INVESTMENT ADVISER RESPONSIBILITIES AND RECENT S.E.C. DEVELOPMENTS

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I would like to talk tonight about problems in the federal regulation of investment companies, particularly those created by the relationships between externally managed investment companies and their investment advisers. As you will see, a number of these difficulties relate to, or served as the reason for, particular provisions of the recently enacted 1970 Amendments to the Investment Company Act of 1940. Instead of immediately trying to discuss the problems themselves, I think it would be helpful if I first set the historical background for the Commission's interest and responsibilities in this area, but before doing so let me point out that my comments during the course of these remarks reflect my own views and are not necessarily representative of the views of my fellow Commissioners or members of the Commission's staff.

During the 1920's investment company formation and public participation in these then relatively novel investment vehicles proceeded at a rapid pace. The key selling point stressed by promoters of those early companies was the alleged safety they provided for investors due to diversification of risk. Many sponsors looked upon investment companies as an adjunct to their normal operation as sources of brokerage commissions, sales commissions and management fees. In order to assure profits from those sources, sponsors devised schemes which insured their control of the investment company but minimized investment and exposure of their own risk capital. The sponsor, of course, possessed initial control over the investment company since it selected the company's first board of directors; it often obtained more permanent control by issuing stock with unequal voting rights, eliminating stockholders' pre-emptive rights, establishing voting trusts or entering into long-term management contracts with the sponsors or affiliates of the sponsors. An even more direct means of assuring control was to provide for it in the organizing documents of the company. To state it mildly, these devices were inequitably one-sided in favor of management.

The period during the 1920's and early 1930's was further notable for the virtually complete lack of protections for public investors of investment companies. There was no federal legislation regarding securities or investment companies; the common law provided remedies in only limited instances against gross mismanagement of investment company assets, and state blue-sky laws were in the embryonic stage. In view of this relative vacuum in meaningful protections for public investors and the ability of investment company sponsors to obtain and retain control over the sponsored companies, it is not surprising that excessive abuses occurred in the industry. Some abuses involved relatively sophisticated practices, including methods to achieve dilution of the public shareholder's investment and pyramiding of investment companies. Other practices were not so sophisticated. These included the sponsor's investing the investment company's assets in illiquid ventures, borrowing from the investment company at low interest rates, dumping undesirable securities into the investment company and, the crudest practice, outright raiding and looting of the investment company's portfolio.

It was against this background that Congress enacted the Investment Company Act of 1940. That Act contains numerous provisions designed to combat investment company management's historical disregard for conflicts of interest and the interests of the public. For example, the Act provided for a minimum number of unaffiliated directors and protection against certain kinds of self-dealing by affiliated persons or principal underwriters. Other provisions, including granting the Commission authority to require an investment company's officers and employees to be bonded against larceny and embezzlement, indicate the depths to which management relations with investment companies had fallen. The 1940 Act also empowered the Commission to seek injunctions against the officers, directors, members of advisory boards, investment advisers, depositors or principal underwriters of investment companies for gross misconduct or gross abuse of trust.

Later, in 1966, a report entitled "Public Policy Implications of Investment Company Growth" was submitted to Congress proposing certain amendments to the Investment Company Act. The Report emphasized the lack of effective shareholder controls over investment company management. The original Act had attempted to provide for some measure of arms-length bargaining in its requirement that forty percent of an investment company's directors be unaffiliated with the investment company or its investment adviser. In addition, the Act required that where a regular broker or principal underwriter is used, or an investment banker is connected with the fund, a majority of the fund's board of directors be unaffiliated with those persons. As a practical matter, however, supposedly independent directors could have strong ties with the investment adviser-underwriter since they could own close to five percent of the adviser-underwriter's stock; have substantial business relationships with the investment company or adviser-underwriter or have close family relationships with the adviser-underwriter or affiliated persons. In addition, the Act required certain matters to be submitted to shareholders for their approval, such as the fund's management contracts with its adviser. It must be realized, however, that a strong compulsion exists for shareholders to approve the contract submitted by management, whatever the compensation structure, because disapproval would lead to disruption of the advisory function while either a new contract was drawn for submission to shareholders or a new adviser was sought.

In view of the apparent ineffective bargaining position of the unaffiliated directors and the compulsions leading stockholders to approve automatically contracts submitted by managements, the Commission sought to strengthen statutory protections for investment company shareholders as a part of the 1970 Amendments to the Investment Company Act which it advocated.

In order to strengthen the check on management through independent directors and make these directors more meaningfully objective in their representation of shareholder interests in decisions regarding the investment company's affairs, the amended Act requires forty percent of a fund's directors to be "disinterested persons," with certain exceptions. The concept of "disinterested" director is stronger than of "unaffiliated" director which was already in the Act and which I have just described. Specifically, a person is not disinterested and may not serve as a disinterested director if he is an affiliated person of the investment company, investment adviser or principal underwriter or a member of the immediate family of such an affiliated person. Furthermore, he is not disinterested if he is a broker-dealer or affiliated person of a broker-dealer or has any direct or indirect beneficial interest, or legal interest as a fiduciary, in any securities issued by the investment adviser, principal underwriter or their controlling persons, or has acted as legal counsel for the adviser or underwriter. In addition, the Commission may by order determine that a person is an interested person by reason of having a material professional or business relationship with the adviser or principal underwriter or certain persons affiliated with them. These new requirements of independence, coupled with the requirement that management and underwriting contracts and the selection of auditors be approved by a majority of the independent directors, should help assure that the interests of public shareholders are more effectively represented in connection with decisions regarding the investment company's affairs.

As regards the standard of conduct of certain affiliated persons of investment companies in their actions taken with respect to those companies, new Section 36(a) authorizes the Commission to seek injunctive relief if such affiliated persons violate prevailing standards of fiduciary duty involving personal misconduct. Thus, the more restrictive standard requiring gross misconduct or gross abuse of trust has been abandoned. The legislative history of this new section makes clear, moreover, that violations of this standard are not limited to situations where an actual intent to violate the law can be shown or to acts of affirmative misconduct but can include nonfeasance of duty or abdication of responsibility. The Amendments also establish a new Section 36(b) of the Act which specifies for the first time that the adviser has a fiduciary duty with respect to compensation or other payments paid by the fund or its shareholders to the adviser or affiliated persons of the adviser and authorizes the Commission and shareholders to bring actions seeking to enjoin alleged violations of fiduciary duty. That section will not be effective, however, until June 14, 1972.

With further regard to management fees, the Amendments have affected performance fees charged funds by investment advisers. The new requirements, effective December 14, 1971, make it clear that performance fees must be proportionate; that is, they must go down as much as they go up, and the point from which increases and decreases are measured must be the fee that would be payable if investment performance were equal to that of the index permitted to be used by the fund.

One question raised by performance fee structures is the effect of uneven incentives offered by two or more different investment vehicles under the control of one adviser. This situation may place the portfolio manager in the difficult position of determining what securities should be allocated to which portfolio. Assuming a security with high appreciation potential is available and that security is suitable for both a high incentive fee portfolio and low incentive fee portfolio, which is to be favored? Should the fund or other client paying the most money get that security? Should the security be allocated evenly between the two portfolios? The Commission's Institutional Study Report recently submitted to Congress showed a wide disparity of treatment in a limited sampling of advisers of funds and other clients, and further study may lead the Commission to make rules or otherwise deal with these problems.

Performance fees now in use tend to measure performance solely on the rate of return. They do not take into account varying degrees of risk borne by the stockholder of the investment company that may be involved in the portfolio. The Institutional Investor Study highlighted this problem, and concluded that incentive compensation should be based on returns which have been adjusted for the degree of speculation or volatility of the portfolio. The 1970 Amendments, in permitting investment advisers to charge the limited type of performance fees I mentioned a few minutes ago, gave the Commission authority to specify appropriate measures of performance other than a stock index. The Commission has not yet acted on this authority to require a volatility adjustment to performance compensation.

Another area involving compensation which is of some concern is the possible application of Section 17(d) of the Act to transfer agency arrangements between an investment company and its investment adviser or an affiliate of the adviser. The banking community, which has historically performed the transfer agency function, appears increasingly reluctant to provide this service to investment companies. A trend is developing, therefore, where investment advisers undertake the transfer function themselves or set up affiliated companies to do the work.

The question arises whether these transfer agency arrangements constitute joint arrangements between the investment companies and their advisers subject to the Commission's review under Section 17(d) of the Act and Rule 17d-1. The lack of arms-length bargaining between the fund and its adviser regarding such arrangements raises the spectre of the kind of abuses which Section 17 was directed against. Thus, the Section 17(d) question would not arise where such dangers are not present as, for example, in a case where services are performed at cost or the fund itself creates its own subsidiary to perform these services. This area is still under staff consideration, and no firm determinations have yet been made.

In another area regarding conflicts of interest, specifically transactions involving securities in the investment company's portfolio, the 1970 Amendments have established a new Section 17(j) of the Act regarding trading by investment company insiders in securities held or to be acquired by a registered investment company. This new section is designed to curtail investment company insiders' trading on the market impacts of a fund's portfolio transactions. Trading by insiders in a fund's portfolio securities will be prohibited if in contravention of rules yet to be adopted by the Commission which are to define fraudulent, deceptive and manipulative practices and establish minimum standards for codes of ethics in these situations.

An area that has become of special concern to me during the recent general financial troubles in the brokerage industry has been the interrelationships and dependencies existing between investment companies and the trading markets. A primary example of the reason for my concern occurs in the typical situation where a broker-dealer which is also investment adviser and principal broker for an investment company suddenly fails for lack of capital or because it has lost control of its records. If the investment company has unsettled accounts with that broker-dealer, bankruptcy proceedings in the past have had drastic effects on the investment company. A fund in this situation might be forced to cease selling its shares and suspend redemptions if it is unable to determine whether or not amounts owed to it as customer are collectible and, hence, unable to ascertain the net asset value of its shares. In the future, the new Securities Investor Protection Corporation should go far to alleviate at least the lengthy delays now prevalent in bankruptcy proceedings in connection with delivering out customers' accounts.

Where a broker-dealer fails, and it is also investment adviser and principal underwriter to a fund, the fund loses its services as investment adviser or underwriter since the adviser-underwriter is unable to perform. The termination of performance is generally abrupt and throws at least the management function back to the fund's officers and board of directors. In some cases, perhaps more common with smaller funds, the directors may not have the investment experience necessary to give reasonably competent investment advice, and the fund's public investors may suffer seriously as a result of the neglect or mismanagement of the fund's portfolio.

Another possible ramification of broker-dealer-adviser financial difficulties is the possibility that an adviser in such difficulty may seek to generate volume for itself by causing excessive transactions to be made in the fund's portfolio securities. The resultant enlarged stream of brokerage would be advantageous to the broker-dealer but detrimental to fund shareholders whose pro rata interest in the fund would be diminished by the excessive amount of brokerage. Furthermore, trades executed only for the purpose of creating brokerage commissions are contrary to the obligation of advisers to seek best price and execution for fund portfolio transactions.

Still another area for concern involves the situation where a broker-dealer-adviser also acts as the custodian for its fund's securities. In some instances restrictions regarding commingling of the fund's securities with the broker-dealer's securities and the limitations on hypothecation may not be observed to the same degree as where the custodian was unaffiliated with the fund. If the broker-dealer-adviser is in financial difficulties, the possible lack of diligence in this area is certainly increased.

In view of the detriments to fund shareholders as a result of possible financial problems of investment advisers, especially those which are broker-dealers, it would seem that at a minimum the directors of a fund should closely consider the financial stability of any proposed advisory firm in determining whether or not to approve a management or underwriting contract with it on behalf of the fund. To that end, in accordance with the 1970 Amendments' clarification of directors' duties in Section 15 of the Act, the board should request pertinent financial data regarding the proposed adviser which indicates it is capable of performing possible obligations under proposed contracts with the fund. At the same time, it would appear that potential advisers have an obligation to maintain an adequate financial position to assure their ability to perform such contracts.

Even where a fund is simply a general creditor of a troubled broker-dealer, severe complications can arise. Until collection, the fund would only have a claim in litigation against the bankrupt firm. That claim may have to be valued at zero and could force a material decrease in the net asset value of the fund's shares to the detriment of fund shareholders. In addition, the fund would lose the use of the money which would have normally been at work in its portfolio. Another problem is what to do with the proceeds of such a claim if it is finally realized and paid over to the fund. If the claim had been valued at zero until realized upon, it would seem misleading to add those proceeds into net asset value and thus create actual or potential instant performance for the fund. Also, ownership of the fund's shares might have changed during the intervening period.

While the conflicts I have just mentioned seem to raise relatively new areas of concern, the Commission has spoken in a recent case involving Provident Management Corporation, et al. 1/ regarding a related, but more

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1/ In the Matter of Provident Management Corporation, et al., Securities Act Release No. 5115 (Dec. 1, 1970).

familiar, problem. I am referring to the practices of fund management involving reciprocal arrangements in connection with brokerage generated by a fund's portfolio transactions. We are all well aware of the impacts of management's power to allocate the rich stream of brokerage commissions created on a fund's portfolio transactions. Brokers who effectuate these transactions on behalf of a fund are acting as agent for the fund. Under Section 17(e) of the Investment Company Act, affiliates acting as agents may not receive any compensation on such transactions, other than regular salary from the investment company, except in the course of their business as a broker or underwriter. Unfortunately, certain affiliated persons of funds and their management have attempted to gain some reciprocal personal reward from brokers to whom they allocated brokerage business. The Commission's decisions in this area clearly indicate that receipt of brokerage commissions permitted under the statute in the course of one's business as broker means, quite simply, that the affiliated recipient must have performed some brokerage service to earn that commission.

Perhaps the root cause for all of the schemes devised by some affiliates of investment companies to profit from fund brokerage is that at many levels brokerage commissions paid by the funds are too high, and the brokers know it. One avenue that appears to be opening for institutions to reduce commission expenses is to join an exchange directly, or through a broker-dealer subsidiary, in order to become eligible for the inter-member commission rates. Several applications for membership have been filed with the New York Stock Exchange by institutions, and the Exchange appears to be moving toward some resolution of the problems involved. The Commission's General Counsel has indicated his view that management does not have a fiduciary duty to acquire a stock exchange seat if, in the exercise of its best business judgment, management determines it is not in the best interests of the fund to do so. 2/ As a practical matter, however, if institutional membership does come to pass, it would appear that competitive pressures will force at least the larger institutions to become exchange members. We are watching this situation closely in view of the complications involved for the entire securities industry.

The Commission has taken important action in a related area in determining that minimum commissions on those portions of New York Stock Exchange transactions over $500,000 in size are unreasonable. The Exchange has responded by instituting competitive rates of commission for portions of orders over that level. There has been some trepidation expressed over what competitive rates may mean for fund managers who will be presumably in the continuous process of trading at the competitive levels. What will be the best price in a competitive commission rate market place? I don't think there are any hard answers to that question yet, but it certainly seems

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2/ Securities Exchange Act Release No. 8746 (Nov. 10, 1969).

extreme to say that every trade will open up the possibility of a law suit on the basis that there may have been some better trade available. I think that the concept of best price and execution for any trade under competitive rates will have to involve analysis of all the factors regarding the trade, including the other prices and commission rates in the market place, the execution capability of the trader, and the size of the block and of the market. The competitive rate structure does raise serious questions, however, where a fund may attempt to place transactions through an affiliated broker who will profit from such transactions. In that case, management may be viewed, in effect, as being on both sides of the deal. It has the conflict of attempting to obtain the highest rate for its affiliated broker-dealer while under the duty to get the best price and execution for the fund.

In addition to management fees and brokerage, another element of the public's cost of participation in mutual funds is the sales load charged to purchasers of mutual fund shares. The most common sales load is 8.5%, which amounts to a sales charge on the amount invested of over 9.2%. The Commission originally proposed that the maximum sales charge on mutual fund shares should not exceed five percent of the net asset value of the fund shares at the time of sale. This proposal was rejected by Congress, however, in favor of assigning to the National Association of Securities Dealers the task of studying the entire mutual fund distribution system and prohibiting its members by rule from offering mutual fund securities at a price which includes an "excessive sales load." Any NASD rules must allow for reasonable compensation for sales personnel, broker-dealers and underwriters and for reasonable sales loads to investors. At any time after the expiration of 18 months from the date of enactment of the new Amendments, or after the NASD has adopted its rules, the Commission may alter or supplement the NASD rules. The Commission has recently emphasized in public correspondence with the NASD that the NASD's study should cover, among other things, sales loads on variable annuities and contractual plans and the elimination of sales loads on income dividend reinvestments. Moreover, the Commission has stated that a study analyzing the existing sales load structure and distribution costs would be incomplete unless improvements in the existing distribution system and alternative methods of distribution were considered as methods of achieving efficiencies and lower costs for investors.

As many of you know, the industry is protected by Section 22(d) of the Investment Company Act from price competition between retail dealers in connection with sales of mutual fund shares. The section is perhaps best described as a fair trade law. The Commission is now conducting a study, at the request of Congress, to determine whether the retail price maintenance requirements of Section 22(d) should be amended or deleted from the Act and the probable consequences of that amendment or deletion on the investing public and sales organizations.

The 1970 Amendments to the Act also affected front-end loads on periodic payment plans. Briefly, the thrust of the Amendments in this regard is to require those selling such plans to choose either to impose a fifty percent front-end load on the condition the investor be permitted certain rights of refund or to adopt a system where the load is spread more evenly with a modified refund privilege.

The areas I have highlighted this evening all involve the relationship of management to the fund which it advises and thereby ultimately to the public shareholders of that fund. The Investment Company Amendments Act of 1970 recognized that the hand of those public shareholders must be strengthened if there is to be any meaningful participation by shareholders or their representatives in decisions regarding the affairs of their investment companies. Certainly, management should heed the thrust of these developments and be aware of areas involving possible conflicts of interest in their relationships with the respective investment companies which they manage. In view of the new standards of fiduciary duty imposed upon fund management and the heightened awareness of shareholders regarding those standards, fund management can only benefit by assuring the essential fairness of transactions between it and the investment company which it manages.

Thank you for the opportunity of being with you this evening.