

portfolio securities unwarranted by investment considerations for the purpose of generating brokerage commissions.⁹⁹ It can lead fund managers to eschew those markets where the best prices in portfolio transactions might have been obtained and may cause them to pay unnecessary charges for the execution of such transactions. Thus, mutual funds have made appreciably less use than other institutional investors of the third market, which has no minimum commission schedule and therefore cannot provide give-ups.¹⁰⁰

Mutual fund reciprocal and give-up practices also may impair the integrity of dealer recommendations upon which customers rely. They operate as hidden influences by tempting dealers to base their recommendations on the amount of brokerage and give-ups received rather than on the investment needs of their customers.¹⁰¹

The use of portfolio brokerage commissions as compensation for sales of fund shares also has undesirable anti-competitive effects. It places small funds and fund complexes, which cannot allocate as much brokerage for sales as larger ones, at a distinct disadvantage in competing for dealer favor.¹⁰² Moreover, the use of fund brokerage as compensation for sales gives exchange members an unwarranted advantage over nonmembers in the competition for sales.¹⁰³ Finally, mutual fund reciprocal and give-up practices lead the securities markets to compete with each other on the basis of mechanisms that facilitate broader distribution of fund brokerage rather than on the basis of efficiency and economy.¹⁰⁴

(d) *Proposed action*

Existing regulatory controls have neither curbed the growth of reciprocal and give-up practices nor dealt with the basic regulatory problems they pose.¹⁰⁵ In the over-the-counter markets where brokerage costs are subject to negotiation, customer-directed give-ups to brokers who perform no necessary function in connection with a transaction long have been recognized as improper and illegal.¹⁰⁶ Mutual fund give-up practices have been tolerated and have spread in the exchange markets only because of exchange minimum commission rate schedules, which do not take into account the nature and cost of providing brokerage services to large institutional investors. However, such give-up practices are patently inconsistent with the principles of a fair and equitable commission rate schedule.

Accordingly, the Commission has advised all national securities exchanges and the NASD that it believes that exchange rules must be changed so as to preclude most customer-directed give-ups.

Reciprocal brokerage practices—the selection of brokers to execute fund portfolio transactions on the basis of their sales of fund shares—also tend to have undesirable effects on mutual funds and their shareholders. The adverse effects of such reciprocity could be substantially mitigated if exchange minimum commission rate schedules provided a discount for the execution of large block transactions or otherwise took into account the generally lower costs to brokerage firms of executing transactions for institutional investors. Hence, the Commission has

⁹⁹ *Pd.* 174–175, *infra*.

¹⁰⁰ *Pp.* 175–177, *infra*.

¹⁰¹ *Pp.* 179–180, *infra*.

¹⁰² *P.* 180, *infra*.

¹⁰³ *Pp.* 180–181, *infra*.

¹⁰⁴ *P.* 182, *infra*.

¹⁰⁵ *Pp.* 182–184, *infra*.

¹⁰⁶ *P.* 185, *infra*. See also *pp.* 178–179, *infra*.

asked the national securities exchanges to consider change? in their commission rate schedules to provide a volume or institutional discount for the benefit of the many millions of small investors who invest through institutional media.¹⁰⁷

If these changes do not substantially reduce the adverse effects of mutual fund give-up and reciprocal practices on the funds and their shareholders, the Commission will consider additional steps to deal with these problems.

(e) *Broker-affiliated investment companies*

Close affiliations between investment companies and broker-dealers who execute their portfolio transactions raise questions similar to some of those raised by the use of brokerage commissions to compensate dealers for the sale of fund shares.¹⁰⁸ However, brokerage affiliations provide small investment companies with resources that might otherwise be beyond their means. And such affiliations may produce significant benefits for larger companies if, as the Commission recommends, all managerial compensation received by affiliated persons of investment companies is subjected to an express statutory standard of reasonableness which takes account of the benefits that investment company managers obtain from the companies' brokerage.¹⁰⁹

(f) *Capital gains distributions*

Almost all mutual funds regularly distribute all or most of their realized long-term capital gains to their shareholders. Although tax considerations no longer encourage this practice, its persistence reflects the expectations of shareholders and dealers.¹¹⁰

Frequent capital gains distributions facilitate improper comparisons of the totals of capital gains and dividend distribution paid by mutual funds with the dividends paid by other types of business enterprises. They also facilitate the improper sales practice known as "selling dividends" where the investor is induced to purchase fund shares—after a distribution has been announced but before the record date—in the erroneous belief that he will benefit from the impending distribution.¹¹¹

Investor expectations of regular and frequent capital gains distributions also tend to increase pressures on the managers of investment company portfolios to realize and distribute capital gains irrespective of investment considerations. There are several proven instances of investment company portfolios having been deliberately churned to generate realized capital gains.¹¹²

A complete ban on the distribution of capital gains would be contrary to the expectations of many investors, but, in the Commission's view, there is no justification for such distributions more often than once a year. A majority of investment companies now adhere to this limitation, and it has been endorsed by the Investment Company Institute. To extend that limitation to all investment companies, the Commission recommends that the Act be amended to prohibit capital gains distributions except at fiscal year ends or soon thereafter.¹¹³

¹⁰⁷ P. 187, *infra*.

¹⁰⁸ Pp. 188-190, *infra*.

¹⁰⁹ P. 190, *infra*. See also p. 145, *infra*.

¹¹⁰ Pp. 190-191, *infra*.

¹¹¹ Pp. 191-192, *infra*.

¹¹² Pp. 192-193, *infra*.

¹¹³ PD. 194-195, *infra*.

(g) *Insider transactions involving investment company portfolio securities*

The Special Study found that persons associated with investment companies frequently bought and sold securities on the basis of their knowledge of the companies' projected portfolio transactions despite industry awareness of the ethical problems raised by this practice.¹¹⁴ It recommended that all investment companies and investment advisers establish specific policies concerning insider trading in portfolio securities and appropriate procedures for their implementation.¹¹⁵

However, this type of insider trading remains an unresolved problem in the investment company industry. Many companies have failed to adopt codes of ethics or policies with respect to insider trading, and many of the codes and policies adopted appear too weak, too vague or lacking effective implementation procedures.¹¹⁶

Although the Commission has authority under the provisions of the Investment Company, Exchange, and Investment Advisers Acts to adopt rules with respect to insider trading, it believes that the problem should be treated more flexibly than those provisions may permit. For example, the Commission may be unable under existing law to require companies to adopt and enforce their own codes of ethics meeting specified minimum standards, but this may be an adequate way of dealing with this problem. Accordingly, it recommends that the Investment Company Act be amended to empower the Commission to adopt rules and regulations for the protection of investors in connection with trading in securities purchased and sold by such companies by persons affiliated with investment companies and their advisers.¹¹⁷

4. *Chapter V—Distribution and Its Cost*(a) *Mutual fund growth and sales of shares*

Sales of fund shares on a continuous basis have contributed greatly to the growth of the mutual fund industry. Some new sales are necessary to offset redemptions. But during the 1956–65 period inflow from investment of dividend income and capital gains distributions by existing shareholders offset more than half of the outflow attributable to redemptions.¹¹⁸

(b) *Sales load levels*

The "sales load" is the difference between the current net asset value per share received by the fund and the public offering price paid by investors. It is by far the most significant charge paid by mutual fund investors. The basic load most typically amounts to 8.5 percent of the offering price per share and is rarely below 7.5 percent.¹¹⁹ Expressed in the way sales charges are normally calculated in the securities industry—as a percentage of the net amount actually invested—the typical 8.5 percent sales load amounts to a sales charge of 9.3 percent.¹²⁰

The basic sales load usually is reduced for large purchases. These reductions benefit relatively few investors because they are seldom

¹¹⁴ P. 195, *infra*.

¹¹⁵ P. 196, *infra*.

¹¹⁶ Pp. 196–198, *infra*.

¹¹⁷ P. 200, *infra*.

¹¹⁸ P. 204, *infra*.

¹¹⁹ *Ibid.*

¹²⁰ P. 205, *infra*.

available for purchases of less than \$10,000. Many funds do not apply them to purchases of less than \$25,000.¹²¹

The sales load pays only for selling effort. The principal underwriter retains from 0.5 percent, to 2.5 percent of the offering price—the median is 2 percent. The balance of the load goes to the dealer who, in turn, typically pays at least half of his share to the salesman.¹²²

(c) *Sales loads compared to sales charges for other securities*

Investors pay higher sales charges for mutual fund shares than for listed securities that they might buy directly for their own accounts. For example, the typical mutual fund sales charge is more than nine times the 1 percent exchange commission on a typical \$4,000 round-lot order and more than five times the round trip exchange commission (including the odd-lot differential) if the amount of the median mutual fund purchase (\$1,240) were invested in a \$40 listed stock instead of a fund.¹²³

Unlike listed securities, mutual fund shares usually can be converted into cash without payment of an additional charge. However, even when compared to the round trip cost of buying and selling a listed security (assuming no change in its value), mutual fund sales charges are still much higher.¹²⁴ They are also significantly higher than sales charges in the over-the-counter markets.¹²⁵

Indeed, mutual fund sales loads are higher than the spreads that underwriters receive in connection with most underwritten distributions of nonfund securities,¹²⁶ where, unlike mutual fund underwriters, they assume the risk and make the special effort required to distribute a relatively large amount of securities in a limited period of time.

(d) *Sales load or investments of dividend income*

Many mutual fund shareholders use the dividends and the capital gains distributed by the funds to acquire additional shares through "reinvestment plans." Sales loads are not charged on reinvested capital gains. But a substantial minority of funds impose the basic sales load on the investment of ordinary dividends.¹²⁷ Loads on invested dividends are not related to or justified by any special selling effort apart from that involved in the initial sale.¹²⁸

(e) *The adequacy of existing statutory controls*

Sales load levels are required to be disclosed in the fund prospectuses which normally are given to prospective purchasers at the time of their initial contact with the salesman. However, except for contractual plan and face-amount certificates, the Act imposes no express statutory limits on sales loads. It gives the Commission and the National Association of Securities Dealers, Inc., only rulemaking authority to prevent "unconscionable or grossly excessive" sales loads.¹²⁹

These controls reflect congressional acceptance of the Commission's recommendation in 1940 that sales loads should be left "for the pres-

¹²¹ Pp. 205-206, *infra*.

¹²² P. 207, *infra*.

¹²³ Pp. 209-211, *infra*.

¹²⁴ Table V-3, p. 210, *infra*.

¹²⁵ Pp. 211-212, *infra*.

¹²⁶ Pp. 212-214, *infra*.

¹²⁷ P. 215, *infra*.

¹²⁸ Pp. 215-216, *infra*.

¹²⁹ Pp. 217-218, *infra*.

ent, at least," to competition among principal underwriters.¹³⁰ However, the type of competition which has developed for dealer favor has not tended to reduce sales loads; on the contrary, it has raised the loads. Load fund underwriters have been placed in the position of having to compete for the favor of retailers by raising dealer concession and sales load levels.¹³¹ They have done so within the framework of section 22(d) of the Act which bars retail price competition by prohibiting dealers from selling a redeemable investment company security to the public except at a current offering price described in the prospectus.¹³² The Act thus suppresses the downward pressures that normal market forces might otherwise exert on sales load levels.

(f) *Recommendations and conclusions*

While some disparity between mutual fund sales loads and the cost of investing in listed securities may be warranted, in the Commission's view the disparity that now exists is unjustified. In order to effect meaningful reductions in sales loads, the Commission has considered recommending modifications to the retail price maintenance provisions of section 22(d) so as to permit sales loads to be determined by competitive forces. Price competition among dealers might permit investors to purchase mutual fund shares at sales loads substantially lower than those now prevailing. However, competition might not operate as effectively against loads for shares of funds distributed by captive sales forces as it would for shares of broker-dealer distributed funds, thereby introducing an unwarranted disparity in the sales compensation available for selling mutual fund shares. The Commission therefore recommends an alternative solution: a statutory limitation on sales charges to 5 percent of the net amount invested in the fund.¹³³

In addition, the Act should be amended so as to give the Commission express authority to raise or lower the maximum sales charges when circumstances or conditions warrant and when necessary or appropriate in the public interest and for the protection of investors. This authority would enable the Commission to adjust the maximum sales charges so as to provide appropriate reductions for larger purchases. The Commission would also be able to raise or lower sales charges for mutual fund securities with unusual attributes and for unusual types of offerings, such as initial underwritten public offerings of fund shares.

The Act also should be amended to empower the Commission to prohibit anomalous and inequitable sales charges, such as the loads now imposed on the investment of dividends.¹³⁴

(g) *Contractual plans*

There are two arrangements for accumulating shares of load funds on an installment basis. They differ primarily in the way the sales load is deducted. In one, the so-called "voluntary" plan, the normal sales load is deducted from each payment. In the other, the so-called "contractual" plan, a sales load of up to 50 percent is deducted from each of the first year's monthly payments or their equivalent. This feature, known as the "front-end load," is permitted

¹³⁰ P. 221, *infra*.

¹³¹ Pp. 208-209, *infra*.

¹³² Pp. 218-221, *infra*.

¹³³ Pp. 221-223, *infra*.

¹³⁴ P. 223, *infra*.

by section 27 of the Act, which also limits contractual plan sales loads to no more than 9 percent of the total payments to be made.¹³⁵ A lower sales load is deducted from each of the remaining payments.

With a few exceptions, the portfolios of contractual plan companies consist solely of the shares of a particular underlying mutual fund. The plan company is itself an investment company distinct from its underlying fund. It is almost always established by a firm known as the "plan sponsor" which acts as principal underwriter of the securities issued by the plan company—certificates evidencing indirect ownership of the underlying mutual fund shares.

Contractual plans provide for the investment of specified sums over a predetermined period and for schedules of uniform monthly or other periodic payments to achieve that goal. Most typical is the plan certificate which provides for investing \$3,000 by making \$25 payments monthly for 10 years. Although termed a "contractual plan," the contractual planholder has no obligation to complete his plan or to make any specified number of payments. In this respect, contractual plans are like voluntary plans, which generally do not provide for formal payment goals or schedules, but can be used to make systematic payments for the achievement of an investment goal.¹³⁶

(h) Impact of the front-end load

The sales compensation from the scheduled first year's payments on a contractual plan is about six times the sales compensation on the same amount invested in shares of the underlying mutual fund on a lump sum or voluntary plan basis. This high sales charge works to the disadvantage of all contractual planholders. All contractual planholders, including those who complete their plans on schedule, have a smaller proportion of their payments working for them than if a level sales load had been deducted from each payment.¹³⁷

The front-end load is especially disadvantageous to those who redeem before completing their payments or who simply stop making payments. They often pay effective sales loads which amount to many times the sales load on the underlying mutual fund shares. The front-end load provides incentives responsible for undesirable high-pressure selling practices. But the argument that it has been an effective stimulus to systematic investment is refuted by the plan sponsors' own statistics which show that most contractual plans accounts are not completed on schedule. Those statistics confirm the Special Study's findings that many contractual plan purchasers pay effective sales loads of from 20 to 50 percent—sales charges on the net amount invested of 25 to 100 percent.¹³⁸

The Commission therefore recommends that section 27 of the Act be amended to prohibit future sales of contractual plan certificates on a front-end load basis. It also recommends that the maximum aggregate permissible sales load for such certificates be reduced from the present level of 9 percent to the 5 percent charge that it considers appropriate for other mutual fund investments.¹³⁹

(i) The front-end load on face-amount certificates

Face-amount certificates are debt securities which provide for investing on an installment basis over a period of years. Unlike

¹³⁵ Pp. 226-228, 229, *infra*.

¹³⁶ Pp. 231-232, *infra*.

¹³⁷ Pp. 235-237, *infra*.

¹³⁸ Pp. 233-234, 237-240, *infra*.

¹³⁹ Pp. 246-247, *infra*.

contractual plan certificates, their ultimate dollar values are fixed at the time of purchase. Rates of return on them are lower than present rates on United States Government Series E Bonds or on federally insured savings accounts in banks and in savings and loan associations.

The Act permits as much as a 50 percent front-end sales load to be deducted from the payments scheduled for the first year. If the investor redeems at an early point in his payment schedule, he will receive substantially less than his total payments.¹⁴⁰ Statistics prepared by the largest company in the field indicate that only one-third of faceamount certificate purchasers complete their payments. Hence the remaining two-thirds pay high effective sales charges. Accordingly, the Commission recommends that section 28 of the Act be amended to prohibit front-end loads—as well as total sales charges of more than 5 percent—in future sales of face-amount certificates.¹⁴¹

In assessing the recommendations in this report with respect to contractual and face-amount certificate plans, existing planholders should consider that early redemption of a plan almost invariably results in a loss to the planholder and that planholders who cease to make payments may be failing to take advantage of the reduced sales load that applies to payments scheduled to be made after the first year of the plan. The recommendations in the report are focused solely on *future* contractual plan sales as distinguished from **plans** already in effect.

5. Chapter VI—Mutual Fund Size and Investment Performance

(a) Introduction

Concern over the effects of size on the investment performance of both very large and very small mutual funds is reflected in the Act and its legislative history. Section 14(a) of the Act prohibits investment companies from making public offerings of their securities unless they have obtained or have made adequate provision to obtain a net worth of at least \$100,000. Although the Act has no maximum size restrictions, the question of whether they should be imposed was considered in 1940, and the Commission was authorized to investigate the effects of substantial further increases in investment company size.¹⁴²

(b) Management problems of small and large funds

Both large and small funds have disadvantages and advantages attributable to their size. The problems of small fund management often center around the development and maintenance of a staff capable of providing satisfactory levels of investment skill.¹⁴³ In addition, small funds have higher operating expense ratios and since they frequently have higher portfolio turnover rates, they may incur higher brokerage charges per dollar of assets managed than large funds.¹⁴⁴

The management problems of large funds revolve mainly around the fact that they buy and sell large blocks of securities. Since large funds' managers seek to obtain substantial positions in portfolio securities, the investments of large funds are generally limited to the

¹⁴⁰ Pp. 247-248, *infra*.

¹⁴¹ Pp. 248-250, *infra*.

¹⁴² P. 251, *infra*.

¹⁴³ P. 252, *infra*.

¹⁴⁴ Pp. 252-255, *infra*.

more actively traded and widely held securities. Even within the framework of these limitations, large funds frequently have difficulty in acquiring and disposing of securities at prices close to those prevailing at the time of the original investment decision.¹⁴⁵

(c) *Investment performance*

The advantages and disadvantages of fund size are reflected in performance records.¹⁴⁶ A study of fund performance for the 5- and 10-year periods ended December 31, 1965, shows no pattern of above or below average performance among funds at either end of the size spectrum. In these groups, and especially among the very smallest funds, performance records varied widely.¹⁴⁷ Further analysis of the performance records of the very largest funds showed that there has been no consistent pattern of change in their performance relative to the market as they have grown.¹⁴⁸

(d) *Conclusions*

At this time the Commission does not believe that the performance records of small funds call for changes in the Act's \$100,000 minimum capital requirement. Nor does the evidence warrant, for reasons of investment performance alone, the imposition of maximum size restrictions at this time.

However, the advantages of the largest funds have been apparently offset by the lack of portfolio mobility and flexibility attributable to their size. During the past 5- and 10-year periods the performance of the largest funds has not been enhanced by their growth, and there is no reason to conclude that shareholders of these funds would benefit from further growth.¹⁴⁹

Should the growth of the largest funds and fund complexes continue, these funds might soon reach the point where their portfolio mobility would be so impaired as to affect adversely the interests of their shareholders. Indeed, it is possible that the future investment performance of the largest funds, even if their sizes were to continue near the present levels, might be so affected. For these reasons, questions pertaining to large fund size and to the need for maximum size limitations on individual funds and fund complexes require periodic evaluation in the context of changing conditions in the securities markets and in the economy.¹⁵⁰

6. *Chapter VII—Investment Company Growth and Market Impact*

The Wharton Report viewed the impact of fund growth on stock prices as one of the "more current problems in the mutual fund industry." This chapter examines that problem in the light of the substantial recent growth of the investment company industry and of institutional investment generally since the close of the period studied by the Wharton Report.¹⁵¹

(a) *The growing importance of institutional investors*

During the post-World War II era, the percentage of all corporate stock held in institutional portfolios has risen at a rapid rate. At the

¹⁴⁵ Pp. 255-257, *infra*.

¹⁴⁶ P. 257, *infra*.

¹⁴⁷ Pp. 257-261, *infra*.

¹⁴⁸ Pp. 261-262, *infra*.

¹⁴⁹ P. 262, *infra*.

¹⁵⁰ Pp. 262-263, *infra*.

¹⁵¹ P. 275, *infra*.

end of 1965 institutional stockholdings amounted to \$105.8 billion, or 15.7 percent of the value of all outstanding corporate stock. The growth of noninsured pension funds has been particularly striking. They now rival investment companies as important holders of corporate stock.¹⁵²

Institutional investors account for an increasing share of trading volume in securities. A 1965 New York Stock Exchange study found that institutions and intermediaries accounted for an estimated 31.4 percent of total share volume on one day studied. Institutional investors are also responsible for the increased trading volume on regional exchanges and for the growth of the third market in listed securities.¹⁵³

(b) *Mutual funds as institutional investors*

The net inflow of capital to mutual funds is more affected by market fluctuations than is the rate of capital inflow to other institutional investors.¹⁵⁴ Mutual funds also have the highest portfolio turnover rates of all institutional investors and, for that reason, figure more prominently in the trading markets' volume than their holdings would indicate.¹⁵⁵ The funds also tend to engage in larger size transactions than other institutional investors,¹⁵⁶ and they account for a large portion of secondary distributions of securities.¹⁵⁷

(c) *Mutual fund impact on stock market movements*

During most of the postwar period, stock prices and price earnings ratios have been rising. Although an assessment of mutual fund impact on stock market movements is difficult, the funds, as substantial net purchasers of stock, appear to have contributed to this trend.¹⁵⁸ However, pension funds in recent years have been larger net purchasers of corporate stock than mutual funds, and have probably been an even more important factor in the upward trend.¹⁵⁹

During market declines the limited available evidence indicates that generally mutual funds have not behaved significantly differently from other types of investors. The funds shifted from positions as net purchasers to net sellers of common stock in the third quarter of 1962, following the sharp decline in May 1962, and in the third quarter of 1966, a period of generally declining prices. This shift was due to the discretionary investment decisions of fund managers rather than to the pressure of redemptions. Available data indicate that the mutual fund industry as a whole has not been in a net redemption status since 1932. During the 1962 and 1966 declines, sales of new fund shares also declined, but even in those periods sales of new shares continued to exceed redemptions by substantial margins.¹⁶⁰

(d) *Mutual fund impact on markets for particular securities*

Mutual funds tend to concentrate their portfolio holdings in relatively few securities. Portfolio concentration has not been lessened by the growth of the industry.¹⁶¹ Despite substantial inflow of new capital in recent years, many of the largest funds have reduced the

¹⁵² Pp. 276, 277, *infra*.

¹⁵³ Pp. 278-282, *infra*.

¹⁵⁴ P. 283, *infra*.

¹⁵⁵ P. 285, *infra*.

¹⁵⁶ *Ibid.*

¹⁵⁷ P. 286, *infra*.

¹⁵⁸ P. 287, *infra*.

¹⁵⁹ P. 288, *infra*.

¹⁶⁰ P. 289, *infra*.

¹⁶¹ P. 291, *infra*.

number of common stock issues in their portfolios.¹⁶² Such concentration increases the power of fund managers to affect the market in particular securities by their investment decisions.

(e) *Regulatory implications of institutional investor growth*

The growing importance of institutional investors in the stock markets has a significant impact on the securities markets. To the extent that irregular and relatively infrequent transactions in sizable blocks of securities by large institutional investors become more significant and orders from small investors become less significant, the markets for individual securities became more susceptible to wide and erratic price fluctuations.

Apart from limited emergency powers, the Commission does not have and does not seek responsibility for controlling price fluctuations—even extreme ones—in the securities markets. The growing institutionalization of the stock markets does not appear at this time to require that the Commission's responsibilities in this area be broadened.¹⁶³

However, some of the principal regulatory implications of the growth of institutional investors stem from the large number of sizable blocks of individual securities that such investors hold.¹⁶⁴

In some respects the market impact of mutual fund activity is even more significant than that of other institutional investors because mutual funds have higher portfolio turnover rates than other institutional investors and because much of the capital of the funds comes to them from people who, but for the funds, would have invested in securities directly for their own accounts.¹⁶⁵ Hence the growth of the funds tends to substitute the decisions of a few professional managers with respect to massive blocks of securities for the decisions of large numbers of individual investors.

While the Nation's securities markets on the whole have thus far responded well to the changes wrought by increasing institutionalization of the markets, there are signs of increasing strains on the mechanism of the auction market. The changes to which institutionalization has led require a reappraisal of existing practices and procedures in those markets by the Commission, the securities industry, and the institutional investors themselves. Such a reappraisal requires fuller data concerning the securities holdings and trading patterns of institutional investors than is now available. While this information can be obtained by the Commission with respect to investment companies, there is a lack of reliable and comprehensive data concerning the securities holdings and trading activities of most other types of institutional investors, including pension funds. Closing this informational gap is an indispensable step to adequate analysis of the problems raised by the institutionalization of the stock markets.¹⁶⁶

(f) *Mutual funds and increased trading activity*

There has been a recent tendency toward more active trading by mutual funds.¹⁶⁷ Moreover, some investors are using mutual funds as speculative vehicles by investing relatively large sums in single

¹⁶² P. 295, *infra*.

¹⁶³ P. 300, *infra*.

¹⁶⁴ *Ibid.*

¹⁶⁵ P. 301, *infra*.

¹⁶⁶ P. 303, *infra*.

¹⁶⁷ P. 304, *infra*.

payment contractual plans. These plans lend themselves to speculative use because they allow investors to make repeated withdrawals and reinvestments of up to 90 percent of the underlying value of their shares without additional sales charges. One fund with assets of over half a billion dollars recently reported that almost a quarter of its assets, previously withdrawn from single payment plans, had been reinvested during a single 6-month period.¹⁶⁸

Extensive speculation in mutual funds by a relatively few large shareholders can circumscribe at critical times the exercise of managerial discretion in the interests of the large majority of shareholders who invest for the long run. Moreover, these investors bear most of the burden of the increased brokerage costs incurred because a few shareholders use the funds for speculative purposes. The NASD and many individual funds already have taken action to discourage the use of withdrawal privileges for speculative purposes and the Commission is exploring the possibility of adopting a rule to this end under its existing authority. Should its existing authority be insufficient, it will recommend appropriate legislation.¹⁶⁹

7. Chapter VIII—Investment Company Relationships With Portfolio Companies

(a) Relationships with portfolio companies other than investment companies

The Act expresses concern over investment company impact "on concentration of control of wealth and industry and on companies in which investment companies are interested."¹⁷⁰ Nevertheless its substantive provisions do not preclude investment companies from holding substantial or even dominant positions in the enterprises in which they invest."

The Wharton Report found, however, that mutual fund managers participated in portfolio company affairs in only limited ways and concluded that mutual fund influence on portfolio companies did not warrant serious concern.¹⁷² Mutual funds now are more important as shareholders than they were during 1952 to 1958, the period studied in the Wharton Report.¹⁷³ Although many funds seem to have become somewhat more active in portfolio company affairs, generally, they have not misused their power or influence as substantial shareholders. Indeed, the assumption by investment company managers of an active stockholder role could yield significant benefits to all investors."

Questions pertaining to investment company relationships with portfolio companies are common to all types of institutional investors.¹⁷⁵ However, the Act contains protections for companies in which an investment company holds 5 percent or more of its outstanding stock. These protections do not apply to portfolio company relationships with other types of institutional investors.¹⁷⁶ Accordingly, the Commission concludes that (except for the special questions raised by investment companies that invest in other investment

¹⁶⁸ P. 305, *infra*.

¹⁶⁹ P. 306, *infra*.

¹⁷⁰ Sec. 14(b) of the Act.

¹⁷¹ P. 307, *infra*.

¹⁷² Pp. 308-309, *infra*.

¹⁷³ P. 303, *infra*.

¹⁷⁴ Pp. 309-310, *infra*.

¹⁷⁵ P. 310, *infra*.

¹⁷⁶ Pp. 3, 11, *infra*.

companies) there is no present need for new legislation on investment company-portfolio company relationships.”

(b) Mutualfund holding companies

(i) Introduction.—One of the most striking recent developments in the investment company industry has been the emergence of the “(fund holding company,” an investment company which invests in other mutual funds.¹⁷⁸ The Act permits investment companies to own interests in other investment companies. However, it forbids, with certain exceptions, a registered investment company from acquiring more than 3 percent of the outstanding stock of another investment company.

The Act’s limitations are inapplicable to unregistered investment companies, and several foreign-based unregistered fund holding companies are now operating. The largest, Fund of Funds, L.M., stated its June 30, 1966, assets at more than \$420 million, of which \$365 million was invested in U.S. mutual funds and over \$19 million was invested in mutual fund management companies. Recently, two domestic fund holding companies have been organized and are now registered under the Act.¹⁷⁹

(ii) Control of portfolio companies.—Fund holding companies, both registered domestic and unregistered foreign-based companies, may control or exercise undue influence over the activities of their portfolio funds. The basis of this power is the possibility of large-scale redemptions by the fund holding company of the shares of its portfolio funds.

Although registered domestic fund holding companies are subject to the percentage limitations of the Act, several such companies under the same management, each holding 3 percent interests in the same funds, or a single such company holding 3 percent interests in several funds belonging to the same complex, could exert substantial pressure on the managements of those funds.¹⁸⁰ They could exercise their influence to the detriment of the large majority of shareholders who choose to have their capital managed by the fund’s adviser, not by its dominant shareholders.¹⁸¹ Moreover, unlike other institutional investors, the fund holding company in certain circumstances may have no control over the pace or amount of its redemptions, since it too is subject to redemption pressures from its own investors. Where the fund holding company is foreign-based, such pressures for redemption could be unduly magnified by the instability of certain foreign economies, political upheavals abroad, exchange controls or other factors irrelevant to investment in domestic mutual funds.¹⁸²

(iii) The utility of the fund holding company to investors.—Inherent in the fund holding company structure is a layering of advisory fees, administrative expenses and sales loads. This makes a fund on funds a particularly expensive investment vehicle.¹⁸³ Moreover, fund holding companies are of doubtful utility to investors.¹⁸⁴ The diversification that they provide only duplicates and reduplicates

¹⁷⁷ P. 311, *infra*.

¹⁷⁸ *Ibid.*

¹⁷⁹ P. 314, *infra*.

¹⁸⁰ P. 316, *infra*.

¹⁸¹ *Ibid.*

¹⁸² P. 318, *infra*.

¹⁸³ *Ibid.*

¹⁸⁴ P. 320, *infra*.

the diversification achieved through an ordinary mutual fund investment.¹⁸⁵ Although a fund holding company may claim an ability to assist the investor in selecting professional management through its investments in portfolio funds, with the proliferation of fund holding companies, investors would still be faced with a choice of professional management to assist them in selecting professional management.¹⁸⁶

(iv) Conclusions and recommendations.—The problems and the potential dangers posed by fund holding companies—both registered and unregistered—coupled with their lack of utility and their layered costs require that the Act be amended to prevent the creation and operation of fund holding companies.¹⁸⁷

8. Chapter IX—*The Administration and Enforcement of the Act*

This chapter proposes a number of amendments to the Investment Company Act and to the Investment Advisers Act to meet the many recurring problems that arise in the day-to-day administration and enforcement of those statutes. Most of these problems can be corrected by amendments which are essentially technical in nature or limited in scope. A few, particularly those problems arising in connection with enforcement, require more substantive amendments.

(a) *The Act's coverage*

(i) *Eliminating exception for certain companies issuing redeemable securities.*—Section 3(c)(6) provides an exclusion from the definition of an investment company for companies primarily engaged in the factoring, discounting, or real estate businesses. A similar exclusion from regulation under the Act is contained in section 3(c)(11) for any company substantially all of whose business is holding oil, gas, or other mineral royalties or leases.¹⁸⁸

In recent years several companies which purport to fall within these exclusions have actively sought to capitalize on the popularity of mutual funds by appealing to unsophisticated investors of modest means and by issuing redeemable securities which evidence interests in a portfolio of notes, commercial paper, real estate mortgages, or oil and gas leases. In the Commission's view there is no justification for exempting such companies from regulation under the Act and it recommends that the Act be amended to make clear that these exclusions are not available to those companies if they issue redeemable securities or face amount certificates of the installment type.¹⁸⁹

(ii) *Other coverage recommendations.*—The Commission also recommends that the Act be amended to —

(1) make clear that the 60-day automatic exemption for a company filing an application under section 3(b)(2) is available only if such application is filed in good faith;¹⁹⁰

(2) repeal section 3(c)(8) to remove the exclusion from investment company status for a company 90 percent of the value of whose investment securities are represented by securities of a single insurance company, **bank**, or other financial institution enumerated in sections 3(c)(3), (5), (6), and (7);¹⁹¹

¹⁸⁵ P. 320, *infra*.

¹⁸⁶ P. 321, *infra*.

¹⁸⁷ Pp. 322-324, *infra*.

¹⁸⁸ Pp. 328-329, *infra*.

¹⁸⁹ *Id.*

¹⁹⁰ Pp. 327-328, *infra*.

¹⁹¹ Pp. 329-330, *infra*.

(3) change section 3(c)(10) to make clear that a company initially registered under the Public Utility Holding Company Act of 1935 is not excluded from the coverage of the Investment Company Act unless the company is subject to regulation under the Public Utility Holding Company Act;¹⁹²

(4) change section 18 to prohibit the further issuance by a registered investment company of separate series of securities;¹⁹³ and

(5) repeal section 11(b)(2), which permits series companies or their principal underwriters to charge an additional sales load when shareholders in one series exchange their shares for shares in another series.¹⁹⁴

(b) Management-shareholder relationships

(i) Strengthening the independence of directors.—Section 10 of the Act provides that at least 40 percent of the board of directors of a registered investment company must consist of persons who are neither officers nor employees of the company and who neither serve as, nor are affiliated with, its investment adviser. Section 10 also provides that if any officer, director or employee of the investment company acts as, or is affiliated with, its principal underwriter or regular broker, a majority of the board must consist of persons other than those affiliated with such principal underwriter or regular broker. The Act, however, classifies a director as unaffiliated even though he has substantial business or professional relationships with the investment company or its adviser-underwriter, or close family relationships with the adviser-underwriter or with persons affiliated with it.

To strengthen shareholder representation in investment company affairs, the Commission recommends that the Act be amended to provide that the percentages of boards of directors now specified in section 10 must consist of persons who are not "interested persons." The Act would include as "interested persons" (1) any affiliated person as that term is now defined in the Act, (2) any principal underwriter or regular broker to an investment company, (3) any member of the immediate family of such persons, (4) any person who (a) directly or indirectly owns securities issued by persons affiliated with investment companies or (b) has, or has had within the past three years, any material business or professional relationship with such an affiliated person and (5) any affiliated person of such persons. This amendment would apply only to the provisions of sections 10, 15, and 32.¹⁹⁵

(ii) Other recommendations as to management-shareholder relationships.—The Commission also recommends that the Act be amended to:

(1) include corporate trustees that perform advisory functions in the definition of investment adviser in section 2(a)(19);¹⁹⁶

(2) strengthen sections 15 and 32 to provide that (a) a renewal of advisory contract, (b) approval and renewal of underwriting contracts, and (c) selection of independent auditors can be accomplished only by directors who are physically present at the meetings at which the votes are taken;¹⁹⁷

¹⁹² P. 330, *infra*.

¹⁹³ Pp. 330-331, *infra*.

¹⁹⁴ Pp. 331-332, *infra*.

¹⁹⁵ Pp. 332-334, *infra*.

¹⁹⁶ P. 332, *infra*.

¹⁹⁷ Pp. 334-335, *infra*.

(3) amend sections 15(a)(4) and 15(b)(2) to make clear that the term "assignment" for purposes of the Act includes action by persons other than the investment adviser or underwriter;¹⁹⁸

(4) change section 17(f) to provide that if an investment company employs a bank as custodian, all cash assets in addition to "securities and similar investments" shall likewise be kept in the custody of a bank except for amounts covered by a fidelity bond;¹⁹⁹

(5) change section 25(c) to provide that a Federal court shall enjoin any plan of reorganization of an investment company which it finds not to be fair and equitable to all persons affected;²⁰⁰

(6) change section 26(a)(4) to make clear that prior Commission approval must be obtained for a substitution of the underlying investment of a unit investment trust;²⁰¹ and

(7) change section 33 to require that all papers filed in shareholder suits involving registered investment companies be transmitted promptly to the Commission.²⁰²

(c) Administrative and other proceedings

(i) *Administrative proceedings.*—The Commission recommends that section 9 be amended to include a new subsection which would empower the Commission, after notice and opportunity for hearing, to bar an individual either permanently or for such time as may be appropriate from serving an investment company in the official capacities now enumerated in section 9, or as an employee of an investment company, if such individual has willfully violated any provision of the Securities Act, the Exchange Act, the Investment Advisers Act, the Investment Company Act, or any rule or regulation thereunder.²⁰³ These amendments would provide investment company shareholders with protections comparable to those customers of registered broker-dealers and clients of registered investment advisers now enjoy under provisions of the Exchange Act and the Investment Advisers Act.²⁰⁴

(ii) *Breach of fiduciary duty.*—Section 36 authorizes the Commission to seek court injunctions against persons acting in certain capacities for investment companies if they are "guilty" of "gross misconduct or gross abuse of trust" with respect to the investment company which they serve. The proposed amendment, which would complement the Commission's existing power under the Investment Advisers Act and the Exchange Act to deal flexibly with the misconduct of broker-dealers and investment advisers in dealings with their clients, would delete the words "gross" and "guilty" and broaden the statutory relief specified under section 36 beyond that of disciplinary sanctions. The amendment would authorize the Commission to seek injunctions in Federal courts against any act, practice or course of conduct which involves a breach of fiduciary duty on the part of any of the persons now enumerated in section 36 with respect to any investment company which they serve and to seek such other relief as the court may deem necessary or appropriate for the protection of investors.²⁰⁵

¹⁹⁸ P. 335, *infra*.

¹⁹⁹ Pp. 335-336, *infra*.

²⁰⁰ Pp. 336-337, *infra*.

²⁰¹ P. 338, *infra*.

²⁰² P. 338, *infra*.

²⁰³ Pp. 338-340, *infra*.

²⁰⁴ P. 340, *infra*.

²⁰⁵ Pp. 340-341, *infra*.

(d) Formal changes in the Act

The Commission recommends that section 38(a) of the Act, which, empowers the Commission to make rules and regulations necessary or appropriate to the exercise of the powers conferred upon the Commission in the Act, be amended to give the Commission rulemaking authority consistent with the language of similar provisions in the other Federal securities acts.²⁰⁶ The other amendments are designed to correct outdated references and patent ambiguities in the text of the Act.²⁰⁷

(e) The Investment Advisers Act

The Commission recommends that section 203(d) of the Investment Advisers Act be amended to authorize the Commission to proceed directly against a person who is subject to an injunction or has been convicted of or committed any act or omission specified in that section, without joining an investment adviser with whom such person may have been affiliated.²⁰⁸ This provision would give the Commission flexibility in the administration of the Investment Advisers Act comparable to the procedure available for persons associated with broker-dealers registered under the Exchange Act.

The Commission also recommends that sections 203(b)(2), 203(b)(3) and 205 of the Investment Advisers Act be amended to make investment advisers to investment companies subject to the registration provisions of that Act, and to require that contracts between registered investment companies and their advisers may not provide for compensation to the investment adviser on the basis of a share of capital gains or capital appreciation of the funds of the investment company.²⁰⁹

The Commission recommends that the Investment Advisers Act be amended to include a section, similar to section 15(b)(4) of the Exchange Act, providing that violations of provisions of the Investment Advisers Act by a registered investment adviser, or any person acting on behalf thereof, may be established without the necessity of proving a use of the mails or any means or instrumentality of interstate commerce in connection therewith. Such a provision would recognize, as did the Congress in the 1964 Amendments to the Securities Acts in adding section 15(b)(4) to the Exchange Act, that registration alone furnishes a sufficient constitutional basis for Federal regulation.²¹⁰

The Commission recommends that a new section be added to the Investment Advisers Act giving the Commission authority to exempt any person, security, or transaction, or class or classes thereof, from provisions of the Act or of rules or regulations thereunder, if appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act. Such exemptive authority would be similar to that granted the Commission in section 6(c) of the Investment Company Act and would provide desirable flexibility in the administration of the Investment Advisers Act.²¹¹

²⁰⁶ P. 343, *infra*.

²⁰⁷ Pp. 341-343, *infra*.

²⁰⁸ Pp. 343-344, *infra*.

²⁰⁹ Pp. 344-345, *infra*.

²¹⁰ P. 346, *infra*.

²¹¹ Pp. 345-346, *infra*.