would be easy to prepare and

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<sup>182</sup>(...continued)

For stock funds, the impact on fund performance of expense differentials may be insignificant compared to the impact of portfolio gains and losses. See, e.g., Jonathan Clements, *Does Your Stuck Fund Pass These Three Tests*, WALL ST. J., July 22, 1991, at C-1 ("With money funds and most bond funds, analysts say, the most important criteria are each fund's annual expenses . . . . But when it comes to hunting down a well-managed stock fund, analysts put a bit of emphasis on past performance, especially a fund's results over larger time periods such as five and ten years."); Letter from John C. Bogle, Chairman, The Vanguard Group of Investment Companies, to George A. Fitzsimmons, Secretary, SEC 11 (Mar. 9, 1983), File No. S7-955 (commenting on Investment Company Act Release No. 12888 which requested public comment on mutual fund governance) ("In stock funds, where annual performance differs by large magnitudes from one fund to another, total performance, not the expense ratio and its relatively modest impact on performance, is the focus of investor attention").

<sup>183</sup>Nonetheless, bond funds today compete in part on expense levels. The Bernstein Report gives this example:

Franklin [Resources, Inc.'s] municipal yields are among the best in the industry owing to fund expense levels of about 50 basis points versus an industry average of 80 basis points. . . . Virtually all of this pricing advantage relates to non-advisory expenses (transfer agent, custody, professional fees) which are spread over three funds with combined assets of \$16.5 billion. Franklin provides these services to the funds, and at cost.

BERNSTEIN REPORT, *supra* note 176, at 77. This report also states that "direct price competition increasingly makes sense for the largest firms, who enjoy scale advantages in name awareness, servicing costs and actual money management. We believe pricing will be a more important factor and therefore expect both sales loads and management fees on fixed income products to be under pressure." *Id.* at 12.

In addition, bond and equity index funds appear to compete on expense levels. The chief difference in yield or total return among such funds will be any difference in expenses.

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understand, and readily compared with those of other funds of the same type.<sup>184</sup> Additionally, the true cost of investing in the vehicle would be apparent, since distribution-related and other charges would be included in all published figures for fund yield and total return. From the perspective of sponsors and directors, bundling all costs of operation and distribution into a single fee also should reduce the time and expense of detailed accounting reports, legal analyses, and deliberations surrounding expenditures from fund assets that must be allocated for advisory, distribution, and other services.

## **B. Operation of a Unified Fee Investment Company**

The UFIC would be organized and operated as described below.<sup>185</sup>

### **1. Role of the "Investment Manager" and Parameters of the "Unified Fee"**

A UFIC would be organized and operated by an "investment manager." The UFIC would be defined as a type of open-end investment company organized under the laws of any state or states, that is operated by an investment manager pursuant to a written contract in return for a unified fee. The term "investment manager" would be defined to distinguish the sponsor and manager of a UFIC from the investment advisers of other management investment companies. The term "investment manager" would be added, where appropriate, to provisions of the Act and rules that refer to a fund's "investment adviser."<sup>186</sup>

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<sup>184</sup>The benefits of a single fee fund and of off-the-page advertising (discussed in Chapter 9) would be mutually reinforcing. A unified fee vehicle would lend itself to off-the-page advertisements by simplifying the task of providing the relevant expense and historical performance information. The ability to advertise off-the-page would facilitate the use of single fee funds by providing an efficient means of informing investors of this alternative vehicle and promote price competition.

<sup>185</sup>As discussed in Chapter 7, some industry observers have previously advanced an alternative type of open-end investment company termed a unitary investment fund ("UIF"). The UIF would feature a fixed expense ratio or manager's fee, subject to a statutory cap, that would finance all fund expenses except for extraordinary expenses and transfer agency costs. The latter expense would be charged directly to each shareholder's account and not to the fund. Accordingly, the cost of investment in the UIF would be readily apparent to investors. Because the UIF would not have the protections provided by boards of directors and shareholder voting, would not diminish costs substantially, and would not significantly facilitate internationalization, we do not recommend it. As is evident from our present proposal, however, we believe that the single fee aspect of the UIF has merit, if accompanied by appropriate protections.

<sup>186</sup>For example, section 36(a) would be amended to include the investment manager among those persons whom the Commission may sue for breach of fiduciary duty involving personal misconduct.

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A written "management contract" between the investment manager and the UFIC would specify a single, unified fee payable to the manager in exchange for all services necessary for the UFIC's operation and bind the manager to provide or contract with third parties for these services. This fee would be subject to market pressure and the continuous "vote" of investors in the form of investor decisions to purchase or redeem shares. The fee would be computed as a percentage of fund assets and deducted from assets on a daily basis.

From an investor's perspective, the UFIC would be a "pay-as-you-go" vehicle. All costs of operating the fund and distributing its shares -- other than portfolio transaction costs and extraordinary expenses<sup>187</sup>-- would be financed by the investment manager out of the unified fee or its own resources.<sup>188</sup> Thus, UFIC investors could not be assessed sales charges of any type or redemption fees,<sup>189</sup> and the portion, if any, of the fee that could be spent on distribution would be within the discretion of the manager. The manager could not use fund brokerage to pay for services such as custody, or free credit balances to pay for transfer agency services. To facilitate election of UFIC status and because a unified fee structure obviates the need to unbundle costs, the UFIC would be exempt from section 12(b) and rule 12b-1.

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<sup>187</sup>Treating brokerage costs as a general fund expense would be contrary to the current approach of applying these costs to the cost basis of each individual security. It also would require an investment manager to set its fee rate at a level that would include compensation for executing the fund's securities transactions or contracting with others to perform this function. This exercise would entail a certain amount of guesswork, and once undertaken, it could lead to "reversechurning," as the manager's interest in actively managing the portfolio might wane, given that all transactions would reduce the manager's profitability.

To ensure clarity and comparability among UFICs, "extraordinary" expenses would be defined under Commission rules implementing the **UFIC**.

<sup>188</sup>Allowing shareholders to be directly assessed any operating costs would impair investors' ability to compare expenses -- the heart of any market-oriented reform of mutual fund fee arrangements. Thus, the fact that certain operating costs are variable, *i.e.*, they are affected by the number and level of activity of fund shareholders, does not justify their exclusion from the single fee.

The UFIC's fee structure bears some resemblance to a proposal put forth by John Markese of the American Association of Individual Investors in response to the Study Release. Citing investor confusion and comparability problems, Mr. Markese advocated limiting funds to a single asset-based distribution charge, capped at 0.50% annually of the investor's holdings, and an investment management fee out of which fund advisers could pay for additional distribution costs to the extent of their profits. See John Markese, *A Simplified Fee Proposal*, AAIJ., Aug. 1990, at 17. A large number of individual investors endorsed Mr. Markese's article in their comments on the Study Release.

<sup>189</sup>Of course, as with other mutual funds, redemption from UFICs may not be entirely cost free since UFIC shareholders may realize capital gains upon redemption.



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The terms of the management contract between a UFIC and its investment manager would be governed by new section 15(g). Section 15(g) would make it unlawful for any person to serve or act as a UFIC's investment manager except pursuant to a written contract which precisely describes all compensation to be paid under the contract, and would specify that such compensation shall be limited to a unified fee payable to the investment manager, "extraordinary expenses," as defined by Commission rule, and interest, taxes and portfolio transaction costs (*i.e.*, brokerage fees). The investment manager would have the discretion to change the fee on ninety days' advance notice to shareholders of any increase. A fee could not be changed until it had been in effect for a full year. The section would incorporate the requirements of sections 15(a) and 15(c) regarding director approval of the initial contract and any renewals, but would provide that, in approving the rate of the unified fee, the directors need only ensure it is not "unconscionable or grossly excessive." The section would also require that the contract provide, in substance, that it may be terminated at any time by the full board or by the independent directors, voting separately.

## 2. Limits on the Unified Fee .

Because the unified fee would be subject to competitive pressures, it need not be limited by statute or rule, except that no fee should be so grossly excessive as to constitute a waste of corporate assets as that standard is understood under state corporate law.<sup>190</sup> Accordingly, section 36(b) would be amended to exempt UFICs, their sponsors, investment advisers, affiliated entities, and other persons identified in the section, and to prohibit only unconscionable or grossly excessive UFIC fees. Section 22(b) would also be amended to exclude UFICs from the NASD's "excessive sales load" rules.

We do not believe that the UFIC's investors need the protections of the defensive procedures generally followed by investment company boards to ensure compliance with section 36(b). The UFIC would have few barriers to competitive pricing, so that competition could be substituted for regulation. Its key features -- a readily determinable single fee and minimal exit barriers -- would permit the UFIC to be freed from the regulatory restraint of section 36(b), imposed to compensate for the limited competition that was ineffectual in restraining fee levels. Similarly, the unified fee would not be subject to section 22(b).

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<sup>190</sup>The Commission would enforce the prohibition *to* protect investors where market pressure proves an illusory check on a greedy investment manager. The limit would provide a uniform standard for all UFICs by essentially codifying state corporate law standards concerning "waste of corporate assets," which governed excessive advisory fee litigation before the enactment of section 36(b) in 1970. See generally 2 FRANKEL, *supra* note 45, at 252-262. See also *infra* note 194.

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### 3. Composition and Role of the Board of Directors

Except as to fee issues, a UFIC generally would have the same types of operational conflicts and potential for overreaching by management that inhere in the structure of open-end investment companies.<sup>191</sup> Thus, UFIC shareholders, like shareholders in other management companies, would need the protection afforded by board oversight of management. Moreover, the UFIC structure would perhaps create or exacerbate some risks that are not present, or not to the same degree, in the standard mutual fund structure. This suggests that UFIC investors would have a somewhat greater need than other investors for a third party monitor to oversee management's activities, and would require particularly effective, independent, and investor-minded monitors to protect their interests.

The first potential risk is that the investment manager, which would have discretion to allocate the unified fee as it deems appropriate and need not disclose the method of allocation, might be tempted to skimp on the basic level of services needed to operate the UFIC to bolster its own profitability. Market pressures might not check the temptation because investors, who typically lack the expertise or incentive to assess the quality and level of fund services, could not police the manager's choices.

A similar risk is that if market pressures on fee rates were extreme, the investment manager might be tempted to cut back or eliminate basic services to keep the fund in business. These temptations could create serious investor protection problems, if, for example, the manager hired an incompetent custodian.

To protect investors against these various conflicts and the possibility of management overreaching, the UFIC, like other open-end companies, would have a board of directors, which would be elected by shareholders in accord with section 16(a).<sup>192</sup> To foster the requisite qualities of effectiveness, independence, and investor-mindedness, section 10 would be amended to require that two-thirds of the UFIC's directors be independent.<sup>193</sup> The UFIC sponsor would nominate

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<sup>191</sup>See Chapter 7.

<sup>192</sup>Section 16(a) requires that at least two-thirds of the membership of the board of directors consist of directors who have been elected by shareholders. 15 U.S.C. § 80a-16(a).

<sup>193</sup>We use the term "independent directors" to refer to individuals on the board of directors of a registered investment company who are not "interested persons," as defined in section 2(a)(19). In Chapter 7, we recommend that the proportion of independent directors that must be independent for management investment companies generally be increased to a majority from the 40% level section 10(a) today requires. 15 U.S.C. § 80a-10(a).

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the initial independent directors, but the UFIC's independent directors would be self-nominating as to any vacancies occurring once the UFIC was organized.

The duties of the board would include evaluating and approving the management contract. The board would be required to review the fee only to ensure that the fee was not "unconscionable or grossly excessive;"<sup>194</sup> the board would not be required to engage in more extensive evaluation.<sup>195</sup> The board also would approve any management contract continuing in effect for a period of more than two years. The UFIC's independent directors would separately evaluate and approve the initial contract, and any renewal of the contract, and either the full board or the independent directors, voting separately, would be authorized to terminate the management contract at any time on sixty days' written notice. Given the proposed exemption of the UFIC from section 12(b) and rule 12b-1, the UFIC's board of directors would not be required to authorize, review, or evaluate the component of the unified fee representing asset-based distribution fees.

The Division also recommends that new section 15(g) specify that the board, including the independent directors voting separately, must approve and periodically review all material contracts the investment manager has executed with others furnishing services to the fund, to ensure provision of adequate services to the fund. It also would provide that either the full board or its independent directors may terminate a material contract at any time, on appropriate notice. Section 15(a) and 15(c) would be amended to state that the directors shall not review the fee provisions of any investment advisory contract. This material contract review would ensure that the UFIC is provided the level of services needed for its safe operation. To buttress this oversight authority, either the full board or its independent directors, voting separately, would be authorized to terminate each material contract at any time on sixty days' written notice.

In addition to their ongoing scrutiny of the management contract and of material contracts for fund services, the UFIC's directors would police actions of the investment manager (or of parties with which the manager has contracted for

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<sup>194</sup>We intend "unconscionable or grossly excessive" to be consistent with a corporate waste standard. See, e.g., *Saxe v. Brady*, 184 A.2d 602, 610 (Del. Ch. 1962) (the essence of a claim of corporate waste of assets is that the consideration received by the corporation is "so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid" or that the fee is "unconscionable" or "shocking"). *Accord*, *Acampora v. Birkland*, 220 F. Supp. 527, 548-49 (D. Colo. 1963); *Grobow v. Perot*, 539 A.2d 180,189 (Del. Sup. 1988).

<sup>195</sup>The degree of board review of the unified fee would thus be significantly less than that undertaken currently by the boards.

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fund services) that involve potentially serious conflicts that are not readily monitored by shareholders: the investment manager's method of portfolio valuation, permissible principal and agency transactions with affiliates, and a host of other operational matters. For example, investors in money market funds organized as UFICs would have the benefit of board oversight of the valuation process under rule 2a-7.<sup>196</sup> In this respect, their responsibilities would be identical to those of other mutual fund directors.

#### 4. Shareholder Voting Rights

The UFIC's shareholders would be accorded all voting rights accorded shareholders in other registered open-end investment companies, except those regarding fee-related issues,<sup>197</sup> as to which UFIC shareholders would be entitled to notice sent not less than ninety days in advance of a proposal's implementation.<sup>198</sup> In addition, a fee could not be changed until it had been in effect for one year. Providing such notice would give investors the opportunity to approve or reject a fee-related proposal by remaining in the fund or redeeming their shares.<sup>199</sup> Streamlining these rights, with respect to fees, is consistent with protecting shareholders' interests through price competition and the ready redeemability of UFIC shares. Thus, it would not be necessary for the UFIC's shareholders to vote formally their approval, or termination, of the management contract, advisory or sub-advisory contracts, any new contracts resulting from assignment of prior management, advisory, or sub-advisory contracts, principal underwriting contracts or contracts with others for fund services. Nor would it be necessary that shareholders formally approve an increase in the unified fee. In each instance, shareholders would receive advance notice of a proposed fee increase or contractual change. Finally, given the UFIC's exemption from rule 12b-1, its shareholders would not be consulted as to whether the fee would be used for distribution-related purposes.

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<sup>196</sup>17 CFR. § 270.2a-7.

<sup>197</sup>Thus, our recommended changes to existing shareholder voting requirements for registered investment companies, generally, discussed in Chapter 7, would apply to the UFIC where they do not conflict with the more particularized requirements discussed here.

<sup>198</sup>The notice would be deemed a solicitation of a proxy, consent, or authorization for purposes of section 20(a) of the Investment Company Act (15 U.S.C. § 80a-20(a)), and would include all information now required to be included in a proxy statement.

<sup>199</sup>The Division considered substituting a notice requirement for the requirement of shareholder approval of matters that are not fee-related. We rejected this approach because exit from the UFIC is not entirely cost-free (see *supra* note 189) and because the manager, in complying with a notice requirement, would incur costs similar to those incurred in soliciting shareholder approval.

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Accordingly, the definition of "voting security" would be amended to include any security issued by a UFIC. Also, section 15(a) would be amended to state that an investment advisory contract or other contracts with a unified fee company for fund services need not be approved (initially or annually) by the UFIC's shareholders and that its shareholders are not authorized to terminate such contracts.

### C. Investor Protection Issues

We have considered four concerns that may be raised by the UFIC. As set forth below, we believe the concerns would be addressed by the recommended statutory amendments.

First, some may object that "bundling" the fee would leave investors without specific information as to the costs of particular aspects of a fund's operations. We do not see the harm, as we believe that relatively few investors can analyze the specific expense items in fund financial statements in a meaningful way. Indeed, the fee table in Form N-1A requires only that fund expenses be separated into three categories: "management" fees, rule 12b-1 fees, and other expenses.<sup>200</sup> In contrast, the benefits of introducing UFICs seem clear: increased investor and media focus on bottom-line fund expenses, in general, and their importance to investment performance, in particular.

Second, because the UFIC would not be mandated, but would be an optional form of organization for open-end companies, arguably it would introduce to an already complex market a vehicle that departs in significant respects from the current mutual fund model. To ameliorate concerns about introducing a new vehicle, the Division would monitor the operations of the first UFICs and report its findings to the Commission after three years. For monitoring purposes, we considered limiting eligibility for UFIC status to money market funds and relatively short-term bond funds, the types of funds whose fee rates are most subject to market forces and whose current structure most easily lends itself to conversion to the UFIC structure. On balance, we concluded that limiting the types of open-end companies that may organize as UFICs is unnecessary and would delay the introduction of competitive pressures on long-term bond funds and stock funds, the funds whose investors would most benefit from more competitive pricing.<sup>201</sup>

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<sup>200</sup>See *Inv. Co. Act Rel. 16244*, *supra* note 85.

<sup>201</sup>Of course, the differences in degree to which expenses affect the short-term performance of money market, bond, and stock funds suggest that eliminating sales charge and expense comparability problems among bond and stock funds, as well as significant barriers to their shareholders' exit, will promote the type of price competition among these funds that money market funds now exhibit, but not necessarily the same level of competition.

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Third, one could argue that permitting a "bundled" fee would afford investment managers the opportunity to build an excessive profit into the single fee, particularly for fund types whose investors de-emphasize fund expenses in their quest for the services of an investment manager with perceived stock- or bond-picking ability, if the market does not function efficiently to check the level of the fee. We believe that the market will work to keep fees at reasonable levels, given the single fee and minimal exit barriers, and that the statutory prohibition on an "unconscionable or grossly excessive" unified fee will protect investors should the market prove inefficient. We expect that a vigorous, competitive market would keep fees fluctuating within a range that is not excessive. As an alternative, we considered imposing a statutory maximum fee level, as was posited for the unitary investment fund, but concluded that a fee cap is unnecessary. Moreover, because expense levels vary greatly across different types of portfolios, a single cap would not be appropriate.

Fourth, some may argue that, because the investment manager would be responsible for paying for all services provided to the UFIC, it would have a strong incentive to contract with low-cost service providers. Investor protection risks would be created if these providers are not competent. As discussed above, we believe that interposing board review of all material contracts will address this concern.

## **V. Conclusion**

The Division recommends that the Commission pursue several legislative and rulemaking proposals designed to enhance competition and improve investor understanding of investment costs. We recommend legislation to end retail price maintenance and to permit a single fee investment company. We recommend rule changes to permit multiple class arrangements. Finally, we recommend that the Commission generally support the NASDs initiative to provide comparable regulation for all types of sales charges.

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## APPENDIX 8-A

### Proposed Amendment to Section 22(d) of the Investment Company Act

(new language is shaded; deleted language is struck through)

Section 22 [15 U.S.C § 80a-22].

\* \* \*

(d) ~~No registered investment company shall sell any redeemable security issued by it to any person except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus, and, if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter, or the issuer, except at a current public offering price described in the prospectus.~~ The Commission may make such rules and regulations limiting the sale of redeemable securities by registered investment companies, principal underwriters, and dealers at prices other than the public offering prices described in the prospectus as are necessary and appropriate for the protection of investors. Nothing in this subsection shall prevent a sale made (i) pursuant to an offer of exchange permitted by section 11 including any offer made pursuant to section 11(b); (ii) pursuant to an offer made solely to all registered holders of the securities, or of a particular class or series of securities issued by the company proportionate to their holdings or proportionate to any cash distribution made to them by the company (subject to appropriate qualifications designed solely to avoid issuance of fractional securities); or (iii) in accordance with rules and regulations of the Commission made pursuant to subsection (b) of section 12.