Public Law 91-547

AN ACT

To amend the Investment Company Act of 1940 and the Investment Advisers Act of 1940 to define the equitable standards governing relationships between investment companies and their investment advisers and principal underwriters, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Investment Company Amendments Act of 1970".

SEC. 2 (a) Section 2(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)) is amended as follows:

(1) Paragraph (5) is amended by striking out "under section 11 (k) of the Federal Reserve Act, as amended" and inserting in lieu thereof "under the authority of the Comptroller of the Currency".

(2) Paragraphs (19) through (35) are redesignated as paragraphs (20) through (36), respectively, and paragraphs (36) through (42) are redesignated as paragraphs (38) through (44), respectively.

(3) A new paragraph is inserted immediately after paragraph (18) to read as follows:

"(19) 'Interested person' of another person means—

"(A) when used with respect to an investment company—

"(i) any affiliated person of such company,

"(ii) any member of the immediate family of any natural person who is an affiliated person of such company,

"(iii) any interested person of any investment adviser of or principal underwriter for such company,

"(iv) any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such company,

"(v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and

"(vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any other investment company having the same investment adviser or principal underwriter or with the principal executive officer of such other investment company:

Provided, That no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso; and

"(B) when used with respect to an investment adviser of or principal underwriter for any investment company—

"(i) any affiliated person of such investment adviser or principal underwriter,

"(ii) any member of the immediate family of any natural person who is an affiliated person of such investment adviser or principal underwriter,

"(iii) any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued either by such investment adviser or principal underwriter of by a controlling person of such investment adviser or principal underwriter,

"(iv) any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such investment company has acted as legal counsel for such investment adviser or principal underwriter,

"(v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and

"(vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since the beginning of the last two fiscal years of such investment company a material business or professional relationship with such investment adviser or principal underwriter or with the principal executive officer or any controlling person of such investment adviser or principal underwriter.

For the purposes of this paragraph (19), 'member of the immediate family' means any parent, spouse of a parent, child, spouse of a child, spouse, brother, or sister, and includes step and adoptive relationships. The Commission may modify or revoke any order issued under clause (vi) of subparagraph (A) or (B) of this paragraph whenever it finds that such order is no longer consistent with the facts. No order issued pursuant to clause (vi) of subparagraph (A) or (B) of this paragraph shall become effective until at least sixty days after the entry thereof, and no such order shall affect the status of any person for the purposes of this title or for any other purpose for any period prior to the effective date of such order."

(4) A new paragraph is inserted immediately after redesignated paragraph (36) (formerly paragraph (35)) as follows:

"(37) 'Separate account' means an account established and maintained by an insurance company pursuant to the laws of any State or territory of the United States, or of Canada or any province thereof, under which income, gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company."

(5) A new paragraph is inserted immediately after redesignated paragraph (44) (formerly paragraph (42) as follows:

"(45) 'Savings and loan association' means a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution, and a receiver, conservator, or other liquidating agent of any such institution."

(b) Section 13 (b) of such Act (15 U.S.C. 80a-13(b)) is amended by striking out "paragraph (40)" and inserting in lieu thereof "paragraph (42)".

SEC. 3. (a) The second sentence of paragraph (2) of section 3(b) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(b) (2)) is amended by inserting "in good faith" after "paragraph".

(b) Section 3(c) of such Act (15 U.S.C. 80a-c(c)) is amended as follows:

(1) The material preceding paragraph (1) is amended to read as follows:

"(c) Notwithstanding subsection (a), none of the following persons is an investment company within the meaning of this title:".

(2) Strike paragraph (8); redesignate paragraphs (5) through (15) as paragraphs (4) through (13), respectively; and strike "paragraphs

(3), (5), and (6)" in redesignated paragraph (6) (formerly paragraph (7)) and insert in lieu thereof "paragraphs (3), (4), and (5)".

(3) Redesignated paragraph (5) (formerly paragraph (6)) is amended by inserting "redeemable securities," before "face-amount certificates".

(4) Redesignated paragraph (8) (formerly paragraph (10)) is amended to read as follows:

"(8) Any company subject to regulation under the Public Utility Holding Company Act of 1935."

(5) Redesignated paragraph (11) (formerly paragraph (13)) is amended to read as follows:

"(11) Any employees' stock bonus, pension, or profit-sharing trust which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954; or any collective trust fund maintained by a bank consisting solely of assets of such trusts; or any separate account the assets of which are derived solely from (A) contributions under pension or profit-sharing plans which meet the requirements of such section or the requirements for deduction of the employer's contribution under section 404(a) (2) of such Code, and (B) advances made by an insurance company in connection with the operation of such separate account."

(c) (1) Section 8 (b) (2) of such Act (15 U.S.C. 80a-8 (b) (2)) is amended to read as follows:

"(2) a recital of all investment policies of the registrant, not enumerated in paragraph (1), which are changeable only if authorized by shareholder vote;".

(2) Paragraphs (3) and (4) are redesignated as paragraphs (4) and (5), respectively.

(3) A new paragraph is inserted immediately after paragraph (2) to read as follows:

"(3) a recital of all policies of the registrant, not enumerated in paragraphs (1) and (2), in respect of matters which the registrant deems matters of fundamental policy;".

(d) Section 13 (a) (3) of such At (15 U.S.C. 80-a-13 (a) (3)) is amended to read as follows:

"(3) deviate from its policy in respect of concentration of investments in any particular industry or group of industries as received in its registration statement, deviate from any investment policy which is changeable only if authorized by shareholder vote, or deviate from any policy recited in its registration statement pursuant to section 8 (b) (3);".

SEC. 4. (a) That part of section 9 (a) of the Investment Company Act of 1940 (15 U.S.C. 80a-9(a)) which precedes paragraph (1) is amended by inserting "employee," before "officer".

(b) Section 9 of such Act (15 U.S.C. 80a-9) is further amended by redesignating subsection (b) as subsection (c) and inserting immediately after subsection (a) a new subsection to read as follows:

"(b) The Commission may, after notice and opportunity for hearing, by order prohibit, conditionally or unconditionally, either permanently or for such period of time as it in its discretion shall deem appropriate in the public interest, any person from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter, if such person—

"(1) has willfully made or caused to be made in any registration statement, application or report filed with the Commission under this title any statement which was at the time and in the light of the circumstances under which it was made false or

misleading with respect to any material fact, or has omitted to state in any such registration statement, application, or report any material fact which was required to be stated therein; or

"(2) has willfully violated any provision of the Securities Act of 1933, or of the Securities Exchange Act of 1934, or of title II of this Act, or of this title, or of any rule or regulation under any of such statutes; or

"(3) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of the Securities Act of 1933, or of the Securities Exchange Act of 1934, or of title II of this Act, or of this title, or of any rule or regulation under any of such statutes."

SEC. 5. (a) Section 10(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-10(a)) is amended to read as follows:

"(a) No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company."

(b) Section 10(b) of such Act (15 U.S.C. 80a-10(b)) is amended—

(1) by striking out "After one year from the effective date of this title, no" and inserting in lieu thereof "no"; and

(2) by striking out "affiliated", each place it appears in paragraph (2) and inserting in lieu thereof "interested".

(c) Section 10(c) of such Act (15 U.S.C. 80a-10(c)) is amended to read as follows:

"(c) No registered investment company shall have a majority of its board of directors consisting of persons who are officers, directors, or employees of any one bank, except that, if on March 15, 1940, any registered investment company had a majority of its directors consisting of persons who are directors, officers , or employees of any one bank, such company may continue to have the same percentage of its board of directors consisting of persons who are directors, officers, or employees of such bank."

(d) Section 10(d) of such Act (15 U.S.C. 80a-40(d)) is amended to read as follows:

"(d) Notwithstanding subsections (a) and (b) (2) of this section, a registered investment company may have a board of directors all the members of which, except one, are interested persons of the investment adviser of such company, or are officers or employees of such company, if—

"(1) such investment company is an open-end company;

"(2) such investment adviser is registered under title II of this Act and is engaged principally in the business of rendering investment supervisory services as defined in title II;

"(3) no sales load is charged on securities issued by such investment company;

"(4) any premium over net asset value charged by such company upon the issuance of any such security, plus any discount from net asset value charged on redemption thereof, shall not in the aggregate exceed 2 per centum;

"(5) no sales or promotion expenses are incurred by such registered company; but expenses incurred in comply with laws regulating the issue or sale of securities shall not be deemed sales or promotion expenses;

"(6) such investment adviser is the only investment adviser to such investment company, and such investment adviser does not receive a management fee exceeding 1 per centum per annum of the value of such company's net assets averaged over the year or taken as of a definite date or dates within the year;

"(7) all executive salaries and executive expenses and office rent of such investment company are paid by such investment adviser; and

"(8) such investment company has only one class of securities outstanding, each unit of which has equal voting rights with every other unit."

SEC. 6. Section 11(b) of the Investment Company Act of 1940 (15 U.S.C. 80a-11(b)) is amended to read as follows:

"(b) The provisions of this section shall not apply to any offer made pursuant to any plan of reorganization, which is submitted to and requires the approval of the holders of at least a majority of the outstanding shares of the class or series to which the security owned by the offeree belongs."

SEC. 7. Section 12(d) of the Investment Company Act of 1940 (15 U.S.C. 80a-12(d) is amended to read as follows:

"(d) (1) (A) It shall be unlawful for any registered investment company (the 'acquiring company') and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any other investment company (the 'acquired company'), and for any investment company (the 'acquiring company') and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any registered investment company (the 'acquired company'), if the acquiring company and any company or companies controlled by it immediately after such purchase or acquisition own in the aggregate—

"(i) more than 3 per centum of the total outstanding voting stock of the acquired company;

"(ii) securities issued by the acquired company having an aggregate value in excess of 5 per centum of the value of the total assets of the acquiring company; or

"(iii) securities issued by the acquired company and all other investment companies (other than Treasury stock of the acquiring company) having an aggregate value in excess of 10 per centum of the value of the total assets of the acquiring company.

"(B) It shall be unlawful for any registered open-end investment company (the 'acquired company') , any principal underwriter therefor, or any broker or dealer registered under the Securities Exchange Act of 1934, knowingly to sell or otherwise dispose of any security issued by the acquired company to any other investment company (the 'acquiring company') or any company or companies controlled by the acquiring company, if immediately after such sale or disposition—

"(i) more than 3 per centum of the total outstanding voting stock of the acquired company is owned by the acquiring company and any company or companies controlled by it; or

"(ii) more than 10 per centum of the total outstanding voting stock of the acquired company is owned by the acquiring company and other investment companies and companies controlled by them.

"(C) It shall be unlawful for any investment company (the 'acquiring company') and any company or companies controlled by the acquiring company to purchase or otherwise acquire any security issued by a registered closed-end investment company, if immediately after such purchase or acquisition the acquiring company, other investment companies having the same adviser, and companies controlled by such investment companies, own more than 10 per centum of the total outstanding voting stock of such closed-end company.

"(D) The provisions of this paragraph (1) shall not apply to a security received as a dividend or as a result of an offer of exchange approved pursuant to section 11 or of a plan of reorganization of any company (other than a plan devised for the purpose of evading the foregoing provisions).

"(E) The provisions of this paragraph (1) shall not apply to a security (or securities) purchased or acquired by an investment company if—

"(i) the depositor of, or principal underwriter for, such investment company is a broker or dealer registered under the Securities Exchange Act of 1934, or a person controlled by such a broker or dealer;

"(ii) such security is the only investment security held by such investment company (or such securities are the only investment securities held by such investment company, if such investment company is a registered unit investment trust that issues two or more classes or series of securities, each of which provides for the accumulation of shares of a different investment company); and

"(iii) in the event such investment company is not a registered investment company, the purchase or acquisition is made pursuant to an arrangement with the issuer of, or principal underwriter for the issuer of, the security whereby such investment company is obligated—

"(aa) either to seek instructions from its security holders with regard to the voting of all proxies with respect to such security and to vote such proxies only in accordance with such instructions, or to vote the shares held by it in the same proportion as the vote of all other holders of such security, and

"(bb) to refrain from substituting such security unless the Commission shall have approved such substitution in the manner provided in section 26 of this Act.

"(F) The provisions of this paragraph (1) shall not apply to securities purchased or otherwise acquired by a registered investment company if—

"(i) immediately after such purchase or acquisition not more than 3 per centum of the total outstanding stock of such issuer is owned by such registered investment company and all affiliated persons of such registered investment company; and

"(ii) such registered investment company has not offered or sold after January 1, 1971, and is not proposing to offer or sell any security issued by it through a principal underwriter or otherwise at a public offering price which includes a sales load of more than 1½ per centum.

No issuer of any security purchased or acquired by a registered investment company pursuant to this subparagraph shall be obligated to redeem such security in an amount exceeding 1 per centum of such issuer's total outstanding securities during any period of less than thirty days. Such investment company shall exercise voting rights by proxy or otherwise with respect to any security purchased or acquired pursuant to this subparagraph in the manner prescribed by subparagraph (E) of this subsection.

"(G) For the purposes of this paragraph (1), the value of an investment company's total assets shall be computed as of the time of a purchase or acquisition or as closely thereto as it reasonably possible.

"(H) In any action brought to enforce the provisions of this paragraph (1), the Commission may join as a party the issuer of any security purchased or otherwise acquired in violation of this para-

graph (1), and the court may issue any order with respect to such issuer as may be necessary or appropriate for the enforcement of the provisions of this paragraph (1).

"(2) It shall be unlawful for any registered investment company and any company or companies controlled by such registered investment company to purchase or otherwise acquire any security (except a security received as a dividend or as a result of a plan of reorganization of any company, other than a plan devised for the purpose of evading the provisions of this paragraph) issued by any insurance company of which such registered investment company and any company or companies controlled by such registered company do not, at the time of such purchase or acquisition, own in the aggregate at least 25 per centum of the total outstanding voting stock, if such registered company and any company or companies controlled by it own in the aggregate, or as a result of such purchase or acquisition will own in the aggregate, more than 10 per centum of the total outstanding voting stock of such insurance company.

"(3) It shall be unlawful for any registered investment company and any company or companies controlled by such registered investment company to purchase or otherwise acquire any security issued by or any other interest in the business of any person who is a broker, a dealer, is engaged in the business of underwriting, or is either an investment adviser of an investment company or an investment adviser registered under title II of this Act, unless (A) such person is a corporation all the outstanding securities of which (other than short-term paper securities representing bank loans, and directors qualifying shares) are, or after such acquisition will be, owned by one or more registered investment companies; and (B) such person is primarily engaged in the business of underwriting and distributing securities issued by other persons, selling securities to customers, or any one or more of such or related activities, and the gross income of such person normally is derived principally from such business or related activities."

SEC. 8. (a) Section 15 (a) of the Investment Company Act of 1940 (15 U.S.C. 80a-15(a)) is amended to read as follows:

"(a) It shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, has been approved by the vote of a majority of the outstanding voting securities of such registered company, and—

"(1) precisely describes all compensation to be paid thereunder;

"(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;

"(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

"(4) provides, in substance, for its automatic termination in the event of its assignment."

(b) Section 15(b) of such Act (15 U.S.C. 80a-15(b)) is amended to read as follows:

"(b) It shall be unlawful for any principal underwriter for a registered open-end company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, except pursuant to a written contract with such company, which contract—

"(1) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company; and

"(2) provides, in substance, for its automatic termination in the event of its assignment."

(c) Section 15(c) of such Act (15 U.S.C. 80a-15(c)) is amended to read as follows:

"(c) In addition to the requirements of subsection (a) and (b) of this section, it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms o any contract whereby a person undertakes regularly to serve or act as investment adviser of such company."

(d) Section 15 of such Act (15 U.S.C. 80a-15) is amended by striking out subsection (d) and redesignating subsection (e) and (f) as subsections (d) and (e), respectively.

SEC. 9. (a) Section 17(f) of the Investment Company Act of 1940 (15 U.S.C. 80a-17(f)) is amended to read as follows:

"(f) Every registered management company shall place and maintain its securities and similar investments in the custody of (1) a bank or banks having the qualifications prescribed in paragraph (1) of section 26(a) of this title for the trustees of unit investment trusts; or (2) a company which is a member of a national securities exchange as defined in the Securities Exchange Act of 1934, subject to such rules and regulations as the Commission may from time to time prescribe for the protection of investors; or (3) such registered company, but only in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors. Subject to such rules, regulations, and orders as the Commission may adopt as necessary or appropriate for the protection of investors, a registered management company or any such custodian, with the consent of the registered management company for which acts as custodian, may deposit all or any part of the securities owned by such registered management company in a system for the central handling of securities established by a national securities exchange or national securities association registered with the Commission under the Securities Exchange Act of 1934, or such other person as may be permitted by the Commission, pursuant to which system all securities of any particular class or series of any issuer deposited within the system are treated as fungible and may be transferred or pledged by bookkeeping entry without physical delivery of such securities. Rules, regulations, and orders of the Commission under this subsection, among other things, may make appropriate provision with respect to such matters as the earmarking, segregation, and hypothecation of such securities and investments, and may provide for or require periodic or other inspections by any or all of the following: Independent public accountants, employees and agents of the Commission, and such other persons as the Commission may designate. No such member

which trades in securities for its own account may act as custodian except in accordance with rules and regulations prescribed by the Commission for the protection of investors. If a registered company maintains its securities and similar investments in the custody of a qualified bank or banks, the cash proceeds from the sale of such securities and similar investments and other cash assets of the company shall likewise be kept in the custody of such a bank or banks, or in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors, except that such a registered company may maintain a checking account in a bank or banks having the qualifications prescribed in paragraph (1) of section 26(a) of this title for the trustees of unit investment trusts with the balance of such account or the aggregate balances of such accounts at no time in excess of the amount of the fidelity bond, maintained pursuant to section 17(g) of this title, covering the officers or employees authorized to draw on such account or accounts."

(b) Section 17(g) of such Act (15 U.S.C. 80a-17(g)) is amended to read as follows:

"(g) The Commission is authorized to require by rules and regulations or orders for the protection of investors that any officer or employee of a registered management investment company who may singly, or jointly with others, have access to securities or funds of any registered company, either directly or through authority to draw upon such funds or to direct generally the disposition of such securities (unless the officer or employee has such access solely through his position as an officer or employee of a bank) be bonded by a reputable fidelity insurance company against larceny and embezzlement in such reasonable minimum amounts as the Commission may prescribe.

(c) Section 17 of such Act (15 U.S.C. 80a-17) is further amended by adding at the end thereof a new subsection as follows:

"(j) It shall be unlawful for any affiliated person of or principal underwriter for a registered investment company or any affiliated person of an investment adviser of or principal underwriter for a registered investment company, to engage in any act, practice, or course of business in connection with the purchase or sale, directly or indirectly, by such person of any security held or to be acquired by such registered investment company in contravention of such rules and regulations as the Commission may adopt to define, and prescribe means reasonably necessary to prevent, such acts, practices, or courses of business as are fraudulent, deceptive or manipulative. Such rules and regulations may include requirements for the adoption of codes of ethics by registered investment companies and investment advisers of, and principal underwriters for, such investment companies establishing such standards as are reasonably necessary to prevent such acts, practices, or courses of business."

SEC. 10. Section 18(f) (2) of the Investment Company Act of 1940 (15 U.S.C. 80a-18(f)(2)) is amended to read as follows:

"(2) "Senior security" shall not, in the case of a registered open-end company, include a class or classes or a number of series of preferred or special stock each of which is preferred over all other classes or series in respect of assets specifically allocated to that class or series: *Provided,* That (A) such company has outstanding no class or series of stock which is not so preferred over all other classes or series, or (B) the only other outstanding class of the issuer's stock consists of a common stock upon which no dividend (other than a liquidating dividend) is permitted to be paid and which in the aggregate represents not more than one-half of 1 per centum of the issuer's outstanding voting securities. For the purpose of insuring fair and equitable treatment of the holders of the outstanding voting securities of each class or series of

stock of such company, the Commission may by rule, regulation, or order direct that any matter required to be submitted to the holders of the outstanding voting securities of such company shall not be deemed to have been effectively acted upon unless approved by the holders of such percentage (not exceeding a majority) of the outstanding voting securities of each class or series of stock affected by such matter as shall be prescribed in such rule, regulation, or order."

SEC. 11. Section 19 of the Investment Company Act of 1940 (15 U.S.C. 80a-19) is amended by inserting "(a)" after "SEC. 19", and by adding at the end thereof a new subsection as follows:

"(b) It shall be unlawful in contravention of such rules, regulations, or orders as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors for any registered investment company to distribute long-term capital gains, as defined in the Internal Revenue Code of 1954, more often than once every twelve months."

SEC. 12. (a) Section 22(b) of the Investment Company Act of 1940 (15 U.S.C. 80-22(b)) is amended to read as follows:

"(b) (1) Such a securities association may also, by rules adopted and in effect in accordance with said section 15A, and notwithstanding the provisions of subsection (b) (8) thereof but subject to all other provisions of said section applicable to the rules of such an association, prohibit its members from purchasing, in connection with a primary distribution of redeemable securities of which any registered investment company is the issuer, any such security from the issuer or from any principal underwriter except at a price equal to the price at which such security is then offered to the public less a commission, discount, or spread which is computed in conformity with a method or methods, and within such limitations as to the relation thereof to said public offering price, as such rules may prescribe, in order that the price at which such security is offered or sold to the public shall not include an excessive sales load but shall allow for reasonable compensation for sales personnel, broker-dealers, and underwriters, and for reasonable sales loads to investors. The Commission shall on application or otherwise, if it appears that smaller companies are subject to relatively higher operating costs, make due allowance therefor by granting any such company or class of companies appropriate qualified exemptions from the provisions of this section.

"(2) At any time after the expiration of eighteen months from the date of enactment of the Investment Company Amendments Act of 1970, or after a securities association has adopted rules as contemplated by this subsection, the Commission may make such rules and regulations pursuant to section 15(b) (1) of the Securities Exchange Act of 1934 as are appropriate to effectuate the purpose of this subsection with respect to sales of shares of a registered investment company by broker-dealers subject to regulation under section 15(b) (8) of that Act: *Provided*, That the underwriter of such shares may file with the Commission at any time a notice of election to comply with the rules prescribed pursuant to this subsection by a national securities association specified in such notice, and thereafter the sales load shall not exceed that prescribed by such rules of such association, and the rules of the Commission as hereinabove authorized shall thereafter be inapplicable to such sales.

"(3) At any time after the expiration of eighteen months from the date of enactment of the Investment Company Amendments Act of 1970 (or, if earlier, after a securities association has adopted for purposes of paragraph (1) any rule respecting excessive sales loads), the Commission may alter or supplement the rules of any securities association as may be necessary to effectuate the purposes of this subsection

in the manner provided by section 15A (k) (2) of the Securities Exchange Act of 1934.

"(4) If any provision of this subsection is in conflict with any provision of any law of the United States in effect on the date this subsection takes effect, the provisions of this subsection shall prevail."

(b) Section 22(c) of such Act (15 U.S.C. 80a-22(c)) is amended to read as follows:

"(c) The Commission may make rules and regulations applicable to registered investment companies and to principal underwriters of, and dealers in, the redeemable securities of any registered investment company, whether or not members of any registered securities association, to the same extent, covering the same subject matter, and for the accomplishment of the same ends as are prescribed in subsection (a) of this section in respect of the rules which may be made by a registered securities association governing its members. Any rules and regulations so made by the Commission, to the extent that they may be inconsistent with the rules of any such association, shall so long as they remain in force supersede the rules of the association and be binding upon its members as well as all other underwriters and dealers to whom they may be applicable."

(c) Section 22(d) of such Act (15 U.S.C. 80a-22(d)) is amended to read as follows:

"(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. 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."

SEC. 13. Section 24 (d) of the Investment Company Act of 1940 (15 U.S.C. 80a-24(d)) is amended to read as follows:

"(d) The exemption provided by paragraph (8) of section 3 (a) of the Securities Act of 1933 shall not apply to any security of which an investment company is the issuer. The exemption provided by paragraph (11) of said section 3 (a) shall not apply to any security of which a registered investment company is the issuer, except a security sold or disposed of by the issuer or bona fide offered to the public prior to the effective date of this title, and with respect to a security so sold, disposed of, or offered, shall not apply to any new offering thereof on or after the effective date of this title. The exemption provided by section 4(3) of the Securities Act of 1933 shall not apply to any transaction in a security issued by a face-amount certificate company or in a redeemable security issued by an open-end management company or unit investment trust if any other security of the same class is currently being offered or sold by the issuer or by or through an underwriter in a distribution which is not exempted from section 5 of said Act, except to such extent and subject to such terms and conditions as the Commission, having due regard for the public interest and the protection of investors, may prescribe by rules or regulations with respect to any class of persons, securities, or transactions."

(b) Section 24 of such Act (15 U.S.C. 80a-24) is further amended by adding at the end thereof a new subsection to read as follows:

"(f) In the case of securities issued by a face-amount certificate company or redeemable securities issued by an open-end management company or unit investment trust, which are sold in an amount in excess of the number of securities included in an effective registration statement of any such company, such company may, in accordance with such rules and regulations as the Commission shall adopt as it deems necessary or appropriate in the public interest or for the protection of investors, elect to have the registration of such securities deemed effective as of the time of their sale, upon payment to the Commission, within six months after any such sale, of a registration fee of three times the amount of the fee which would have otherwise been applicable to such securities. Upon any such election and payment, the registration statement of such company shall be considered to have been in effect with respect to such shares. The Commission may also adopt rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors to permit the registration of an indefinite number of the securities issued by a face-amount certificate company or redeemable securities issued by an open-end management company or unit investment trust."

SEC. 14. Section 25 (c) of the Investment Company Act of 1940 (15 U.S.C. 80a-25(c)) is amended to read as follows:

"(c) Any district court of the United States in the State of incorporation of a registered investment company, or any such court for the district in which such company maintains its principal place of business, is authorized to enjoin the consummation of any plan of reorganization of such registered investment company upon proceedings instituted by the Commission (which is authorized so to proceed upon behalf of security holders of such registered company, or any class thereof), if such court shall determine that any such plan is not fair and equitable to all security holders."

SEC. 15. (a) Section 26 of the Investment Company Act of 1940 (15 U.S.C. 80a-26) is amended by redesignating subsections (b) and (c) thereof as subsections (c) and (d), respectively, and by inserting immediately after subsection (a) a new subsection as follows:

"(b) It shall be unlawful for any depositor or trustee of a registered unit investment trust holding the security of a single issuer to substitute another security for such security unless the Commission shall have approved such substitution. The Commission shall issue an order approving such substitution if the evidence establishes that it is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

(b) Redesignated subsection (c) (formerly subsection (b)) of section 26 of such Act is amended to read as follows:

"(c) In the event that a trust indenture, agreement of custodianship, or other instrument pursuant to which securities of a registered unit investment trust are issued does not comply with the requirements of subsection (a) of this section, such instrument will be deemed to meet such requirements if a written contract or agreement binding on the parties and embodying such requirements has been executed by the depositor on the one part and the trustee or custodian on the other part, and three copies of such contract or agreement have been filed with the Commission."

SEC. 16. Section 27 of the Investment Company Act of 1940 (15 U.S.C. 80a-27) is amended by adding at the end thereof the following new subsections:

"(d) Notwithstanding subsection (a) of this section, it shall be unlawful for any registered investment company issuing periodic

payment plan certificates, or for any depositor of or underwriter for such company, to sell any such certificate unless the certificate provides that the holder thereof may surrender the certificate at any time within the first eighteen months after the issuance of the certificate and receive in payment thereof, in cash, the sum of (1) the value of his account, and (2) the amount, from such underwriter or depositor, equal to that part of the excess paid for sales loading which is over 15 per centum of the gross payments made by the certificate holder. The Commission may make rules and regulations applicable to such underwriters and depositors specifying such reserve requirements as it deems necessary or appropriate in order for such underwriters and depositors to carry out the obligations to refund sales charges required by this subsection.

"(e) With respect to any periodic payment plan certificate sold subject to the provisions of subsection (d) of this section, the registered investment company issuing such periodic payment plan certificate, or any depositor of or underwriter for such company, shall in writing (1) inform each certificate holder who has missed three payments or more, within thirty days following the expiration of fifteen months after the issuance of the certificate, or, if any such holder has missed one payment or more after such period of fifteen months but prior to the expiration of eighteen months after the issuance of the certificate, at any time prior to the expiration of such eighteen-month period, of his right to surrender his certificate as specified in subsection (d) of this section, and (2) inform the certificate holder of (A) the value of the holder's account as of the time the written notice was given to such holder, and (B) the amount to which he is entitled as specified in subsection (d) of this section. The Commission may make rules specifying the method, form, and contents of the notice required by this subsection.

"(f) With respect to any periodic payment plan, the custodian bank for such plan shall mail to each certificate holder, within sixty days after the issuance of the certificate, a statement of charges to be deducted from the projected payments on the certificate and a notice of his right of withdrawal as specified in this section. The Commission may make rules specifying the method, form, and contents of the notice required by this subsection. The certificate holder may within forty-five days of the mailing of the notice specified in this subsection surrender his certificate and receive in payment thereof, in cash, the sum of (1) the value of his account, and (2) an amount, from the underwriter or depositor, equal to the difference between the gross payments made and the net amount invested. The Commission may make rules and regulations applicable to underwriters and depositors of companies issuing any such certificates specifying such reserve requirements as it deems necessary or appropriate in order for such underwriters and depositors to carry out the obligations to refund sales charges required by this subsection.

"(g) Notwithstanding the provisions of subsections (a) and (d), a registered investment company issuing periodic payment plan certificates may elect, by written notice to the Commission, to be governed by the provisions of subsection (h) rather than the provisions of subsections (a) and (d) of this section.

"(h) Upon making the election specified in subsection (g), it shall be unlawful for any such electing registered investment company issuing periodic payment plan certificates, or for any depositor of or underwriter for such company, to sell any such certificate, if—

> "(1) the sales load on such certificate exceeds 9 per centum of the total payments to be made thereon;
>
> "(2) more than 20 per centum of any payment thereon is deducted for sales load, or an average of more than 16 per centum

is deducted for sales load from the first forty-eight monthly payments thereon, or their equivalent;

"(3) the amount of sales load deducted from any one of the first twelve monthly payments, the thirteenth through twenty-fourth monthly payments, the twenty-fifth through thirty-sixth monthly payments, or the thirty-seventh through forty-eighth monthly payments, or their equivalents, respectively, exceeds proportionately the amount deducted from any other such payment, or the amount deducted from any subsequent payment exceeds proportionately the amount deducted from any other subsequent payment;

"(4) the deduction for sales load on the excess of the payment or payments in any month over the minimum monthly payment, or its equivalent, to be made on the certificate exceeds the sales load applicable to payments subsequent to the first forty-eight monthly payments or their equivalent;

"(5) the first payment on such certificate is less than $20, or any subsequent payment is less than $10;

"(6) if such registered company is a management company, the proceeds of such certificate or the securities in which such proceeds are invested are subject to management fees (other than fees for administrative services of the character described in clause (C) of paragraph (2) of section 26(a) exceeding such reasonable amount as the Commission may prescribe, whether such fees are payable to such company or to investment advisers thereof; or

"(7) if such registered company is a unit investment trust the assets of which are securities issued by a management company, the depositor of or principal underwriter for such trust, or any affiliated person of such depositor or underwriter, is to receive from such management company or any affiliated person thereof any fee or payment on account of payments on such certificate exceeding such reasonable amount as the Commission may prescribe."

SEC. 17. Section 28 of the Investment Company Act of 1940 (15 U.S.C. 80a-28) is amended by adding at the end thereof a new subsection as follows:

"(i) The foregoing provisions of this section shall apply to all face-amount certificates issued prior to the effective date of this subsection; to the collection or acceptance of any payment on such certificates; to the issuance of face-amount certificates to the holders of such certificates pursuant to an obligation expressed or implied in such certificates; to the provisions of such certificates; to the minimum certificate reserves and deposits maintained with respect thereto; and to the assets that the issuer of such certificate was and is required to have with respect to such certificates. With respect to all face-amount certificates issued after the effective date of this subsection, the provisions of this section shall apply except as hereinafter provided.

"(1) Notwithstanding subparagraph (A) of paragraph (2) of subsection (a), the reserves for each certificate of the installment type shall be based on assumed annual, semiannual, quarterly, or monthly reserve payments according to the manner in which gross payments for any certificate year are made by the holder, which reserve payments shall be sufficient in amount, as and when accumulated at a rate not to exceed 3½ per centum per annum compounded annually, to provide the minimum maturity or face amount of the certificate when due. Such reserve payments may be graduated according to certificate years so that the reserve payment or payments for the first three certificate years shall amount to at least 80 per centum of the required gross annual payment for such years; the reserve payment or payments for the fourth certificate year shall amount to at least 90 per centum of

such year's required gross annual payment; the reserve payment or payments for the fifth certificate year shall amount to at least 93 per centum of each such year's gross annual payment; and for the sixth and each subsequent certificate year the reserve payment or payments shall amount to at least 96 per centum of each such year's required gross annual payment: *Provided,* That such aggregate reserve payments shall amount to at least 93 per centum of the aggregate gross annual payments required to be made by the holder to obtain the maturity of the certificate. The company may at its option take as loading from the gross payment or payments for a certificate year, as and when made by the certificate holder, an amount or amounts equal in the aggregate for such year to not more than the excess, if any, of the gross payment or payments required to be made by the holder for such year, over and above the percentage of the gross annual payment required herein for such year for reserve purposes. Such loading may be taken by the company prior to or after the setting up of the reserve payment or payments for such year and the reserve payment or payments for such year may be graduated and adjusted to correspond with the amount of the gross payment or payments made by the certificate holder for such year less the loading so taken.

"(2) Notwithstanding paragraphs (1) and (2) of subsection (d), (A) in respect of any certificate of the installment type, during the first certificate year, the holder of the certificate, upon surrender thereof, shall be entitled to a value payable in cash not less than 80 per centum of the amount of the gross payments made on the certificate; and (B) in respect of any certificate of the installment type, at any time after the expiration of the first certificate year and prior to maturity, the holder of the certificate, upon surrender thereof, shall be entitled to a value payable in cash not less than the then amount of the reserve for such certificate required by clauses (1) and (2) of subparagraph (d) of paragraph (2) of subsection (a), less a surrender charge that shall not exceed 2 per centum of the face or maturity amount of the certificate, or 15 per centum of the amount of such reserve, whichever is the lesser, but in no event shall such value be less than 80 per centum of the gross payments made on the certificate. The amount of the surrender value for the end of each certificate year shall be set out in the certificate."

SEC. 18. Section 32(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-31(a)) is amended to read as follows:

"(a) It shall be unlawful for any registered management company or registered face-amount certificate company to file with the Commission any financial statement signed or certified by an independent public accountant, unless—

"(1) such accountant shall have been selected at a meeting held within thirty days before or after the beginning of the fiscal year or before the annual meeting of stockholders in that year by the vote, cast in person, of a majority of those members of the board of directors who are not interested persons of such registered company;

"(2) such selection shall have been submitted for ratification or rejection at the next succeeding annual meeting of stockholders if such meeting be held, except that any vacancy occurring between annual meetings, due to the death or resignation of the accountant, may be filled by the majority of those members of the board of directors who are not interested persons of such registered company, cast in person at a meeting called for the purpose of voting on such action;

"(3) the employment of such accountant shall have been conditioned upon the right of the company by vote of a majority of

the outstanding voting securities at any meeting called for the purpose to terminate such employment forthwith without any penalty; and

"(4) such certificate or report of such accountant shall be addressed both to the board of directors of such registered company and to the security holders thereof.

If the selection of an accountant has been rejected pursuant to paragraph (2) or his employment terminated pursuant to paragraph (3) the vacancy so occurring may be filled by a vote of a majority of the outstanding voting securities, either at the meeting at which the rejection or termination occurred or, if not so filled, at a subsequent meeting which shall be called for the purpose. In the case of a common-law trust of the character described in section 16(b), no ratification of the employment of such accountant shall be required but such employment may be terminated and such accountant removed by action of the holders of record of a majority of the outstanding shares of beneficial interest in such trust in the same manner as is provided in said section 16(b) in respect of the removal of a trustee, and all the provisions therein contained as to the calling of a meeting shall be applicable. In the event of such termination and removal, the vacancy so occurring may be filled by action of the holders of record of a majority of the shares of beneficial interest either at the meeting, if any, at which such termination and removal occurs, or by instruments in writing filed with the custodian, or if not so filled within a reasonable time then at subsequent meeting which shall be called by the trustees for the purpose. The provisions of paragraph (42) of section 2(a) as to a majority shall be applicable to the vote cast at any meeting of the shareholders of such a trust held pursuant to this subsection."

SEC. 19. Section 33 of the Investment Company Act of 1940 (15 U.S.C. 80a-32) is amended to read as follows:

"FILING OF DOCUMENTS WITH THE COMMISSION IN CIVIL ACTIONS

"SEC. 33. Every registered investment company which is a party and every affiliated person of such company who is a party defendant to any action or claim by a registered investment company or a security holder thereof in a derivative or representative capacity against an officer, director, investment adviser, trustee, or depositor of such company, shall file with the Commission, unless already so filed, (1) a copy of all pleadings, verdicts, or judgments filed with the court or served in connection with such action or claim, (2) a copy of any proposed settlement, compromise, or discontinuance of such action, and (3) a copy of such motions, transcripts, or other documents filed in or issued by the court or served in connection with such action or claim as may be requested in writing by the Commission. If any document referred to in clause (1) or (2)—

"(A) is delivered to such company or party defendant, such document shall be filed with the Commission not later than ten days after the receipt thereof; or

"(B) is filed in such court or delivered by such company or party defendant, such document shall be filed with the Commission not later than five days after such filing or delivery."

SEC. 20. Section 36 of the Investment Company Act of 1940 (15 U.S.C. 80a-35) is amended to read as follows:

"BREACH OF FIDUCIARY DUTY

"SEC. 36. (a) The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the

United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

"(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

"(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 1 (b) of this title.

"(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

"(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

"(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

"(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one years before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

"(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

"(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

"(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this title for the purposes of section 9 and 49 of this title, section 15 of the Securities Exchange Act of 1934, or section 203 of title II of this Act, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section."

SEC. 21. The last sentence of section 43(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-42(a)) is amended by striking out "sections 239 and 240 of the Judicial Code, as amended" and inserting in lieu thereof "section 1254 of title 28, United States Code".

SEC. 22. Section 44 of the Investment Company Act of 1940 (15 U.S.C. 80a-43) is amended—

(1) by striking out the next to the last sentence and inserting in lieu thereof "Judgments and decrees so rendered shall be subject to review as provided in sections 1254, 1291, 1292, and 1294 of title 28, United States Code"; and

(2) by adding at the end thereof a new sentence as follows: "The Commission may intervene as a party in any action or suit to enforce any liability or duty created by, or to enjoin any noncompliance with, section 36(b) of this title at any stage of such acting or suit prior to final judgment therein."

SEC. 23. Section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)) is amended as follows.

(1) Paragraph (2) is amended by striking out "under section 11(k) of the Federal Reserve Act, as amended" and inserting in lieu thereof "under the authority of the Comptroller of the Currency".

(2) Paragraphs (17) through (20) are redesignated as paragraphs (18) through (21), respectively, and a new paragraph is inserted immediately after paragraph (16) to read as follows:

"(17) The term 'person associated with an investment adviser' means any partner, officer, or director of such investment adviser (or any person performing similar functions), or any person directly or indirectly controlling or controlled by such investment adviser, including any employee of such investment adviser, except that for the purposes of section 203 of this title (other than subsection (f) thereof), persons associated with an investment adviser whose functions are clerical or ministerial shall not be included in the meaning of such term. The Commission may by rules and regulations classify, for the purposes of any portion or portions of this title, persons, including employees controlled by an investment adviser."

SEC. 24. (a) Section 203(b) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(b)) is amended as follows:

"(b) The provisions of subsection (a) shall not apply to—

"(1) any investment adviser all of whose clients are residents of the State within which such investment adviser maintains his or its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange;

"(2) any investment adviser whose only clients are insurance companies; or

"(3) any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under title I of this Act."

(b) Section 203(c) of such Act (15 U.S.C. 80b-3(c)) is amended by striking out subparagraph (F) and inserting in lieu thereof the following:

"(F) whether such investment adviser, or any person associated with such investment adviser, is subject to any disqualification which would be a basis for denial, suspension, or revocation of registration of such investment adviser under the provisions of subsection (e), and".

(c) Section 203 of such Act (15 U.S.C. 80b-3) is further amended by redesignating subsection (d) as subsection (e), redesignating subsection (e) as subsection (g), and inserting after subsection (c) a new subsection as follows:

"(d) Any provision of this title (other than subsection (a) of this section) which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce are used in connection therewith shall also prohibit any such act, practice, or course of business by any investment adviser registered pursuant to this section or any person acting on behalf of such an investment adviser, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith."

(d) Redesignated subsection (e) (formerly subsection (d) of section 203 of such Act) (15 U.S.C. 80b-3(d)) is amended to read as follows:

"(e) The Commission shall, after appropriate notice and opportunity for hearing, by order censure, deny registration to, or suspend for a period not exceeding twelve months, or revoke the registration of, an investment adviser, if it finds that such censure, denial, suspension, or revocation is in the public interest and that such investment adviser or any person associated with such investment adviser, whether prior to or subsequent to becoming such—

"(1) has willfully made or caused to be made in any application for registration or report filed with the Commission under this title, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or who has omitted to state in any such application or report any material fact which is required to be stated therein; or

"(2) has been convicted within ten years preceding the filing of the application or at any time thereafter of any felony or misdemeanor which the Commission finds (A) involves the purchase or sale of any security, (B) arises out of the conduct of the business of a broker, dealer, or investment adviser, (C) involves embezzlement, fraudulent conversion, or misappropriation of funds or securities, or (D) involves the violation of section 1341, 1342, or 1343 of title 18, United States Code; or

"(3) is permanently or temporarily enjoined by order, judgment or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, or dealer, or an affiliated person or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security; or

"(4) has willfully violated any provision of the Securities Act of 1933, or of the Securities Exchange Act of 1934, or of title I of this Act, or of this title, or of any rule or regulation under any of such statutes; or

"(5) has aided, abetted, counseled, commanded, induced, or procured the violation by any other person of the Securities Act of 1933, or the Securities Exchange Act of 1934, or of title I of this Act, or of this title, or of any rule or regulation under any of such statutes or has failed reasonably to supervise, with a view to pre-

venting violations of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision; *Provided,* That, for the purposes of this paragraph (5), no person shall be deemed to have failed reasonably to supervise any person, if—

"(A) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person; and

"(B) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with; or

"(6) is subject to an order of the Commission entered pursuant to subsection (f) of this section barring or suspending the right of such person to be associated with an investment adviser, which order is in effect with respect to such person."

(e) Section 203 of such Act (15 U.S.C. 80b-3) is further amended by redesignating subsection (f) and (g) as subsection (h) and (i), respectively, and inserting after redesignated subsection (e) a new subsection as follows:

"(f) The Commission may, after appropriate notice and opportunity for hearing, by order censure any person or bar or suspend for a period not exceeding twelve months any person from being associated with an investment adviser, if the Commission finds that such censure, barring, or suspension is in the public interest and that such person has committed or omitted any act or omission enumerated in paragraph (1), (4), or (5) of subsection (e) of this section, or has been convicted of any offense specified in paragraph (2) of subsection (e) within ten years of the commencement of the proceedings under this subsection, or is enjoined from any action, conduct, or practice specified in paragraph (3) of subsection (e). It shall be unlawful for any person as to whom such an order barring or suspending him from being associated with an investment adviser is in effect, willfully to become, or to be, associated with an investment adviser, without the consent of the Commission, and it shall be unlawful for any investment adviser to permit such a person to become, or remain, a person associated with such investment adviser without the consent of the Commission, if such investment adviser knew, or in the exercise of reasonable care should have known of such order."

SEC. 25. Section 205 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-5) is amended to read as follows:

"INVESTMENT ADVISORY CONTRACTS

"SEC. 205. No investment adviser, unless exempt from registration pursuant to section 203(b), shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to enter into, extend, or renew any investment advisory contract, or in any way to perform any investment advisory contract entered into, extended, or renewed on or after the effective date of this title, if such contract—

"(1) provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client;

"(2) fails to provide, in substance, that no assignment of such contract shall be made by the investment adviser without the consent of the other party to the contract; or

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91ST CONGRESS 1st Session | SENATE | REPORT No. 91-184

INVESTMENT COMPANY AMENDMENTS ACT OF 1969

MAY 21, 1969.—Ordered to be printed

Mr. SPARKMAN, from the Committee on Banking and Currency, submitted the following

REPORT

[To accompany S. 2224]

The Committee on Banking and Currency, to which was referred the bill (S. 2224) to amend the Investment Company Act of 1940 and the Investment Advisers Act of 1940 to define the equitable standards governing relationships between investment companies and their investment advisers and principal underwriters, and for other purposes, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

Committee Deliberations

S. 2224 contains comprehensive amendments to the Investment Company Act of 1940 and amends for limited purposes the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940. This legislation contains many of the proposals encompassed in S. 3724, which was passed by the Senate during the 90th Congress by a voice vote but upon which the House of Representatives failed to act. It also contains a majority of the proposals which were in S. 34, introduced by Senator Sparkman, chairman of this committee on January 15, 1969.

During the last 3 years, this committee held extensive hearings and executive sessions on the subject matter. This proposed legislation was also debated at great length on the Senate floor in July 1968.

In total this bill represents a 3-year effort on the part of your committee to deal with the problems described in the 1962 Wharton School of Finance and Commerce study of mutual funds, the 1963 special study of the securities markets made by the Securities and Exchange Commission and the Commission's 1966 Report on Public Policy Im-

plications of Investment Company Growth. This will also update our Nation's securities laws so that they will be better suited for an ever-expanding investment company industry.

Purpose of the Bill

S. 2224 has three primary objectives. First, it amends those sections of the Investment Company Act of 1940 which pertain to investment company management fees, mutual fund sales commissions, and periodic payment or contractual plan sales commissions. Second, it amends various provisions of the Federal securities laws to permit banks and savings and loan associations to operate commingled managing agency accounts in competition with mutual funds. The bill also clarifies the status of other bank collective funds under the Federal securities laws and assures an equal competitive position for separate accounts established by insurance companies. Third, the bill contains a large number of amendments to the Investment Company Act of 1940 and the Investment Advisers Act of 1940 which would facilitate, update and improve the administration and enforcement of these acts. These latter amendments are supported by almost all segments of the securities industry.

In the case of management fees, the committee believes that the unique structure of mutual funds has made it difficult for the courts to apply traditional fiduciary standards in considering questions concerning management fees.

Therefore your committee has adopted the basic principle that, in view of the potential conflicts of interest involved in the setting of these fees, there should be effective means for the courts to act where mutual fund shareholders of the SEC believe there has been a breach of fiduciary duty. This bill would make it clear that, as a matter of Federal law, the investment adviser or mutual fund management company has a fiduciary duty with respect to mutual fund shareholders. It provides an effective method whereby the courts can determine whether there has been a breach of this duty by the adviser or by certain other persons with respect to their compensation from the fund.

The committee, rather than recommending that the Congress set a maximum statutory commission rate for mutual fund sales loads believes that industry self-regulation is a preferable approach. Under this proposal, the Commission would be empowered to alter or supplement industry rules, after opportunity for full hearings and judicial appeal. Although the committee in this instance recommends that the doctrine of self-regulation be applied to mutual fund sales commissions, it does not wish to prejudice in any way this issue as it applies to other segments of the securities industry. This is especially true as to such matters which are now currently being considered by the Commission.

With respect to contractual plans, the committee has not followed the original recommendation of the Commission which would have prohibited the front-end load. We have, instead, provided two alternatives which will permit a continuation of contractual plans with a front-end load, but which will substantially lessen the sales charges to investors who are unable to complete the specified payments called for under these plans during the first 3 years.

The first alternative follows the provisions of last year's bill and modifies the present act to reduce from 50 to 20 percent the maximum sales load that can be deducted from any periodic installment payment. The second alternative retains the presently authorized front-end load but requires that if the investor for any reason elects to redeem his underlying shares for cash during the first 3 years, he is entitled to receive a refund of the value of the shares and the amount by which all sales shares paid by him exceed 15 percent of the total payments made under the plan.

The bill is supported by the American Bankers Association. The insurance industry supports most provisions relating to the applicability of the Federal securities statutes to its activities. The recommendations with respect to sales loads are supported by the National Association of Securities Dealers, Inc., an industry self-regulatory organization which includes most of our Nation's dealers and underwriters engaged in the sale of mutual fund shares.

The management fee provision is strongly supported by the banking and insurance industries who would be affected by this provision in the same manner as mutual funds.

Background of the Bill

Beginning in 1935, the Congress recognized that investment companies and those who entrust their savings to such companies stand in special need of legal protection. Section 30 of the Public Utility Holding Company Act of 1935 directed the Securities and exchange Commission to make a study of investment truss and investment companies and to report its findings to the Congress. In compliance with that direction the Commission produced the investment trust study. The study resulted in the Investment Company Act of 1940. This act has generally served the Nation well in the areas identified by the study—particularly investment trusts and closed-end investment companies.

When the Congress passed the Investment Company Act it recognized that this act was not and could not be the final answer to all of the questions which might in the future confront the investment company industry. Accordingly, in section 14(b) of the Investment Company Act, the Congress authorized the Commission—

> At such time as it deems that any substantial further increase in size of investment companies creates any problem involving the protection of investors or the public interest to make a study and investigation * * * and from time to time to report the results * * * and its recommendations to the Congress.

During the 1950's a dramatic surge of growth—a surge that has continued to this day—made mutual fund companies an investment medium of major significance. Therefore, in 1958 the Commission under section 14(b) of the act authorized the securities research unit of the Wharton School of Finance and Commerce of the University of Pennsylvania to study investment companies and to report its findings. This study, known as the Wharton report[1] was transmitted

[1]Wharton School of Finance and Commerce, A Study of Mutual Funds, H. Rept. 2274, 57th Cong. 2d Sess. 1 (1962).

to the Congress in August of 1962. The Wharton report assembled a wealth of factual material about the mutual fund sector of the investment company business and identified what its authors believed to be the more important problems facing the industry. The report, however, made no legislative recommendations.

While the Wharton report was being prepared, the Securities and Exchange Commission was also making a detailed study of the securities industry and the securities markets. That study was the result of congressional concern over the health of those markets, as expressed in section 19(d) of the Securities Exchange Act.[2] Among the subjects with which this special study[3] dealt were the sale of mutual fund shares and the special problems connected with the sale of contractual plans on the installment basis.

The Wharton and the special study reports led the Commission to make further inquires. It presented the results of these inquires and a detailed program for amending the act in its report on the Public Policy Implications of Investment Company Growth, transmitted to the Congress on December 2, 1966.[4]

The Commission's original proposals were contained in S. 1650, introduced on November 13, 1967, upon which your committee held extensive and far-reaching hearings. This bill was amended and passed by the Senate as S. 3724. Hearings on S. 34—which was identical to S. 3724—were held during this session of Congress. As a result of these hearings many changes were made in the proposed legislation. This was due to the information derived from written and oral presentations on behalf of the Commission as well as from numerous lawyers, economists, and other individual witnesses knowledgeable in investment company matters. Testimony was also received from many representatives of the investment company industry on economic matters involved and on the regulatory problems presented.

Your committee agrees "that on the whole the investment company industry reflects diligent management by competent persons."[5] The high standards of conduct of the industry since 1040 [sic] in the areas specifically in the statute are in sharp contrast to the derelictions in the handling of other people's money regrettably present in the investment company industry during the 1920's and 1930's. In addition, your committee is impressed by the value of the services that the investment company industry has provided and can provide in the future to the many investors who wish to put their savings in broadly diversified and professionally managed securities portfolios. This factor alone affects the investment company industry with a substantial public interest.

In reporting this bill, your committee recognizes the importance of permitting adequate compensation and incentives so that men of ability and integrity will continue to be attracted to the mutual fund industry. At the same time, this bill recognizes that investors should share equitably, as they do in other areas, in the economies available as a result of the growth and general acceptance of mutual funds.

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[2] 48 Stat. 898.

[3] Report of the Special Study of the Securities Markets. H. Doc. 95, 88th Cong., 1st Sess. 1963).

[4] Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth. H. Rept. 2337. 59th Cong., 2d Sess.

[5] Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, note 4 supra at p. 1.

Advisory Fees and Other Compensation

Mutual funds, with rare exception, are not operated by their own employees. Most funds are formed, sold, and managed by external organizations that are separately owned and operated. These separate organizations are usually called investment advisers. The advisers select the funds' investments and operate their businesses. For these services they receive management or advisory fees. These fees are usually calculated at a percentage of the funds net assets and fluctuate with the value of the funds' portfolio.

Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.

Mutual funds were originally organized by private investment counselors or by securities dealers to provide the advantage of professional investment guidance and diversification of investment risk to small investors at a modest cost. In 1940, when the mutual fund industry was in its infancy, the Congress passed the Investment Company Act. This act provided a comprehensive plan of regulation including provisions concerning management fees and other charges to the investor. Included in this act was a requirement that at least 40 percent of the funds directors be unaffiliated with the investment adviser and that a majority of the fund's directors be unaffiliated with the fund's principal underwriter. Since the adviser and underwriter are usually the same or related entities, a majority of the directors of most funds are unaffiliated with their managers.

These provisions did not provide any mechanism by which the fairness of management contracts could be tested in court. Under general rules of law, advisory contracts which are ratified by the shareholders, or in some States approved by a vote of the disinterested directors, may not be upset in the courts except upon a showing of "corporate waste." As one court put it, the fee must "Shock the conscience of the court." Such a rule may not be an improper one when the protections of arm's-length bargaining are present. But in the mutual fund industry where these marketplace forces are not likely to operate as effectively, your committee has decided that the standard of "corporate waste" is unduly restrictive and recommends that it be changed.

Last year, the Senate passed S. 3724 which contained a provision stating that management fees should be "reasonable." Jurisdiction was placed in the courts to determine what was a reasonable fee. The House, however, took no action on the bill.

This year, S. 34, containing the same provisions as S. 3724, was introduced. After hearings and further deliberation, your committee has decided that these is an adequate basis to delete the express statutory requirement of "reasonableness," and to substitute a different method of testing management compensation. This bill states that the mutual

fund investment adviser has a specific "fiduciary duty" in respect to management fee compensation. This is in accordance with the fact that while the mutual fund is a separate organization, it is generally created and, subject to the supervision of the board of directors, is managed by the investment adviser. It also is in accordance with the traditional function of the courts to enforce such fiduciary duties in similar type relationships.

Your committee believes that the investment adviser should be a fiduciary of the fund in such matters as the handling of the fund's assets and investments. Therefore, we have added a new section 36(b) to the Investment Company Act to specify that the adviser has a fiduciary duty with respect to compensation for services or other payments paid by the fund or its shareholders to the adviser or to affiliated persons of the adviser. Other persons enumerated in section 36(a) who may have a similar fiduciary duty with respect to compensation or payments received by them from the fund or its shareholders may also be sued for a breach of such duty. Subsection (b) also provides that payments by the fund to affiliated persons of the adviser are subject to challenge under this section.

Your committee recognizes the fact that the investment adviser is entitled to make a profit. Nothing in the bill is intended to imply otherwise or to suggest that a "cost-plus" type of contract would be required. It is not intended to introduce general concepts of rate regulation as applied to public utilities.

It is noted, however, that problems arise due to the economies of scale attributable to the dramatic growth of the mutual fund industry. In some instances these economies of scale have not been shared with investors. Recently there has been a desirable tendency of the part of some fund managers to reduce their effective charges as the fund grows in size. Accordingly, the best industry practice will provide a guide.

This section therefore should not be taken as reflecting any finding by the committee that the present industry level of management fees or that the fee of any particular adviser is too high. Its sole purpose is to specify the fiduciary duty of the investment adviser with respect to compensation, and provide a mechanism for court enforcement of this duty.

This section is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees. It does, however, authorize the court to determine whether the investment adviser has committed a breach of fiduciary duty in determining or receiving the fee. The directors of the mutual fund, like directors of any other corporation will continue to have a fiduciary duty to the fund with respect to their own compensation, and, of course, will continue to have overall fiduciary duties as directors for the supervision of all of the affairs of the fund.

Directors of the fund, including the independent directors, have an important role in the management fee area. A responsible determination regarding the management fee by the directors including a majority of disinterested directors is not to be ignored. While the ultimate responsibility for the decision in determining whether the fiduciary duty has been breached rests with the court, approval of the management fee by the directors and shareholder ratification is to be given such weight as the court deems appropriate in the circumstances of a particular case.

These provisions highlight the fact that the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary.

The bill also contains provisions which are designed to assist directors in discharging their responsibilities. Included is a proposal that the directors must request and evaluate, and that the investment adviser must furnish to them, such information as is reasonably necessary to evaluate the terms of the management contract. Thus, the attention of the directors will be fixed on their responsibilities.

Under this proposed legislation either the SEC or a shareholder may sue in court on a complaint that a mutual fund's management fees involve a breach of fiduciary duty.

This provision does not represent a finding by the committee as to the level of fees in the industry. Your committee does not believe itself qualified to make such judgments. Nor it is contemplated that the Commission will seek a general reduction of fees on an industry-wide basis.

Sales Loads

Special structural features calling for affirmative legislative action are also found in the area of mutual fund sales commissions.

The function of selling mutual fund shares is almost always contracted out by the fund to an organization called a principal underwriter. In most cases the principal underwriter is either the adviser itself or a close affiliate of the adviser's. Principal underwriters use two different distribution techniques. Some confine themselves to wholesaling and leave the actual retail selling to independent broker-dealers. Others have their own retail sales organizations called captive sales forces. In both instances, the principal underwriter regards the retail seller as the key figure in the distribution process. The principal underwriter's interest therefore, is to make the price of the shares it distributes as attractive as possible to dealers and salesmen. Since the underwriter is either the same person or organization as the investment adviser this underwriting function—which is the supplying to selling dealers of sales materials and the shares offered—may be performed at cost or even at a loss. The real financial return to the underwriter or the affiliated investment adviser in these instances is the management fee which increases automatically as the fund grows in size.

The basic sales commission charged for mutual fund shares is in most instances about 8½ percent of the total payment or 9.3 percent of the amount invested. This charge is protected by section 22(d) of the Investment Company Act which provides for a unique scheme of retail price maintenance. Under this section, all dealers, regardless of the source of the shares they sell, are prohibited by law from cutting the

sales charge fixed by the mutual fund underwriter. Price cutting in this field is a Federal crime.

In its deliberations your committee considered the possibility of deleting section 22(d) from the act. However, impressive testimony was given that there had not been sufficient study of the consequences of such an amendment. Therefore, you committee requests the Securities and Exchange Commission to review the consequences of such a proposal on both the investing public and mutual fund sales organizations and report to it as soon as is reasonably practicable.

Mutual fund sales charges are much higher than those which prevail elsewhere in the securities industry. The basic New York Stock Exchange commission is about 1 percent, although on small transactions it is slightly higher. Over-the-counter securities transactions, when executed on an agency basis, are the same as stock exchange commissions. When the dealer acts as principal the commission is usually between 2 and 3 percent and is limited by the rules of the National Association of Securities Dealers to not more than 5 percent on almost all transactions.

Partly because of section 22(d) and partly because of the way in which mutual fund shares are sold, competition has tended to operate in reverse in the sale of mutual fund shares—raising prices rather than lowering them. This has occurred because the shares of particular mutual funds are not sold on a "bid and asked" basis as are other securities offered and sole in the competitive over-the-counter market. In contrast, mutual funds compete for the favor of dealers and salesmen by offering higher sales compensation.

This committee believes there is a need to improve the protections afforded mutual fund investors in the sales commission area since existing regulatory controls provide only for the prohibition of unconscionable or grossly excessive sales loads. It has, therefore, decided to rely on the existing self-regulatory machinery of the securities industry in order to protect public investors against unreasonable sales charges subject to appropriate Securities and Exchange Commission oversight.

In the over-the-counter market the National Association of Securities Dealers, Inc. ("NASD") has over the years promulgated rules of fair practice which guard against excessive commissions and unreasonable underwriting compensation. Your committee considers it appropriate to apply the same approach to questions concerning mutual fund sales commissions. This bill would, therefore, amend section 22 of the Investment Company Act of 1940 to permit associations of securities dealers registered with the Commission under the Securities Exchange Act to adopt rules prohibiting excessive mutual fund sales charges. The NASD is the only such association now registered.

The NASD has expressed the willingness to accept this function with respect to mutual fund sales loads. It is also willing to subject itself to the same type of review and oversight by the Commission as is provided in section 15A(k)(2) of the Securities Exchange Act. Your committee is confident that NASD and the Commission, working together, will be able to arrive at a result which is fair and reasonable, both to the sellers of mutual fund shares and to the investing public.

Front End Loads ("Contractual Plans")

Many investors purchase mutual fund shares on a periodic or installment basis by investing small amounts of money at monthly or other periodic intervals. Purchasers of mutual fund shares through such programs, like other mutual fund purchasers pay sales charges or "loads," which usually are set at 9 percent of the moneys contracted to be invested.

In the case of installment purchasers of mutual fund shares the problem of commissions is further aggravated by the "front-end" method of collecting the sales load. The essential characteristic of the "front-end load" is the prepayment of sales charges. Although the basic sales commission is limited by law to 9 percent, selling firms are allowed to, and do, deduct up to one-half of the investors first-year's payments for sales commissions.

It is of course obvious that such an arrangement is usually detrimental to the investor, particularly if for any reason he discontinues his payments at an early date. Unless the stock market rises rapidly, he is almost certain to lose money.

Contractual plans are sold to investors in the lower economic strata who are not as sophisticated as those who purchase ordinary mutual fund shares. They are usually sold on a door-to-door basis with purchasers being solicited in their homes and offices. While the front-end load feature is fully disclosed, in the prospectus, a survey made several years ago indicates that a few months after the purchase many investors did not realize that they were paying such a load. In addition, if an investor is to avoid paying what is by any standard an excessive sales charge, he must be able to forecast his ability to continue his payments over a period of several years. Studies have shown that few small investors have been able to achieve this result. Consequently, over half of all contractual plan investors fail to complete their payments on schedule and thus usually pay excessive sales charges.

Your committee in its proposed legislation has attempted to provide salesmen with adequate economic incentive to solicit small installment purchasers while at the same time protecting these purchasers from overly harsh penalties in the event of their inability or unwillingness to make all of their payments on schedule.

Your committee also hopes that the provisions of this bill will provide a monetary incentive for salesmen to encourage increased investor persistence.

Two alternative methods for employing the front-end load are provided. The first alternative would spread the front-end load out over a 4-year period of time. No more than 20 percent of any one year's payments could be deducted for sales loads. The total deduction allowable during the first 4 years would be limited to 64 percent.

This alternative would change the provisions of present law under which salesmen and the selling organization receive a large percentage of their commissions during the first year of the contractual plan—a system which supplies little incentive for salesmen to exert themselves to reactivate plans that have become delinquent. The spread load by reducing the commissions allowed on payments made during the first year will also allow the purchaser to have more money actually invested in underlying securities and thus decreases the possibility of loss if he

redeems or becomes delinquent during the first years of the plan. Your committee notes that the largest distributor of mutual fund shares in the country has voluntarily chosen to operate on the basis provided for in this alternative and has done so successfully.

Under the second alternative, any contractual plan may include the presently authorized front-end load provided that if the investor elects for any reason to redeem his underlying shares for cash during the first 3 years, he is also entitled to receive a refund of the amount by which all sales charges paid exceed 15 percent of the total payments made under the plan. The Commission is authorized to make rules and regulations determining the form of refund notice required under this alternative and to set flexible net capital rules for reserves required by underwriters to meet their refund obligations. This refund entitlement should discourage sales to individuals who are likely to be unable to make the necessary payments and should have the effect of upgrading the sales force of companies which operate under its provisions.

The bill also deals with sales charges for face amount certificates. Face amount certificates are debt securities that provide for monthly or other periodic payments over a number of years as in the case of contractual plans. Under this system the company promises to pay to the investor a fixed sum of money upon the maturity of the certificate and certain lesser fixed sums if the certificate is surrendered prior to maturity. These lesser sums reflect the deduction from investors' payments of front-end load sales charges.

This bill amends the Investment Company Act to provide a 20 percent front-end load limitation on face-amount certificates. This change, for the most part, reflects existing industry practice. Over 95 percent of face-amount certificate sales are now being made within this proposed limitation.

Banks and Savings and Loan Associations and Insurance Companies

This bill deals with another major concern of your committee—the longstanding need to clarify the status of bank-administered collective investment funds under the Federal securities laws and the various banking statutes. Your committee unanimously agrees that this proposal will clarify the numerous statutes governing this area. It will also assure equal treatment to collective investments offered by insurance companies which are similar to bank-administered collective funds.

In recent years banks and insurance companies have become more and more aware of the growing public interest in equity investment. Banks have sought to engage in this field by offering their investment management services to a broader segment of the public than has traditionally been served by their trust departments. This has been accomplished by the pooling of the individually limited resources of large numbers of ordinary investors into collective investment funds. Insurance companies have engaged in similar equity-oriented investment activities by establishing separate accounts.

These recent development have raised difficult questions under existing Federal securities laws. The legality of certain bank collective investment activities has been challenged in court. One Federal dis-

trict court has held that section 21 of the Banking Act of 1933, commonly known as the Glass-Steagall Act, precludes banks from commingling managing agency accounts.[6] The uncertainty engendered by this decision which is currently being appealed, has impeded banks from competing with mutual funds on an equal footing. This bill would remove that unwarranted comparative disparity. Similar treatment is afforded to savings and loan associations offering similar type securities.

Legislation in this area was introduced during the 89th Congress. Hearings were held before this committee on various proposals, but final action was deferred since the problems involved appeared to have been resolved by administrative actions taken by the Comptroller of the Currency and the Securities and Exchange Commission.[7] Recently, however, the aforementioned district court held that the Glass-Steagall Act prohibits banks from selling interests in collective investment funds to the general public. This decision has once again revived the prior unfortunate confusion.

This circumstance, coupled with your committee's consideration of comprehensive amendments to the Investment Company Act, provided us with the opportunity to reconsider the status of collective investment funds administered by banks as well as that of comparable funds managed and distributed by insurance companies. The provisions of this bill encourage competition in the field of collective investment and provide for full consumer protection by subjecting those banks and savings and loan associations collective funds known as managing agency accounts which are functionally indistinguishable from mutual funds, to full regulation by the Commission under the Investment Company Act of 1940, as well as the Securities Act of 1933 and the Securities Exchange Act of 1934.

Sales personnel of banks and savings and loan associations offering these accounts would be required to meet standards with respect to training and experience similar to those promulgated by the Securities and Exchange Commission under the Securities Exchange Act. Such regulations are to be administered by the Comptroller of the Currency and the Federal Home Loan Bank Board.

The bill exempts bank collective trust funds and insurance company separate accounts for corporate pension plans from all but the anti-fraud provisions of the Federal Securities Acts—an approach which the Commission is currently taking through administrative action. It also provides exemptions for bank collective funds and insurance company separate accounts—"Smathers-Koegh" or H.R. 10 plans—from the Investment Company Act but not from the disclosure provisions of the Securities Act of 1933 or the Securities Exchange Act of 1934.

The committee's action in placing jurisdiction over H.R. 10 plans with the Securities and Exchange Commission rather than in the bank with supervisory agencies as was done in S. 3724 and S. 34 was taken in light of the assurances given us in testimony by the chairman of the Securities and Exchange Commission during the 90th Congress that simplified forms and procedures for registration would be employed in this area. The committee was particularly concerned with burden-

[6] See *Investment Company Institute v. Camp* (U.S. DC., civil Action No. 1082-66, Sept. 27, 1967, per McGarrahy, J.).

[7] See *First National City Bank,* Investment Company Act Release No. 4538 (Mar. 9, 1966).

ing small banks with the high expense of compliance with the SEC registration requirements used for larger corporations.

The bill further provides that no provision of Federal law shall prevent a bank or savings and loan association from operating a collective fund for managing agency accounts in compliance with the Comptroller's and Federal Home Loan Bank Board's regulations and the Federal securities laws. I would also permit mutual savings banks and other banks to distribute securities issued by a registered investment company which are solely for distribution through such banks. Banks will only be permitted to engage in this activity if the securities are sold without a sales charge.

The entry of banks and savings and loan associations into the mutual fund field and the increased activity of insurance companies should provide the American investing public with a wide choice among different equity investment media. Your committee believes that the competition for investor favor, which this bill will create, is an important step toward insuring healthy and viable security markets and fair treatment to the investing public. The Board of Governors of the Federal Reserve Board, the Treasury Department, the Comptroller of the Currency and the Federal Home Loan Bank Board support the objectives of the bill. As the Federal Reserve Board stated last year respecting similar provisions contained in H.R. 14742:

> The Board of Governors concludes that the probable benefits to the public from increased competition are substantial and that the risks are relatively less significant. The Board, therefore, favors the objective of H.R. 14742 * * *

Other Recommendations

This bill also contains more than 40 other proposed amendments to the Investment Company Act and the Investment Advisers Act of 1940. Many of these amendments are purely technical in nature, deleting superfluous language and updating statutory cross-references. Other amendments have substantive significance. They include amendments designed to improve the Commission's administrative disciplinary authority over persons affiliated with investment companies, to empower the Commission to seek court injunctions against breaches of fiduciary duty involving personal misconduct in connection with the transfer of investment company management organizations, to empower the Commission to adopt rules and regulations with respect to insider trading in investment company portfolio investment securities and to prohibit the distribution of capital gains by investment companies more often than once a year. Two additional significant amendments were adopted by your committee. They are as follows:

1. Section 3(b)(5)

Section 3(c)(11) of the Investment Company Act presently exempts from registration an investment company whose portfolio consists of interests in oil and gas leases. The Securities and Exchange Commission in 1967 recommended that this exemption be modified and your committee adopted that recommendation in S. 3724. However, the bill was amended on the Senate floor and this provision was removed. This matter has again been reviewed by your committee and we

recommend modification of this exemption so that it would not apply to companies which issue periodic payment plan certificates or other securities redeemable at the option of the holder.

Companies issuing redeemable interests in oil and gas leases are no different than other investment companies issuing redeemable interests in investment contracts or securities. This exemption from the Investment Company Act was originally insignificant. The risk inherent in such investments made them attractive only to wealthy investors whose income would allow a tax write-off should the venture prove unproductive. Recently, however, there has been an upsurge of interest in these companies. Sales forces in this field have increased along with sales to small unsophisticated investors. Since these are the people the securities laws were enacted to protect, your committee believes that the maximum protections under these statutes should be made available and that these oil and gas lease companies should be required to register under the Investment Company Act.

2. Section 5(e)

Section 5(e) of this bill would expressly permit directors of banks belonging to the Federal Reserve System to become directors of no-load funds. Other provisions of this bill permit these banks to enter the mutual fund business on a no-load basis. Bank directors are also permitted to serve on the boards of their own bank sponsored funds. Therefore, it would also seem appropriate to allow bank directors to serve on the boards of no-loan funds which are not affiliated with banks.

Explanation and Analysis of the Bill

PART A: COSTS OF MUTUAL FUND INVESTMENT

Section 20. Adding New Section 36(b) to the Act—Breach of Fiduciary Duty Involving Management Compensation and Other Payments

In the area of management fees, your committee has added a new section 36(b) to the Investment Company Act which imposes on the mutual fund adviser a fiduciary duty with respect to compensation or payments paid by the investment company, or by its security holders, to the investment adviser or to an affiliated person of such adviser. It provides a judicial remedy for breach of such fiduciary duty. It also authorizes suit against certain other persons who have a fiduciary duty with respect to payments made to them by the investment company.

In the event that court action is brought to enforce this fiduciary duty of the investment adviser as to compensation or payments received by him, it is intended that the court look at all the facts in connection with the determination and receipt of such compensation, including all services rendered to the fund or its shareholders and all compensation and payments received, in order to reach a decision as to whether the adviser has properly acted as a fiduciary in relation to such compensation. In the case of fund complexes, this could, under certain circumstances, include consideration of services rendered by such investment advisers to other funds in such complex and compensation or payments made by such other funds for such services.

The directors of a fund have the initial responsibility of approving management contracts. Section 36(b)(2) therefore instructs the courts to consider the approval given by the directors of the fund to such compensation and provides that their approval shall be given such consideration as the court deems appropriate under all the circumstances. Among other things, the court might wish to evaluate whether the deliberations of the directors were a matter of substance or a mere formality. (However, such consideration would not be controlling in determining whether or not the fee encompassed a breach of fiduciary duty.) To assist the directors in discharging their duties, section 8(c) of the bill requires the investment adviser to furnish to the directors information reasonably necessary to evaluate the management contract and confirms the duty of the directors to evaluate such information in accordance with the best interests of the fund and its shareholders.

the approval by shareholders of the management fee is also to be given such consideration as the court may deem appropriate under all the circumstances.

Thus, upon a challenge in court to compensation or payments, the [illegible], even if the compensation or payments are approved by the directors and stockholders, will not be whether it involves a

"waste" of corporate assets but will be whether the investment adviser has fulfilled his fiduciary duty to the mutual fund shareholders in determining the fee.

Section 36(b) authorizes the Commission and also a shareholder acting on behalf of the fund to institute an equitable action involving a claim of breach of fiduciary duty. The section makes it explicit that the Commission or any other plaintiff has the burden of proving to the satisfaction of the court that the defendant has committed a breach of fiduciary duty.

An action for breach of fiduciary duty may be brought not only against the investment adviser but also against any officer, director, member of any advisory committee, depositor, or principal underwriter of the investment company who, under the circumstances, may also have a fiduciary duty in respect to the payments received. The fiduciary duty of the investment adviser is extended not only to compensation paid to the investment adviser but also to payments made by the investment company or its shareholders to an affiliated person of the investment adviser. This provision affords a remedy if the investment adviser should try to evade liability by arranging for payments to be made not to the adviser itself but to an affiliated person of the adviser.

Section 36(b) authorizes an action only against the recipient of the compensation or payments. Damages may be recovered only from a recipient of the payments and are not recoverable for any period prior to 1 years before the action was instituted. An award of damages against any recipient is limited to actual damages resulting from the breach of fiduciary duty and may not exceed the amount of the payments received by such recipient from the investment company or its security holders. Action under this section may be brought only in an appropriate Federal court.

Although section 36(b) provides for an equitable action for breach of fiduciary duty as does section 36(a0, the fact that subsection (b) specifically provides for a private right of action should not be read by implication to affect subsection (a). Similarly, the fact that subsection (b) specifically places the burden of proof on the plaintiff does not mean that the normal rules of evidence which ordinarily place the burden of proof on a plaintiff would not apply to subsection (a).

Certain questions were raised during your committee's hearings concerning disclosure requirements in registration statements and proxy statements of potential actions brought under subsection 36(b). The committee, therefore, as part of its analysis of this section now includes the policy statement of the Commission, dated May 14, 1969, stating the Commission's views as to appropriate disclosure.

Statement of Procedures in the Administration of Section 36(b) of the Investment Company Act of 1940

During the course of legislative hearings on the Investment Company Amendments Act, various persons expressed concern that if the Commission is granted authority to bring judicial actions with respect to management fees, the Commission or its staff would be able to exert undue "coercion" to change the level of fees paid by particular

investment companies for management services without litigation. There is no cause for any such concern. Nevertheless, it may be appropriate to make this statement.

The expressed concerns generally focused on the fact that in addition to being a potential litigant under the new section and thus being in an adversary posture, the Commission also has administrative authority and responsibilities in connection with various disclosures made by investment companies in documents which are required to be filed or transmitted to shareholders under the Federal securities laws.

There is also concern that the nature of the disclosure of the litigation after it is commenced may, by including the allegation of a breach of fiduciary duty, given an inappropriate connotation to the public and the stockholders of the fund which would not be justified in the context of the purposes of section 36(b). The following should allay any such concerns.

(1) The staff does not make and has never made the decision as to whether or not any court action against anyone should be instituted—this decision is made solely by the Commission. This same procedure would, of course, be followed with respect to section 36(b).

(2) Until the commencement of litigation it would not in the Commission's view, be appropriate to suggest to a registered investment company that it advise investors that the Commission staff believes that an action should be brought or that the Commission may bring one.

(3) In view of these principles, prior to the commencement of litigation, it would not be appropriate for any members of the staff engaged in processing or reviewing such documents to suggest that such documents disclose that the staff or the Commission may believe that an action under 36(b) may or should be brought.

(4) In any case where litigation has actually been commenced under section 36(b), the Commission believes that appropriate disclosures should be made which would describe the parties to the action, the fact that a proceeding has been instituted pursuant to section 36(b), that the particular compensation or payments in question are considered by the Commission or other plaintiff as being too high, and that any recovery of damages would revert to the fund. It would not appear necessary in the overall context of litigation under section 36(b) to recite the allegation, until judicially determined, that the recipient of the compensation has engaged in a "breach of fiduciary duty" in receiving the compensation.

SECURITIES AND EXCHANGE COMMISSION.

Section 12, Amending Section 22—Sales Charges

Your committee believes that sales loads should be regulated through the existing industry-government framework of self regulation. Therefore, this proposed section provides that a registered securities association may by rule prohibit its members from offering redeemable securities at a price which includes an "excessive" sales load and that the Commission may by its rules alter or supplement the rules of such association in the manner provided for by section 15A(k)(2) of the Securities Exchange Act. An underwriter of these type securities who

is not a member of an association may elect to be governed either by the rules or an association or by rules prescribed by the Commission with respect to excessive sales loads.

To assure that fair consideration is given to the interests of both sellers and investors, your committee has directed that the association and the Commission, in formulating rules as to excessive sales loads, “shall allow for reasonable compensation for sales personnel, broker-dealers, and underwriters, and for reasonable sales loads to investors.” This does not mean that such rules must preserve the current level of profitability of every salesman, broker-dealer, or underwriter in the business, irrespective of efficiency. It does mean, however, that consideration must be given to the nature and quantity of services necessary to effect the proper distribution of fund shares to the public.

The provision for “reasonable loads to investors” is intended to assure that the sales loads fixed by the principal underwriters (which continue to be protected against price competition by section 22(d0 of the act) will be established at levels which recognize the interests of investors. These provisions also contemplate that, if warranted, the rules might include provisions for higher sales loads in situations where relatively more selling effort is required. They will also permit flexible treatment of the problem of sales loads on automatic investment of dividends, which involve little or no new selling effort.

It is contemplated that the adoption of rules defining and prohibiting excessive sales loads will be based on a prompt study by the National Association of Securities Dealers, Inc., of all relevant factors. For this reason, the authority of the Commission to alter or supplement the rules of a securities association commences 18 months after the effective date of the act.

The provisions of this proposed section shall prevail over any conflicting provisions of Federal law. This provision, which is identical to section 15A(n) of the Securities Exchange Act, is designed to make it clear that no other provision of Federal law, including the antitrust laws, prevents a registered securities association from adopting rules consistent with, and necessary to effectuate, the purposes and provisions of this section.

Section 16, Amending Section 27—Periodic Payment Plans

In the area of periodic payment plan, generally referred to as “contractual plans,” the committee has not recommended elimination of the “front-end load” feature, as originally urged by the Commission. Instead, your committee recommends two alternative plans, one of which would limit the amount that could be deducted for sales charges during the first 3 years of the plan to 20 percent, and one witch would permit deductions as allowed under present law but would require a refund of part of the sales charge if the investor elects to redeem his shares at any time during the first 3 years of the plan.

Under the current provisions of section 27(a), the total sales load on a contractual plan may not exceed 9 percent of the total payments to be made under the plan, but can include up to 50 percent of the investors total payments made during the first year. This means, for example, that under a 10-year, $12,000 plan involving a total sales load of $1,080, more than half of the total sales load, or $600, can be deducted from the $1,200 paid by the investor during the first year.

This arrangement imposes a disproportionate burden on an investor who is unable or unwilling to continue making payments over the full life of the plan.

The first alternative would alleviate this problem by providing that not more than 20 percent of any one year's payments may be deducted for sales load, and the entire deduction during the first 4 years may not exceed 64 percent. This change would permit the seller of a plan to continue to collect approximately the same amount of sales load over the first 3 or 4 years (at the seller's election) as he does under the present law. However, the load would be spread out more evenly over that period. For example, instead of the present situation in which typical deductions might be 50 percent in the first year and 4.3 percent in each of the next 3 years (averaging 15.9 percent), a seller would be permitted to deduct 16 percent over the entire 4-year period or 20 percent in each of the first 3 years and 4 percent in the fourth year (in each case averaging 16 percent).

Under this alternative it would not be necessary that the same sales load be imposed during each of the first 4 years of the plan, but the sales load deductions from all of the monthly payments within any one of those years would have to be uniform, as would the sales load on all payments after the 48th monthly payment. This provision, which corresponds to a provision found in the present law, is designed to discourage unduly complicated sales load schedules which investors might have difficulty in understanding.

This proposed section does not change the provision of present law which limits the sales load on the entire plan to 9 percent of the total payments to be made.

The problem inherent in the front-end load are presented in aggravated form when the investor is induced to make a number of monthly payments in advance. For example, if an investor in a $50-a-month plan is induced to make a lump-sum payment of $600 is equivalent to his entire first year's payments—at the inception of the plan, he may pay a sales load of $300. Even under the changes proposed in this bill, he could still be required to pay a sales load of $120, which is more than twice the generally prevailing sales load for direct purchases of mutual fund shares. Your committee believes that this practice is totally inconsistent with the industry's justification of the front-end load—that it is necessary to provide adequate compensation for the sale of mutual fund shares to people who are only able to invest small amounts of money at a given time.

Accordingly, this section would provide that the sales load on the excess paid by an investor in any month over the minimum monthly payment called for by the plan may not exceed the sales load applicable to payments subsequent to the first 48 monthly payments under the plan. For example, if an investor bought a 10-year $50-a-month plan with a sales load of 16 percent on the first 48 monthly payments and 4 percent on subsequent payments, and made an initial payment of $600, the sales load would be $30, obtained by adding $8, or 16 percent of the first $50, to $22, or 4 percent of the remaining $550. Of course, plan sellers are not required to accept prepayments.

This provision is not intended to apply to normal and minor variations, such as payment on a quarterly, rather than monthly basis, or the payment of arrears by an investor who is delinquent in his scheduled payments.

The committee understands that there are unusual situations in which it may be to the advantage of the investor to make a lump-sum payment under a plan rather than to invest the same amount directly in the underlying shares. We do not intend to discourage plan sellers from soliciting or accepting prepayments under these circumstances, an we expect the Commission, under its power to grant exemptions by rule, regulation, or order, to deal with this problem.

As an alternative to the "spread load" provision described above, the bill provides that a contractual plan may retain the presently authorized front-end load provided that if an investor elects for any reason whatsoever to redeem his underlying shares for cash during the first 3 years, he is entitled to receive a refund of the amount by which all sales charges paid by him exceed 15 percent of the total payments made under his plan. Under this alternative, contractual plan sponsors are required to give plan holders notification of their refund privileges and provide that plan holders may receive a full refund of the sales charge if they choose to cancel at any time within 60 days after the mailing of the original notice.

The bill provides rulemaking power for the Commission to assure that the contractual plan sponsor has adequate reserves with reasonable flexibility under the net capital rule to meet the contingent liability which may occur under the refund provision. The Commission has further rulemaking authority to require adequate and meaningful notice to investors regarding their rights under the refund provision.

Section 16(b) of this bill would repeal subsection (b) of section 27 of the Investment Company Act. That subsection authorizes the Commission to "relax" the requirements of section 27(a) for "smaller companies—subjected to higher operating costs." Applications for relief under this subsection have been extremely rare, and the Commission has never granted any of them. Many years have elapsed since the last such application was made. Since there is no evidence that the operating costs of the smaller contractual plan sponsors are any higher than those of their larger competitors, it is hard to see how the Commission could ever properly grant a 27(b) application for permission to charge higher loads. If in an unusual case such an application were to be supported by a substantial showing of merit, your committee directs the Commission to grant such application by exercising its general exceptive authority under section 6(c) of the act, Section 27(b) is therefore surplusage and it is recommended that it be deleted.

Section 17, Amending Section 28 of the Act—Face-Amount Certificates

Unlike contractual plans, the face-amount certificate plans dealt with in section 28 of the act are debt securities. However, the loading arrangement in the face-amount certificate plan is analogous to that of the contractual plan.

the issuer of a face-amount certificate promises to pay its holder a fixed sum of money upon the maturity of the certificate, and certain lesser fixed sums if the certificate is surrendered prior to maturity. Section 28 of the ct requires a face-amount certificate company to

establish certain minimum reserves and to pay into those reserves stipulated percentages of the certificate holders' gross payment or payments. The difference between the investor's payment or payments and the portion of those payments that must be put into the reserve is available to the company (the issuer) to meet its expenses, including sales expenses and administrative costs.

Section 28(a)(2)(A) now limits that difference by providing that payments into the reserve for the first certificate year shall amount to at least [illegible] percent of the purchaser's required gross annual payment. It also provides for reserve payments in the second to fifth certificate years, inclusive, of at least 93 percent of the gross annual payment and for reserve payments of at least 96 percent of each subsequent year's gross annual payment. The aggregate reserve payments must amount of at least 93 percent of the aggregate payments to be made under the certificate.

Section 17 of the bill would add a new subsection (i) to section 28 under which:

(1) The existing provisions of section 28 will continue to apply in all respects to all face amount certificates issued prior to the subsection's effective date as well as to new certificates issued pursuant to the terms of such outstanding certificates.

(2) With respect to certificates issued after the effective date of the subsection—

> *(a)* The reserve payment or payments for the first 3 certificate years must amount to at least 80 percent of the required gross annual payment for those years, instead of the present 50 percent in the first year, with 93 percent in the second to the fifth years, inclusive.
>
> *(b)* The reserve payment or payments for the fourth certificate year must amount to at least 90 percent of the gross annual payment required in the fourth year.
>
> *(c)* The reserve payment or payments for the fifth certificate year must amount to at least 93 percent of the gross annual payment required in this year.
>
> *(d)* Reserve payments for years subsequent to the fifth certificate year must amount to at least 96 percent of the required gross annual payments.

Section 6, Amending Section 11(b)(2)—Deletion of Sales Charge in Exchange of Series Shares

Section 6 would delete from the Investment Company Act 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. Section 11(a) of the act specifically prevents the imposition of sales charges when shareholders are induced to exchange their certificates for new certificates in the same or another investment company. This proposed amendment would merely subject series companies to the same treatment as other open end investment companies with respect to offers of exchange. This amendment is not intended to prohibit the imposition of reasonable transaction charges which approximate the administrative expenses incurred in connection with such transactions.

PART B: BANKS AND SAVINGS AND LOAN ASSOCIATIONS AND INSURANCE COMPANIES

Section 2(4), Adding New Subsection 2(a)(37)—Definition of Separate Account

Section 2(4) of the bill would add to the Investment Company Act a new subsection 2(a)(37) which defines the term "separate account" established and maintained by an insurance company. The purpose of adding this new subsection is to provide a definitional base for the exclusion from the act of certain separate accounts provided for in section 3(b)(6) of the bill.

The definition in the new subsection is based on the definition in Commission rule 3c-3 promulgated under the act which, in turn, is based on the definitions in separate account legislation of certain States, including New York. The definition expressly includes separate accounts established and maintained pursuant to the laws of Canada or any Province thereof, but includes such separate accounts of Canadian insurance companies only if such companies are subject to supervision by State insurance officials as provided in section 2(a)(17) of the act.

Section 2(5), Adding New Subsection 2(a)(45)—Definition of Savings and Loan Association

Section 2(5) of the bill would add to the Investment Company Act a new subsection 2(a)(45) which defines the term "Savings and Loan Association." The purpose of this new subsection is to provide a definitional base for including managing agency accounts sold on a no-load basis by savings and loan associations under section 12(d) of the bill.

Section 3(b)(6), Amending Redesignated Section 3(c)(11)—Exclusions for Certain Bank Collective Trust Funds and Insurance Company Separate Accounts

Section 3(b)(6) of the bill would expand a present exclusion from the definition of "investment company" in section 3(c)(13), redesignated section 3(c)(11), of the Investment Company Act to cover certain bank collective trust funds and certain insurance company separate accounts funding pension or profit-sharing plans which meet the requirements of section 401(a) of the Internal Revenue Code. As a purely technical matter the amendment would also delete the reference to section 165 of the code and substitute a reference to section 401(a) of the code which replaced it.

The amendment in section 3(b)(6) of the bill would codify the Commission's current basic position that bank collective trust funds, which consist solely of assets of employees' plans and which meet the conditions of section 401(a) of the code, are entitled to the exclusion which the act presently provides for "[a]ny employees' stock bonus, pension, or profit-sharing trust which meets the conditions of section 165 [now, 401(a)] of the Internal Revenue Code, as amended."

The amendment would exclude only those bank collective trust funds which are maintained solely for the funding of employees' stock bonus, pension or profit-sharing plans including so-called H.R. 10 plans, and which are not used as a vehicle for direct investment by individual members of the public. For example, the amendment

would not exclude a bank collective fund maintained for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as managing agent.

The amendment in section 3(b)(6) of the bill would also exclude from the definition of “investment company” under the act certain insurance company separate accounts, as defined in section 2(4) of the bill. The purpose of this amendment is to give life insurance companies the same treatment with respect to employees’ pensions and profit-sharing plans, which meet the requirements of section 401(a) of the code as is provided for banks. Despite certain differences both in the regulatory pattern now applicable to banks and insurance companies, and, in some instances, the manner in which these interests are offered and sold, your committee recognizes the fact that bank collective trust funds and insurance company separate accounts are very similar to each other and serve essentially the same purpose. Accordingly, the amendment is intended to grant banks and insurance companies equal treatment under the Federal securities laws to the extent that they compete with each other to serve as funding media for employes’ [sic] pension or profit-sharing plans.

Section 5(d) Amending Section 10(d)—Certain Exemptions for Bank Collective Funds for Managing Agency Acts

Section 5(d) of the bill would amend section 10(d) of the Investment Company Act to exempt bank collective funds for managing agency accounts from the provisions of sections 10(a), 19(b)(2), 10(b)(3), and 19(c) of the act and would permit a collective fund for managing agency accounts, maintained by a bank, to have only one director who is not an interested person of the bank. It merely extends to such collective funds, which would be required by section 12(d) of the bill to operate on a no-load basis, the same treatment accorded by section 10(d) of the act to no-load funds managed by investment advisers who are principally engaged in the investment supervisory business. The amendment would also exempt such funds from section 10(a) of the act, which requires that 40 percent of those persons performing the functions of directors be persons who are not officers or directors of, or otherwise affiliated with, the bank managing the fund. This amendment would also exempt such funds from section 10(b)(3) of the act, which provides that at least a majority of the board of directors of an investment company shall be persons who are not affiliated with any investment banker.

This and other sections of the bill codify in certain respects the position of, and the administrative practice followed by, the Commission in the *First National City Bank* case. Your committee recognizes the fact that an interest in a bank collective fund for managing agency accounts is a “security” within the meaning of the Federal securities laws and that both the disclosure and antifraud provision of the Securities Act and the broader regulatory pattern of the Investment Company Act apply to such funds. This section of the bill also codifies certain exemptions from section 10(b) and 10(c) of the Investment Company Act granted by the Commission in the *First National City Bank* case. Section 10(b) now requires that a majority of the directors of an investment company must consist of

persons who are unaffiliated with the company's principal underwriter and with any investment banker. Section 10(c) requires that a majority of the directors consist of persons who are not officers or employees of any one bank. The statutory exemption from these provisions proposed by the committee would be consistent with the Commission's decision in the *First National City Bank* case.

In one respect, this amendment to section 10(d) differs from the holding in the *First National City Bank* case. Under section 10(a) of the Investment Company Act, an investment company is require to have 40 percent of its board of directors consist of persons who are unaffiliated with the company's investment adviser. Under section 10(d), however, mutual funds which operate on a no-load basis and meet certain other conditions are permitted to have only one member of the board of directors who is unaffiliated with the investment adviser. The First National City Bank's collective fund for managing agency accounts did not qualify for this exemption, because the bank is not an investment adviser registered under the Investment Advisers Act. In addition, the bank was not primarily engaged in the business of investment counseling. Since it is expected that bank collective funds will be operated on a no-load basis, the committee believes they should be accorded the same treatment as section 10(d) provides for no-load funds. The amendment, therefore, permits a bank collective fund for managing agency accounts operated on a no-load basis to have a board of directors which includes only one director who is not an interest person of the bank.

Section 5(e), Adding Section 10(e) to Permit Directors of Member Banks of the Federal Reserve System to Become Directors of No-Load Funds

Section 5(e) of the bill would add a new section 10(e) to the Investment Company Act to permit directors of banks belonging to the Federal Reserve System to become directors of bank collective funds for bank managing agency accounts registered under the Investment Company Act and of other registered mutual funds whose securities are sold without a sales load.

Section 9(b), Amending Section 17(g)—Custody of Assets of Bank Collective Funds for Managing Agency Accounts

Section 9(b) of the bill would amend section 17(g) of the Investment Company Act to codify the position taken administratively by the Commission in the *First National City Bank* case. It permits an officer or employee of a bank collective fund for managing agency accounts to have access to assets of the fund held in the custody of the bank if such access if "solely through position as an officer or employee of a bank."

Section 12(d), Adding New Subsection 22(h)—Permitting Banks and Savings and Loan Associations To Engage in Certain Investment Company Activities

Section 12(d) of the bill would add a new subsection 22(h) to the act to make it clear that no provision of law prohibits a bank or savings and loan association from creating or operating a registered investment company which is a collective fund for the investment of managing agency accounts and for funding direct investments by individual members of the public. Such a fund, however, would be required

to issue its securities at no sales load and must comply with applicable regulations of the Comptroller of the Currency and the Federal Home Loan Bank Board.

These collective funds for managing agency accounts are essentially the same as mutual funds. Accordingly, this subsection recognizes that investors in such collective funds for managing agency accounts ought to receive the same protections under the Securities Act and the Investment Company Act as do mutual fund shareholders. This amendment provides that any such fund shall be a "registered investment company," and proposed section 5(d) and 9(a) of the bill amend the Investment Company Act with specific reference to requirements regarding such funds. Since the exemption from the registration requirements of the Securities Act in section 27(b) and the exemptions of this bill do not include securities issued by such funds, they are subject to all provisions of those acts.

This section would also allow banks and savings and loan companies to participate in the underwriting, distribution, and sale of securities issued by registered investment companies for sale through such banks if the securities are sold at a price which does not include a sales load.

Interests in all accounts under this section can only be sold by bank and savings and loan employees who meet standards with respect to training and experience as the Comptroller of the Currency and the Federal Home Loan Bank Board shall prescribe. These regulations shall be consistent with the rules and regulations promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934. At present, there may be some doubt as to whether banks and savings and loan companies may engage in such activities except as an accommodation to their customers. This section is also intended to remove any such doubt.

Section 27(a), Adding New Subsections 27(a)(13) and (14) to the Securities Act—Definitions of "Insurance Company" and Separate Account"

Section 27(a) of the bill would add to the Securities Act a new subsection 27(a)(13) of the act defining the term "insurance company" and a new subsection 27(a)(14) of the act defining the term "separate account" established and maintained by an insurance company. The definition of the term "insurance company" is substantially the same as the definition of the term in section 2(a)(17) of the Investment Company Act. The definition of the term "separate account" is substantially the same as the definition of the term in section 2(4) of this bill. (The description of section 2(4) of the bill discusses the definition of the term "separate account.") These new paragraphs are added to the Securities Act to provide a definitional base for the exemption from the act for interests or participations in certain separate accounts provided under proposed section 29(b) of the bill.

Section 28(a), Amending Section 3(a)(12) of the Securities Exchange Act—Exemptions for Certain Bank Common and Collective Funds and Insurance Company Separate Accounts

Section 28(a) of the bill would expand the definition of the term "exempted securities" in section 3(a)(12) of the Securities Exchange Act to include interests or participations in certain bank common trust funds, certain bank collective funds, and certain insurance com-

that they could be sold to self-employed persons, unsophisticated in the securities field. However, the amendment would grant the Commission authority, by rule, regulaiton [sic], or order, to exempt such interests or participations to the extent that the Commission shall determine this to be necessary or appropriate in the public interest.

Section 29, Amending the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940—Concerning Certain Life Insurance Benefits Issued Prior to March 23, 1959

Section 29 provides that the provisions of the Securities Act of 1933, Securities Exchange Act of 1934, and the Investment Company Act of 1940 shall not apply, except for definitional purposes, to any interest or participation in any contract, certificate or policy providing for life insurance benefits which included a separate account the proceeds of which were shared by all who completed the terms of the contract and which were issued prior to March 23, 1959, the date of the decision in *SEC V. Variable Annuity Life Insurance Company of America*, 359 U.S. 65. These exemptions apply if (1) the form of the contract, certificate, or policy was approved by the insurance commissioner, or similar official or agency, of a State, territory or the District of Columbia and (2) if under such contract, certificate, or policy not more than 49 percent of the gross premiums or other consideration paid were to be allocated to a separate account or other fund providing for the sharing of income or gains and losses.

PART C: PORTFOLIO TRANSACTIONS

Section 9(c), Adding New Section 17(j)—Insider Trading in Investment Company Portfolio Securities

Section 9(c) of the bill would add a new subsection (j) to amend section 17 of the act which would prohibit insider trading in securities held or to be acquired by a registered investment company, in convention of such rules and regulations as the Commission may adopt to define fraudulent, deceptive, and manipulative practices and to prescribe means reasonably necessary to prevent such practices. The section also would provide the Commission with specific authority to adopt rules with respect to minimum standards for codes of ethics governing trading by insiders of investment companies and with the authority to prevent such practices.

This proposal represents a response to the widely recognized need for the development of adequate restraint on the trading of investment company insiders in the companies' portfolio securities. This section would not be self-executing, but would require the adoption of rules or regulations by the Commission. Such rules or regulations could affect transactions involving securities of any issuer whose securities are owned by a registered investment company or of securities of any issuer which the investment company is contemplating purchasing, by any affiliated person of such registered investment company, any affiliated person of an investment adviser or such company, or any affiliated person of such underwriter.

The section would permit the Commission to make rules affecting transactions by such insiders involving any securities of an issuer whose securities are owned by the investment company, or which the investment company contemplates purchasing. Thus the Commission's

rules could apply to insider trading in the convertible securities, options, and warrants of issuers whose underlying securities are owned by an investment company with which the insider is affiliated.

The ability to deal with such transactions by rule is intended to permit the Commission to draw flexible guidelines to prohibit persons affiliated with investment companies, their advisers and principal underwriters, from engaging in securities transactions for their personal accounts when such transactions are likely to conflict with the investment programs of their companies.

Section 11, Adding New Section 19(b)—Distributions of Long-Term Capital Gains

Section 11 of the bill would amend section 19 of the Investment Company Act by adding a new subsection (b), which would prohibit registered investment companies from distributing realized long-term capital gains more frequently than once every 12 months except as the Commission may permit by rule, regulation, or order in the public interest and for the protection of investors.

At present the Investment Company Act does not limit the frequency with which investment companies may distribute their realized long-term capital gains. Section 19 of the present act, which would be designated section 19(a), prohibits investment companies from making any distribution in the nature of a dividend payment other than from certain defined sources unless such payment is accompanied by a written statement which adequately discloses the source or sources of such payment. It also empowers the Commission to prescribe the form of such statement by rules and regulations in the public interest and for the protection of investors.

This proposed amendment would incorporate into the act views expressed in the Investment Company Institute's "Guide to Business Standards." The guide states that no member should make a distribution of "realized capital gains to shareholders in a manner that would indicate that capital gains distributions are part of regular dividends from investment income" and recognizes that "distributions of capital gains other than at fiscal yearends, or soon thereafter, could have such an effect." This amendment would minimize any confusion on the part of investors which might arise from their failure to differentiate regular distributions of capital gains from distributions of investment income. It would not interfere with the ability of registered investment companies to comply with applicable provisions of the Internal Revenue Code. In addition, the Commission could be [sic] rule or regulation permit registered investment companies to take advantage of the "spillover" provisions of the Internal Revenue Code under which certain distributions made after the close of a taxpayer year are considered as made during such taxable year. Among other things, the Commission by rule could likewise permit such a company to change its regular pattern of annual distributions.

PART D: FUND HOLDING COMPANIES

Section 7, Amending Section 12(d)(1)—Preventing the Creation and Enlargement of Fund Holding Companies

Section 7 of the bill would amend section 12(d)(1) of the act to limit the creation and operation of new fundholding companies and the illegible] enlargement of existing companies of this type. These com-

panies are investment companies whose portfolios consist either entirely or largely of the securities of other investment companies.

Before 1940 there were several closed-end investment companies that invested in other closed-end companies. Section 12(d)(1) of the act sought to deal with the regulatory problems they posed by prohibiting (subject to certain exceptions) a registered investment company from purchasing more than 3 percent of the outstanding voting stock of another investment company unless it already owned 25 percent or more of such stock. This section, however, does not cope with the problems that have recently arisen in this area and that may become more acute in the future. Section 12(d)(1) applies only to purchases by registered investment companies. Hence, under existing law, a fundholding company organized under the laws of a foreign country and not subject to registration under the act can buy unlimited quantities of the securities of registered investment companies.

This gap in the statutory scheme has led to the creation of several unregistered, foreign-based fundholding companies that invest primarily in the securities of American mutual funds. The largest of these unregistered foreign-based companies, the Fund of Funds, Ltd., was organized in 1960 and has stated its June 30, 1966, assets at more than $420 million. Its rapid growth has engendered interest in the formation of domestic registered fundholding companies that would be subject to the percentage restrictions of section 12(d)(1), and two such companies have recently registered under the act.

The proposed amendment to section 12(d)(1) would meet these problems by permitting investment company securities to be purchased by other investment companies but only within specified limits and subject to the detailed restrictions spelled out in the section.

Under the proposed amendment to section 12(d)(1) of the act, subparagraph (A) would make it unlawful for a registered investment company and any company or companies controlled by such registered investment company to purchase or otherwise acquire securities issued by another investment company if, as a result of such transaction, the limitations contained in that subparagraph would be exceeded. It also places similar limitations on acquisitions of securities of registered investment companies by unregistered companies.

Subparagraph (B) would make it unlawful for a registered open end company, its principal underwriter or any broker-dealer registered under the Securities Exchange Act of 1934 to sell or otherwise dispose of a security issued by a registered investment company to any other investment company if, as a result of such transaction and to the knowledge of the seller, the limitations contained in that subparagraph would be exceeded.

Subparagraph (C) would make it unlawful for an investment company to purchase or otherwise acquire the securities of a registered closed en investment company if, as a result of such transaction, the limitations with respect to ownership of voting securities contained in that subparagraph would be exceeded. The stock of closed end companies is usually bought and sold in the secondary trading markets rather than through the issuance of new shares as in the case of open end companies. Because of this fact, it would be much more difficult for a buyer or a seller to know how much of a closed end company's stock was owned by investment companies generally. Therefore, in this case, it is appropriate to have the prohibition apply to the buyer

(rather than the seller as in the case of open end companies) and to apply the 10-percent test only to the holdings of the acquiring company, other investment companies with the same investment adviser, and companies controlled by such investment companies.

Subparagraph (D) would retain existing exceptions from the prohibitions against the transfer of investment company interests to other investment companies for securities received because of: *(a)* dividends; *(b)* exchange offers that have been approved by the Commission under section 11 of the act; and *(c)* plans of reorganization. None of these three items involve a new commitment by an investment company. The first item, the exception for dividends, covers only those which the issuer declares in terms of stock and not in terms of money. Dividends and capital gain distributions declared in terms of money, which the recipient may elect to apply to the purchase of additional shares, are not within this exception.

Subparagraph (E) would continue the present exception for acquisitions of interests in investment companies by unit trusts. This exception covers contractual plan companies which invest in a specific mutual fund. This subparagraph would also extend the exception to a security purchased by an investment company, the depositor of or principal underwriter for which is a broker-dealer registered under the Securities Exchange Act of 1934 or a controlled person of such a broker-dealer and investment portfolio of which consists only of that security. In the case of a purchase or acquisition by a nonregistered investment company, the recommended changes also would condition the availability of the exemption upon the existence of an agreement with the registered investment company or its principal underwriter governing *(a)* the voting of proxies and *(b)* the substitution of other securities for the underlying securities.

Subparagraph (F) would exempt from the provisions of paragraph (1) securities purchased or otherwise acquired by a registered investment company where immediately after the purchase or acquisition the registered investment company and all of its affiliated persons own not more than 3 percent of the total outstanding stock of the acquired company and neither the acquiring company nor its principal underwriter or other distributors charge a sales load of more than 1½ percent. In order to provide protection for open-end companies and their shareholders where such companies' securities are acquired within the limitations of subparagraph (F), the subparagraph also provides that no issuer of any security purchased or acquired by a registered investment company under the subparagraph shall be obligated to redeem such securities in an amount exceeding 1 percent of the issuer's total outstanding securities during any period of less than 30 days. In addition, the restrictions on voting rights prescribed by this section would be applicable to the acquiring company.

Subparagraph (G) specifies that for the purposes of paragraph (!) of the section, the value of an investment company's total assets shall be computed as of the time of purchase or acquisition or as close thereto as is reasonably possible. Under the act as presently written, the Commission has the authority to institute actions in the proper U.S. district courts to seek injunctions against violations of the act and to enforce compliance with its provisions. It is contemplated that in a proper case the court would direct divestiture of securities acquired in a transaction which violated the act. Subparagraph (H)

specifies that *(a)* the Commission may join as a party to an enforcement action under this section, the issuer of the security involved and *(b)* a court may issue such orders with respect to the issuer as may be necessary or appropriate for the enforcement of the statute. For example, if the court issues an order requiring divestiture, it might order, if appropriate, the issuer to withhold distribution of dividends and capital gains with respect to the securities acquired in the unlawful transaction pending compliance with the court's divestiture order. The amendment would not require any investment company to divest itself of any existing holding. Only in the case of an illegal acquisition resulting in new holdings or additions to preexisting holdings would the court have the power to direct divestiture. It will be able to do so under the proposed amendment in a flexible fashion that takes into account the varying circumstances of particular cases.

Section 7 of the bill would also make technical changes in section 12(d)(1) and 12(d)(2) of the act to take into account the changed format of that section.

PART E: STRENGTHENING INDEPENDENT CHECKS ON INVESTMENT COMPANY MANAGEMENT

Section 2(3) 5, 8(c) and 18, Amending Sections 2(a), 10, 15 and 32(a)—Adding the Term "Interested Person"

Section 2(3) of the bill would add a new section 2(a)(19) to the Investment Company Act defining the term "interested person" to include persons who have close family or substantial financial or professional relationships with investment companies, their investment advisers, principal underwriters, officers, and employees.

Section 10 of the act now provides that at least 40 percent of a registered investment company's directors must be persons who are neither officers nor employees of the company and who neither serve as, nor are "affiliated" with, its investment adviser. It 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 function of these provisions with respect to unaffiliated directors is to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.

Your committee believes that the definition of an "affiliated person" in section 2(a)(3) of the act does not adequately meet this purpose. Under this definition a director who has strong ties with the company's managers may be classified as "unaffiliated." For example, a director is presently deemed "unaffiliated" even though he owns up to 4.99 percent of the adviser-underwriter's stock, has substantial business or professional relationships with the investment company or its adviser-underwriter, or is closely related by blood or marriage to the company's managers.

Proposed section 2(3) of this bill seeks to remedy the act's deficiencies in this regard by adding a new section 2(a)(19) to the at which would define the term "interested person." Other sections of the bill would substitute that new term for the present term "affiliated person" in the following sections of the act: (1) section 10, relating to

the composition of boards of directors (amended by sec. 5 of the bill); (2) section 15, relating to the approval of advisory and underwriting contracts (amended by sec. 8(c) of the bill); and (3) section 32(a), relating to the selection of independent public accountants (amended by sec. 18 of the bill). The new "interested person" concept will not widen the scope of sections 10(f) and 17 of the act, which prohibits transactions between investment companies, on the one hand, and the companies' affiliated persons as well as the affiliated person of such affiliated persons on the other hand, absent prior Commission approval. These sections remain unchanged.

Under the bill the new term "interested person" would include affiliated persons of an investment company, its investment adviser and principal underwriter, as well as members of the immediate family of such affiliated persons and persons who have beneficial interests or legal interests as fiduciaries in securities issued by the investment adviser, principal underwriter and their controlling persons. The term would also include any broker-dealer registered under the Securities Exchange Act of 1934, and affiliated persons of any such broker-dealer. In addition, the definition would classify as an interested person legal counsel for an investment company, its investment adviser and principal underwriter and partners and employees of such legal counsel.

Interested person would also include persons who have any material business or professional relationships with an investment company, or another investment company having the same investment adviser or principal underwriter, controlling persons of the investment adviser or principal underwriter, or the principal executive officer of such investment companies, and the principal executive officer of the investment adviser or principal underwriter of an investment company.

Under this proposed section, a person would be deemed an interested person because of a business or professional relationship only if the Commission, by order, determines that he has, at any time during the prior 2 fiscal years, had a material business or professional relationship with persons specified in the statute. Such order would not be retroactive. It would take effect 60 days after the entry thereof and would not affect the status of a person for the purpose of the act or for any other purpose for any period prior to the effective date of the order.

The Commission could issue an order under the proposed amendment determining that a director of an investment company is an interested person if it should find that a business or professional relationship was material in the sense that it might tend to impair the independence of such director. Ordinarily, a business or professional relationship would not be deemed to impair independence where the benefits flow from the director of an investment company to the other party to the relationship. In such instances the relationship is not likely to make the director beholden to that party. For example, a director ordinarily would not be considered to have a material business relationship with the investment adviser simply because he is a brokerage customer who is not accorded special treatment. A business relationship arising solely from the fact that the chief executive officer of an investment adviser to an investment company and a director of that investment company are directors of another company, whether that company is an investment company managed by the same invest-

ment adviser or a separate industrial corporation ordinarily would not be deemed material. Similarly, a director of one investment company would not ordinarily be deemed an interested person of that company by reason of being a director of another investment company with the same adviser. This case-by-case method of implementing the material business and professional relationship test would eliminate any danger of inadvertent violations of the requirements of the act and adequately implement your committee's basic intent in proposing this section.

Finally, the section provides that no person is to be deemed to be an interested person of an investment company solely by reason of his being a member of its board of directors, advisory board, an owner of its securities, or a member of the immediate family of such a person.

The committee believes that the Commission has adequate exemptive authority under section 6(c) of the act to administer these amendments in a flexible manner. For example, all broker-dealers and legal counsel for an investment company would be defined as inserted persons, but the Commission could exempt any such person upon an appropriate showing that he, in fact, is in a position to act independently on behalf of the investment company and its shareholders in dealing with the company's investment adviser or principal underwriter.

Situations may arise where persons involuntarily become interested persons. For example, a fund director may find that he is named the executor of an estate which holds stock in the investment adviser or is the beneficiary of a trust which unknown to the beneficiary holds or acquires such stock. Your committee expects the Commission to enact rules prior to the effective date of this amendment to deal with such situations.

PART F: ADMINISTRATIVE AND OTHER PROCEEDINGS

Under the provisions of the Federal securities laws (other than the Investment Company Act) the Commission has authority to use flexible procedures and a variety of remedies to protect investors. The amendments proposed in part F would provide the Commission with comparable flexible procedures and remedies in administering the Investment Company Act.

Section 4, Amending Section 9—Providing for Administrative Action Against Certain Persons Serving Investment Companies

Section 9(a) of the act now prohibits any person from serving in certain capacities with a registered investment company if he has been convicted of any of the crimes set forth in section 9(a)(1) or, as set forth in section 9(a)(2), has been permanently or temporarily enjoined by a court from acting in certain capacities.

Section 4(b) of the bill would add a new subsection (b) to section 9 of the act to 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 capacities enumerated in section 9 or as an employee of an investment company or as an affiliated person of its investment adviser, depositor, or principal underwriter. The Commission could take such action only if it found (1) that the individual in question had willfully

violated, or had willfully participated in violation of any provision of the Securities Act, the Securities Exchange Act, the Investment Company Act or the Investment Advisers Act or any rule or regulation under those statutes; and (2) that the action was in the public interest.

The proposed amendment would supplement the existing provisions of section 9. It would provide grounds and procedures for disqualification from affiliation with an investment company of persons willfully violating the Federal securities laws. To some extent, the present section 9 is the counterpart to the provisions of section 203(d) of the Investment Advisers Act and section 15(b) of the Securities Exchange Act which empowers the Commission to disqualify persons who have committed certain types of misconduct from serving as a registered investment adviser or broker-dealer or as an associated person of a broker-dealer, if such action is found to be in the public interest.

Under the proposed amendment if the Commission finds that an investment adviser or broker-dealer or an associated person thereof has violated the antifraud or other provisions of the Investment Advisers Act or the Exchange Act and has barred or suspended him from serving as an investment adviser or broker-dealer or from association with a broker-dealer, it can also prevent him from being associated with an investment company, its adviser or its principal underwriter.

Like the provisions of section 15(b) of the Securities Exchange Act and section 203(d) of the Investment Advisers Act, the proposed amendment would provide for an administrative proceeding to determine whether persons have engaged in willful misconduct and whether the public interest requires that such persons be barred from serving an investment company.

The proposed amendment will correct another deficiency of section 9 which bars a person convicted of certain crimes or enjoined on the basis of misconduct specified in that section from serving as an officer, director, or investment adviser of an investment company, but permits such a person to be an employee of an investment company.

Further, under the proposed amendment, in appropriate cases, the Commission could proceed against an individual affiliated with a company's investment adviser, principal underwriter, depositor, or sponsor without naming or joining the individual's employer as a party in such proceeding. Moreover, the Commission could, where appropriate, institute private proceedings which would not be made public unless and until the parties so request or adverse findings are made against the individual or company involved.

Your committee does not expect the Commission to exercise its authority to expand administrative proceedings instituted under the other Federal securities laws prior to the effective date of this amendment. However, the Commission would not be precluded from exercising this authority in administrative proceedings instituted after the effective date of the amendment based on violations which occurred before that date.

Section 20, Amending Section 36(a)—Enjoining Breach of Fiduciary Duty Involving Personal Misconduct

Section 36 of the act presently authorizes the Commission to bring an action in the U.S. district courts to enjoin persons from acting in

relation to an investment company if such a person has been guilty of gross misconduct or gross abuse of trust.

The highly punitive overtones of the existing section, together with the injunctive penalty, seriously impairs the ability of the courts to deal flexibly and adequately with wrongdoing by certain affiliated persons of investment companies. Therefore, proposed section 36(a) would authorize actions to enjoin breaches of fiduciary duty involving personal misconduct. It also empowers the courts to grant such relief as it finds necessary or appropriate. The amended section will enable the Commission to move against officers, directors, and advisory board members of an investment company and its investment advisers or principal underwriters if they engage or are about to engage in conduct which violates prevailing standards of fiduciary duty involving personal misconduct.

This section is intended to deal only with such violations committed by individuals. It is not intended to provide a basis for the Commission to undertake a general revision of the practices or structures of the investment company industry. On the other hand, your committee does not intend to limit the Commission under this section to situations where an actual intent to violate the law can be shown or to acts of affirmative misconduct. In appropriate cases, nonfeasance of duty or abdication of responsibility would constitute a breach of fiduciary duty involving personal misconduct.

Section 36(b) deals with breach of fiduciary duty involving management compensation and is explained under part A hereof.

PART G: COVERAGE

The Commission has reported to your committee that in its day-to-day administration and enforcement of the act it has encountered a number of recurring problems caused by certain exemptions provided for in the act and with a number of related provisions dealing with the applicability of the act in certain situations. The amendments proposed in this part are designed to deal with these problems.

Section 3(a), Amending Section 3(b)(2)—Requirement of Good Faith

Under section 3(b)(2) of the act any issuer, other than a registered investment company, may file an application for an order of the Commission declaring it to be exempt from regulation under the act in accordance with the standards of that section. The filing of such application provides an automatic 60-day exemption from all provisions of the act; during this 60-day period, an applicant may engage in activities prohibited under the act even though the Commission may ultimately deny the application.

Section 3(a) of the bill would amend section 3(b)(2) to specify that this automatic 60-day exemption is available only if the application is filed in "good faith."

While a requirement of "good faith" is implicit in the statute, the existing statutory language does not so provide. By making the requirement an explicit one, companies would be placed on notice that an automatic exemption cannot be obtained by the filing of a frivolous application not presenting a colorable claim to the exemption from regulation provided for by section 3(b)(2).

Section 3(b)(2) Amending Section 3(c)(8)—Deletion of Exclusion for Company 90 Percent of More of Whose Securities Are Those of Certain Single Issuers

Section 3(c)(8) excludes from the statutory definition of an investment company a company 90 percent or more of the value of whose investment securities are those of any single bank, insurance company, or other financial institutions of the types enumerated in sections 3(c)(5), (6), and (7) of the act. Section 3(b)(3) of the bill would delete this paragraph from the act.

The availability of the section 3(c)(8) exemption to companies which hold, solely as an investment, securities of certain types of financial institutions appears to be wholly inconsistent with the statutory policy of the coverage of the act and should be removed. Its deletion from the act will not affect existing exclusions for companies which control or manage the enterprises whose securities they hold.

Section 3(b)(3), Amending Section 3(c)(6)—Modification of Exclusion for Companies Engaged in Factoring, Discounting and Real Estate Businesses

Under the existing provisions of section 3(c)(6) companies engaged primarily in factoring, discounting and real estate are excluded from the definition of an investment company unless they are engaged in the business of issuing face-amount certificates of the installment type or periodic payment plan certificates. These limitations reflect widespread abuses prior to 1940 in sales of such securities on an installment basis, usually to relatively unsophisticated investors of modest means.

Section 3(b)(3) of the bill would amend section 3(c)(6) of the act to provide that, in addition to existing limitations, the exclusion from the definition of an investment company provided by that section would be unavailable to any such company issuing a security redeemable at the election of the holder.

Although the companies enumerated in section 3(c)(6) have portfolios of securities in the form of notes, commercial paper, or mortgages and other liens on and interests in real estate, they are excluded from the act's coverage because they do not come within the generally understood concept of a conventional investment company investing in stocks and bonds of corporate issuers. The proposed amendment would have the effect of extending the regulatory provisions of the act to certain of these companies which in recent years have attempted to capitalize on the popularity of open end companies by issuing redeemable securities.

A redeemable security is defined in section 2(a)(31) of the act as "any security other than short-term paper, under the terms of which the holder, upon its presentation * * * is entitled * * * to receive approximately his proportionate share of the issuer's current net assets or the cash equivalent thereof." Thus, the proposed amendment would in no way affect companies which issue securities redeemable at the option of the issuer—the conventional form of redeemable security commonly used in corporate financing. The amendment applies only to those companies which purport to model themselves after open end companies by issuing a security redeemable at the option of the holder.

Section 3(b)(4), Amending Section 3(c)(10)—Clarification of Exemption for Holding Company Registered Under Public Utility Holding Company Act of 1935

Section 3(c)(10) new [sic] excludes from the coverage of the act any company "with a registration statement in effect as a holding company under the Public Utility Holding Company Act of 1935." Section 3(b)(4) of the bill would amend section 3(c)(10) of the act to make the exclusion provided by that section available to companies "subject to regulation under the Public Utility Holding Company Act of 1935."

A holding company may register under the Holding Company Act and subsequently obtain an order exempting it from all or substantially all of the provisions of that act. It has been contended that such a company is still "registered" under the act even though it is no longer regulated thereunder. The proposed amendment would make it clear that a company which is in fact unregulated under the Holding Company Act is not excluded from the coverage of the Investment Company Act.

Section 3(b)(5), Amending Section 3(c)(11)—Modification of Exclusion for Companies Holding Oil, Gas, or Other Mineral Royalties

Section 3(c)(11) of the act excludes from the definition of investment company any company substantially all of whose business is holding oil, gas, or other mineral royalties or leases. Section 3(b)(5) of the bill would amend section 3(c)(11) to delete the exclusion for companies described in that section when they issue redeemable securities, periodic payment plan certificates, or face-amount certificates of the installment type. The proposed amendment is similar in purpose to the proposed amendment to section 3(c)(6).

Section 10, Amending Section 18(f)(2)—Modification of Definition of Senior Security

Section 18(f) of the act makes it unlawful for any registered open end investment company to issue or sell any senior security. The term "senior security" does not, under section 18(f)(2), include shares of a particular "series" the holders of which are preferred over the holders of all other series in respect of assets specifically allocated to that series.

A number of "series companies" existed at the time the act was passed, and new "series companies" have subsequently been created. Each of these companies is a single registered investment company. Thus, at present, matters affecting the interests of holders of share of a particular series are voted on by the holders of shares of all existing series and such vote may be controlled by the holders of an unaffected series. In effect, the shareholders of different series, whose interests may be inconsistent, are lumped together.

Section 10 of the bill would amend section 18(f)(2) to give the Commission specific power by rule, regulation, or order to require that any matter affecting shareholders of any series of shares issued by such companies, including the election of directors, be voted upon separately by such series.

Although it is contemplated that any such rule may provide that approval of stockholders holding a certain percentage of stock is necessary for the election of directors, it is not intended that the authority

granted by this amendment would be used to require that a company set up groups of individuals for each series with functions similar to those of the company's overall board of directors. Similarly, it is not intended that any rule would relieve the company of any requirements with respect to voting that may be applicable under State law. A majority of the outstanding voting securities of a class or series would be computed in the manner set forth in section 2(a)(40) of the act.

PART H: MANAGEMENT-SHAREHOLDER RELATIONSHIPS

The suggested amendment under this part deal with a variety of minor inconsistencies, ambiguities, and anomalies in provisions which relate generally to the area of management-shareholder relationships.

Sections 8(c) and 18, Amending Section 15(c) and 32(a)—Attendance at Directors' Meetings

Sections 15(a), 15(b), 15(c), and 32(a) of the act provide for: (a) renewal of advisory contracts; (b) approval and renewal of underwriting contracts; and (c) the selection of independent auditors by the board of directors of an investment company, including a majority of the unaffiliated directors. These sections do not require the attendance in person of the members of the board of directors at meetings where required action is taken, even though their vote is necessary to meet the statutory requirements.

Sections 8(c) and 18 of the bill would amend sections 15(c) and 32(a) of the act to provide that the voting requirements of sections 15 and 32 can be satisfied only by directors who are personally present at a meeting at which their votes are taken. The proposed amendment is intended to assure informed voting on matters which require action by the board of directors of registered investment companies.

Sections 8(a) and 9(b), Amending Sections 15(a)(4) and 15(b)(2)—Assignment of Advisory and Underwriting Contracts

Section 15(a)(4) of the act requires that an investment advisory contract provide for automatic termination upon its "assignment by the investment adviser." Similarly, section 15(b)(2) requires that underwriting contracts provide for automatic termination upon their "assignment by such underwriter."

Section 8(a) of the bill would amend section 15(a)(4) of the act to delete the words "by the investment adviser" and section 8(b) of the bill would amend section 15(b)(2) to delete the words "by such underwriter."

Section 2(a)(4) defines the term "assignment, " among other things, as occurring when some action is taken by persons other than the investment adviser or underwriter. Thus, under the definition, assignment includes any direct or indirect transfer of a controlling block of outstanding voting securities by a security holder of the adviser or underwriter. Section 15, however, introduces an ambiguity into the act because it refers only to an "assignment" by the adviser or underwriter itself and not by a person holding a controlling block of stock of the adviser or underwriter. The proposed amendment will remove this possible ambiguity without making a substantive change in the existing law.

Section 9(a), Amending Section 17(f)—Cash Assets Included Under Bank Custody

Under section 17(f), an investment company of the management type must place "its securities and similar investments" in the custody of (1) a bank, (2) a stock exchange firm subject to rules prescribed by the Commission or (3) itself, subject to rules or orders prescribed by the Commission. If a company chooses to retain the custody of its securities, it must deposit them with certain specified institutions for safekeeping, subject to certain rules as to access, earmarking, and inspection.

Section 9(a) of the bill would amend section 17(f) of the act to provide that if an investment company employs a bank as custodian for "securities and similar investments," then all of its cash assets, including proceeds from the sale of its own securities and income on its holdings shall likewise be held by a bank, subject to appropriate direction as to expenditure and disposition by proper company officials.

The proposed amendment would not require an investment company to employ a bank as custodian. If, however, a company chooses to use a bank as custodian, its shareholders would appear entitled to expect that the cash held by the company would be afforded a degree of protection similar to that given to securities. The proposed amendment would permit maintenance of a checking account or accounts in one or more banks in amounts not to exceed the amount of the fidelity bond covering persons authorized to draw on the accounts, as required under section 17(g) of the act. It also provides that more than one bank may act as custodian. The Commission would have authority to allow specified amounts of petty cash to be held apart from bank custody.

In view of the amendments in section 5(d) and 12(d) of the bill which would facilitate the entry into the mutual fund business of collective funds maintained by banks subject to appropriate restrictions, section 9(a) of the bill would also amend clause (1) of section 17(f) of the act to make it clear that a registered investment company which is a collective fund maintained by a bank could keep its securities and similar investments in the custody of the sponsoring bank.

Section 14, Amending Section 25(c)—Reorganization Standards

Section 25(c) of the act now authorizes any district court of the United States, upon proceedings, instituted by the Commission, to enjoin the consummation of any plan of reorganization of a registered investment company only "if such court shall determine any such plan to be grossly unfair or to constitute gross misconduct or gross abuse of trust on the part of the officers, directors, or investment advisers of such registered company or other sponsors of such plan."

Section 14 would amend section 25(c) of the act to provide that a court may, upon proceedings instituted by the Commission, enjoin the consummation of any plan of reorganization of a registered investment company which the court finds not "fair and equitable" to all persons affected.

The proposed amendment would eliminate a standard which unduly restricts courts from passing upon plans of reorganization of registered investment companies. It would replace this standard with the "fair and equitable" standard which has had a long history of judicial interpretation in equity receiverships and reorganizations under sec-

tion 77B and chapter X of the Bankruptcy Act and section 11(e) of the Public Utility Holding Company Act. It would thus place the courts in a better position to carry out the congressional intent of protecting the security holders of the investment company when a plan or reorganization is filed.

Section 15(a), Amending Section 26—Substitution of Underlying Investments of Unit Investment Trust

Section 26(a)(4)(B) of the act now requires that the trust instrument of a unit investment trust provide that the sponsor or trustee will notify the shareholders of the unit investment trust within 5 days after a substitution of the underlying securities.

Section 15(a) of the bill would add a new subsection (b) to section 26 of the act to make it unlawful for any depositor or trustee of a registered unit investment trust holding the security of a single issuer to substitute underlying securities without Commission approval.

The proposed amendment recognizes that in the case of a unit investment trust holding the securities of a single issuer notification to shareholders does not provide adequate protection since the only relief available to the shareholders, if dissatisfied, would be to redeem their shares. A shareholder who redeems and reinvests the proceeds in another unit investment trust or in an open-end company would under most circumstances be subject to a new sales load. The proposed amendment would close this gap in shareholder protection by providing for Commission approval of the substitution. The Commission would be required to issue an order approving the substitution if it finds the substitution consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the act.

Section 19, Amending Section 33—Transmission to the Commission of Papers Filed in Shareholder Actions

Section 33 of the act now requires registered investment companies and their affiliated persons who are defendants in derivative suits involving “an alleged breach of official duty” to transmit to the Commission copies of the pleadings and the record in such actions after a verdict or final judgment on the merits has been rendered or a settlement or compromise of the action has been approved by a court of competent jurisdiction.

Section 19 of the bill would amend section 33 of the act to require prompt filing with the Commission of copies of all pleadings, settlements, discontinuances, or judgments served or filed in suits by a registered investment company or a security holder thereof against an officer, director, investment adviser, trustee, or depositor of such company. In addition, the section would require that copies of motions and other documents be filed with the Commission if it requests them.

The proposed amendment would permit the Commission to be kept informed of the progress of the litigation from its outset at the trial court, and would make it possible for the Commission to promptly take such action as may be appropriate.

It is contemplated that the proposed amendment would be administered to eliminate, insofar as possible, duplicative filings in cases involving multiple defendants.

PART I: FORMAL

The amendments in this part are concerned with miscellaneous anomalies and inconsistencies in the act.

Section 2(a), Amending Section 2(a)(5)—Change in Reference to Another Statute Which Has Been Amended

Section 2(a) of the bill would substitute in section 2(a)(5) of the act the words "under the authority of the Comptroller of the Currency" for the words "section 11(k) of the Federal Reserve Act, as amended." Section 11(k) of the Federal Reserve Act has been repealed, and as a result certain authority over banks formerly exercised by the Federal Reserve Board is now exercised by the Comptroller of the Currency.

Sections 3(b)(1) and 3(b)(2), Amending Section 3(c)—Deletion of Superfluous Reference and Renumbering

Section 3(b)(1) of the bill would amend section 3(c) of the act by deleting reference to subsection 3(b) of the act. Section 3(c) excludes certain categories of companies from the definition of an investment company which is found in subsection (a) of section 3. Since only subsection (a) definies [sic] an investment company and subsection (b) merely contains exceptions from that definition, the reference to subsection (b) in subsection (c) is meaningless.

In addition to deleting section 3(c)(8) (see pt. G—Coverage), section 3(b)(2) would also renumber paragraphs (5) through (7) and (9) through (15) of subsection 3(c) to reflect the deletion of paragraph (4) thereof by Public Law 89-418, 89th Congress, second session (1966).

Section 5(c), Amending Section 16(c)—Correcting Inconsistency in Prohibiting Persons From Serving as Directors of Investment Company

Section 10(c) of the act prohibits a registered investment company from having a majority of its board of directors consist of officers or directors of any one bank. Section 5(c) of the bill would add the word "employee" to the first clause of section 10(c). The second clause of section 10(c) provides a limited exception from the prohibition for any registered investment company which on March 14, 1940, had as a majority of its board of directors, the officers, directors, or employees of any one bank. While the first clause does not include employees, the second clause does include them. The proposed amendment would correct this apparent inconsistency.

Sections 8(c) and 8(d), Amending Sections 15(c) and 15(c)—Elimination of Outdated Reference and Section

In addition to the substantive changes described under the heading "Management—Shareholder Relationships."

Section 8(c) of the bill would delete the words "except a written agreement which was in effect prior to March 15, 1940," in section 15(c) of the act. Section 8(d) of the bill would delete section 15(d) from the act. That section prohibits any person after March 15, 1945, from acting as investment adviser to, or principal underwriter for, any registered investment company pursuant to a written contract in

effect prior to March 15, 1940, unless such contract was renewed prior to March 15, 1945, in such form as to make it comply with sections 15(a) or 15(b). The 1940-45 period mentioned in sections 15(c) and 15(d) passed long ago, and references to it are meaningless today. There are no persons who are or will hereafter be affected by section 15(d) or the above clause of section 15(c).

Section 12(d), Amending Section 24(d)—Deletion of Language Required by Proposed Amendments

Section 12(d) of the bill would amend section 22(d) of the act to conform that section to the proposed amendment to section 11(b) of the act by deleting reference to clause (2) of section 11(b) in section 22(d) of the act. Section 22(d) of the act provides, in relevant part, that it shall not prevent a sale made "pursuant to an offer of exchange permitted by section 11 hereof including any offer made pursuant to clause (1) or (2) of section 11(b)." Section 6 of the bill would delete clause (2) of section 11(b) from the act.

Section 13, Amending Section 24(d)—Updating of a Statutory Reference

Section 13 of the bill would amend section 24(d) to refer to section 4(3) of the Securities Act of 1933. Among other things, section 24(d0 of the act states that the exemption provided by clause 3 of section 4(1) of the Securities Act of 1933 shall not be applicable to face amount certificate companies, open-end management companies, or unit investment trusts. When the Securities Act of 1933 was amended in 1964, what had previously been the third clause of section 4(1) became section 4(3).

Sections 21 and 22, Amending Sections 43(a) and (44)—Updating Statutory References

Sections 21 and 22 of the bill would amend sections 43(a) and 44, respectively, to conform references to the Judicial Code with the present designation of the sections involved. Section 43(a) of the act provides for court review of Commission orders. It refers to sections 239 and 240 of the Judicial Code which have been redesignated section 1254 of title 28 of the United States Code, as amended. Similarly, section 44 of the act, which gives the district courts of the United States jurisdiction of violations of the act or rules and regulations thereunder, refers to sections 128 and 240 of the Judicial Code, as amended, which have been redesignated as sections 1254 and 1291-1294 of title 28 of the United States Code.

PART J: AMENDMENTS TO THE INVESTMENT ADVISERS ACT OF 1940

The Investment Advisers Act of 1940 is a companion statute to the Investment Company Act. It regulates the activities of those who receive compensation for advising others with respect to investments in securities or who are in the business of issuing analyses or reports concerning securities. Like other Federal securities statutes, the Advisers Act prohibits fraudulent practices and requires those subject to its provisions to register with the Commission and to keep books and records in accordance with Commission rules. It also empowers

91ST CONGRESS
2d Session

HOUSE OF REPRESENTATIVES

REPORT
No. 91-1382

INVESTMENT COMPANY AMENDMENTS ACT OF 1970

AUGUST 7, 1970.—Committed to the Committee of the Whole House on the State of the Union and order to be printed

Mr. STAGGERS, from the Committee on Interstate and Foreign Commerce, submitted the following

REPORT

[To accompany H.R. 17333]

The Committee on Interstate and Foreign Commerce, to whom was referred the bill (H.R. 17333) to amend the Investment Company Act of 1940 and the Investment Advisers Act of 1940 to define the equitable standards governing relationships between investment companies and their investment advisers and principal underwriters, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment strikes out all after the enacting clause and inserts in lieu thereof a substitute which appears in the reported bill in italic type.

PURPOSE OF THE LEGISLATION

The purpose of the legislation is to make comprehensive amendments to the Investment Company Act of 1940 (the Act) for the first time in three decades. Amendments would also be made to the Investment Advisers Act of 1940 (the Advisers Act) and to other related securities statutes where necessary. In addition to updating the Act in many respects and making numerous technical improvements in the Act, the bill would add a number of new provisions to the Act to provide additional safeguards and protections to public investors. Notable among these are the new standards provided in the bill for the measuring of sales charges and investment advisory fees. The bill also codifies many administrative positions which have been developed by the Securities and Exchange Commission (the Commission) in its administration of this important federal regulatory statute

BACKGROUND OF LEGISLATION

Investment company securities have been and continue to be an important vehicle of investment for millions of Americans. These securities have provided and should continue to provide an avenue of investment to investors interested in putting their savings in a broadly diversified and professionally managed investment portfolio. At least as early as 1935, it was recognized by Congress that mutual funds are affected with a strong public interest and present special features which require attention beyond simply the disclosure philosophy of the Securities Act of 1933. With that recognition in mind, section 30 of the Public utility Holding Company Act of 1935, directed the Commission to make a study of investment trusts and investment companies and to report its findings to the Congress. Pursuant to that direction, the Commission issued its report on investment trust and investment companies in 1938 and 1939.

The Investment Company Act of 1940 was passed as a result of that study and the hearings which followed it. The Act, a significant and vital part of our Federal securities regulatory structure, has not been significantly amended since its enactment over 30 years ago. During this same period of time, however, there has been a dramatic growth in the investment company industry—particularly securities of open-end investment companies (commonly called mutual funds). These are securities of investment companies which continuously offer new shares to the public and continuously stand ready to redeem their existing shares at net asset value. Between the end of 1940 and December 1969 the net assets of mutual funds increased from $450 million to over $53 billion. This latter sum represented the holdings of over 5 million Americans and institutions who held mutual fund shares at the end of 1969.

In 1958 the Commission engaged the Wharton School of Finance of the University of Pennsylvania to make a study of mutual funds. That study, issued on August 28, 1962 (A Study of Mutual Funds, House Report No. 2274, 87th Cong., second sess., 1962) examined the rapid growth of mutual funds and pointed to the resulting emergence of problems not significant when the Act was first considered and enacted. Following the Wharton Study, the Commission directed its attention to certain aspects of mutual funds, particularly selling practices, in its Report of the Special Study of Securities Markets made by the Commission in 1962 pursuant to Congressional direction (Public Law 87-196). The Commission's comprehensive report, issued in 1963, devoted an entire chapter (Chapter 11, Part 4, House Document No. 95, 88th Cong., first sess., 1963) to open end investment companies. Some legislation resulted in 1964 from the Report of the Special Study of Securities Markets, but it did not include legislative attention to mutual funds.

However, in the hearings held by your Committee on Interstate and Foreign Commerce which followed the report of the special study, your committee directed that the Commission consider the matter of mutual funds. That direction resulted in the report by the Commission on Public Policy Implications of Investment Company Growth, issued on December 2, 1966 (House Report No. 2337, 89th Cong., second sess., 1966). That report concluded that ". . . the Investment Company Act of 1940 has substantially eliminated the serious abuses at

which it was aimed, but that the tremendous growth of the industry and the accompanying changes have created a need for additional protections for mutual fund shareholders in areas which were either unanticipated or of secondary importance in 1940." The report went on to make legislative recommendations, many of which were embodied in bills introduced in both Houses of the 90th Congress. Hearings were held before the committees of both Houses and, although a bill was reported by the Senate, the House did not report a bill during the 90th Congress.

HISTORY OF THIS BILL

Bills to amend the Investment Company Act of 1940 were introduced again in both Houses of the 91st Congress. In the course of the Senate hearings on this legislation in early 1969, it was suggested that the Commission and the investment company industry make a further effort to arrive at an understanding with respect to the remaining issues dividing them. That was done and S. 2224, which was approved by the Senate on May 26, 1969, embodies those understandings. On June 10, 1969, Congressman Moss introduced H. R. 11995 which was identical in all respects with the bill which had passed the Senate. Congressman Stuckey introduced a series of bills on the subject (H.R. 8980, March 13, 1969; H.R. 12867, July 15, 1969; and H.R. 14737, November 6, 1969) each of which superseded the previous bill. Mr. Moss also introduced H.R. 13754 on September 11, 1969, a bill to abolish the front-end load on face amount certificates.

Hearings were held by the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 in November and December of 1969. Testimony was received from the Commission from interested industry groups and from all public witnesses who asked to be heard on the subject matter before the subcommittee.

After extensive deliberations by the Subcommittee on Commerce and Finance, a clean bill was introduced which embodied all the decisions made by the subcommittee. This clean bill, H.R. 17333, was introduced by Mr. Staggers on April 29, 1970. This, then, is the bill ordered reported to the House of Representatives by the full committee on Interstate and Foreign Commerce on July 28, 1970, with an amendment. The full committee, having considered the bill, reports favorably thereon with one amendment and recommends that the bill do pass.

SALES CHARGES

1. Generally

At the present time the basic sales commission on mutual fund shares is around 8½ percent of the total payment or 9.3 percent of the amount invested. This charge is protected by section 22(d) of the Act which provides for a unique scheme of retail price maintenance. Under that section, all dealers, regardless of the source of the shares they sell, are prohibited by law from cutting the sales charge fixed by the mutual fund underwriter.

Section 12 of the reported bill would change the existing standard in section 22(b) of the Act which states that sales loads on mutual fund shares shall not be unconscionable or grossly excessive. This section of the Act would be amended by the reported bill to provide that sales commissions shall not be excessive. The bill would continue the general

structure of existing law which places responsibility in a self-regulatory group registered under section 15A of the Securities Exchange Act of 1934 (at the present time the only such group is the National Association of Securities Dealers, the NASD) for promulgating rules to insure that mutual funds are sold to the public at sales loads which comply with the standards set by the Act. Under this provision the NASD would bear the initial responsibility for prescribing rules to assure that the public does not pay excessive sales loads on investment company securities.

The Commission, 18 months after enactment of the legislation or after the NASD had promulgated its rules, would have the responsibility of prescribing rules to prevent excessive sales charges on investment company shares sold by broker-dealers who are not members of the NASD and, therefore, are subject to regulations under section 15(b)(8) of the 1934 act. It is further provided, however, that any broker-dealer in the latter group may file an election to be subject to an be governed by the rules promulgated by the NASD rather than those promulgated by the Commission.

Finally, with respect to sales of shares of mutual funds by broker-dealers subject to the rules promulgated by the self-regulatory association, the existing rulemaking authority of the SEC contained in section 22(c) of the act is changed. A new provision, section 22(b)(3), would require that, 18 months after the date of enactment of this legislation, the Commission may alter or supplement the rules adopted by the registered securities association by the procedures set forth in section 15A(k)(2) of the 1934 act.

The reported bill specifically provides that the rules promulgated on this subject by the self-regulatory association shall allow for reasonable compensation for sales personnel, reasonable opportunity for profit for broker-dealers and underwriters, and reasonable sales loads to investors. It is your committee's intent that, in making determinations of what would or would not constitute excessive sales loads, the decision-making group should allow not only reasonable returns to the sellers, but also reasonable payments of sales charges by the buyers. Your committee has altered the Senate language which provides that consideration should be given to allow "reasonable compensation to brokers, dealers and underwriters" to read that "reasonable opportunity for profit for brokers, dealers, and underwriters" should be a relevant factor. Your committee does not intend this difference in language to be a significant departure from the Senate provision, but rather views it as a clarification of the fact that there is not direct compensation to broker-dealers and underwriters so much as there is profit to them. Your committee's phrasing of this standard to read reasonable opportunity for profit is to make it clear that this is not intended to insure profits but merely to provide an opportunity for them.

2. Front-End Load Charges

Section 16 of the reported bill would amend section 27 of the Act which deals with the front-end loads on periodic payment plans (commonly referred to as contractual plans). Under this method of selling mutual funds, the investor agrees to invest a specific sum of money, usually monthly, for a period of years. With each of the investor's monthly payments his mutual fund holdings grow. The present practice with respect to sale charges on these plans is to calcu-

late the sales charges on the total amount of mutual fund shares to be bought by the investor over the period of years covered by the plan, and then to apply 50 percent of the first year's payments toward that total sales load. The other 50 percent of the first year's payments is invested. The remaining portion of the total sales charges is then taken out of the investor's payments in subsequent years.

This practice results in one half of the investor's gross payments in the first year being placed in investments on his behalf. It further means that, should the investor for any reason not complete his contractual plan, he has incurred sales charges for fund shares which he may never in fact purchase. Your committee has tried to strike a balance in the reported bill between the needs of the selling parties and the interest of investors. It is recognized that the practice of front-end loading is a significant and necessary sales incentive both to the salesmen and to their principals and underwriters. At the same time investors do not always complete their plans and can suffer some inequities as a result of this funding arrangement.

Your committee has not recommended the elimination of the "front-end load" provision, as originally urged by the Commission in its Report on the Public Policy Implications of Investment Company Growth as well as in its original legislative proposal. Instead the reported bill provides alternative methods for dealing with the problem—a spread load and a refund period.

A. SPREAD LOAD

The spread load is provided for in the new subsections 27(g) and 27(h) of the Act. Under this method a sales load not exceeding 9 percent of the total payments would be permitted, and the sales charges could be taken out at the rate of not more than 20 percent of any payment and not more than a total of 64 percent from the first 48 monthly payments or their equivalent. Basically, then, during the first 4 years of the contractual plan, no more than 20 percent of any one year's payments could be taken for sales load and the average percent paid for sales load during each of the first 4 years could not exceed 16 percent. The monthly deductions during each one of the first 4 years would be required to be equal. For example, under these provisions a company could deduct 20 percent of each monthly payment during the first 3 years and then 4 percent of each monthly payment during the fourth year. Or, to give another example of a permissible deduction under this section, a company could deduct 16 percent of each monthly payment during the first 4 years. It should be noted that the spread load provisions of the reported bill are identical to the comparable provisions in the Senate bill. The largest distributor of mutual fund shares in this country has voluntarily chosen to operate on the basis provided for in this spread load and has apparently done so successfully.

B. REFUNDS

As an alternative to the above described spread load, the reported bill would add new subsections 27(d) and (e) to the Act to permit the existing front-end loading, that is, 50 percent of the first year's payments, but it would also add a required refund provision. Under the reported bill, section 27(d) of the Act would require that, if at any time during the first year of the plan the investor redeems for any

reason, he would receive in cash the sum of (1) the value of his account and (2) an amount from the underwriter or depositor equal to that part of the excess paid for sales loading charges over 20 percent of the gross payments made by the investor. For example, if the investor has undertaken a plan which required $50 a month for a 10-year period, he would make payments of $600 during the first year. $300 of that sum could be used toward the total sales commission on all of the shares to be purchased which if we assume a sales load of 9%, would be $540. If, however, just before the end of the first year of the plan the investor elected to redeem, he would be entitled to receive back $300 (assuming that the value of his interest neither went up nor down) plus $180 which would represent the excess he had paid for sales loading over $120 (20 percent of his gross payments of $600).

In addition, the new section 27(f) of the Act provides that, with respect to any periodic payment plan, the investor, within 60 days after the issuance of the certificate, must be provided with a notification of the charges to be deducted and of his right to surrender, within 30 days of the mailing of the notification, and to receive back the sum of (1) the value of his account, and (2) an amount equal to the difference between the gross payments made and the net amount invested.

The new sections 27(d) and 27(f) of the Act also authorize the Commission to specify by rule and regulation such reserve requirements as necessary for underwriters and depositors to carry out the refund obligations set forth in those sections. The purpose of the reserve requirements is to help assure that contractual plan sponsors will be able to pay refunds or rebates of sales loads to investors pursuant to those sections. Your committee does not intend to bind the hands of the Commission in setting the reserve requirements, but it does believe that, after the refund programs have existed for a sufficient period of time to develop experience with refund tendencies of investors, the actual refund and rebate experience of contractual plan sponsors might be one of the best measures of the level of reserves necessary to assure that investors are adequately protected. Your committee assumes that the Commission will be thoughtful and flexible in determining the extent to which the reserves provided for by the new sections are required to be taken into account by contractual plan sponsors in meeting the Commission's net capital requirements.

3. Front-End Load Charges on Face Amount Certificates

The issuer of a face-amount certificate promises to pay the holder a fixed sum of money upon the maturity of the certificate, and certain lesser fixed sums if the certificate is surrendered prior to maturity. The certificates are, in effect, front-end loaded.

Section 17 of the reported bill would add a new subsection 28(i) to the Act to provide for a type of spread load for sales charges on face amount certificates. It would require that the front-end load be spread over the first five years of the plan so that, in effect, a 20-percent load would be taken in each of the first three years, a 10-percent load in the fourth year, a 7-percent load in the fifth year, and no more than a 4-percent load in all subsequent years. This change, for the most part, reflects existing industry practice. Over 95 percent of face-amount certificate sales are now being made within this proposed limitation.

MANAGEMENT FEES

1. Generally

The structure of the mutual fund industry is such that the investment company assets are managed by an external rather than an internal adviser. Most funds are formed, sold, and managed by external organizations that are separately owned and operated. The investment company, then, contracts with the investment adviser for management of the fund assets and pays that adviser a management fee. That fee is usually calculated at a percentage of the fund's net assets and fluctuates with the value of the fund's portfolio.

The relationship between the investment company and its investment adviser results in a structure which is different from the conventional bargaining relationship between buyer and seller. Since the typical mutual fund is organize by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on those services, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.

Under existing provisions of the act, a fund shareholder can challenge the investment advisory fee by a suit under section 36 of the Act alleging gross misconduct or a gross abuse of trust on the part of the fund directors in agreeing to the management fee. This procedure has proven to be cumbersome for plaintiffs. In addition, the courts have determined that, under the applicable standards, the fee must "shock the conscience of the court" before any relief can be granted under section 36(b) of the Act. This result may not be an improper one when the protections of arm's-length bargaining are present, but in the mutual fund industry these market place forces are not likely to operate as effectively or vigorously. Your committee has determined, therefore, that a change in the standard for testing management fees is appropriate and needed.

The reported bill would make some modifications of section 36 and would add a new section 36(b) to the Act which provides that the investment adviser shall be deemed to have a fiduciary duty to the fund shareholders with respect to the receipt of compensation for services paid by the investment company. The new subsection would provide further that the Commission or a shareholder of the registered investment company could bring an action under the provisions of the section.

During consideration of this legislation in the Senate last year, the Commission and representatives of the industry once again engaged in extended discussions to arrive at an agreement on the appropriate expression of a standard for testing the level of management fees. The accommodation which was reached as a result of those discussions was then embodied in the comparable sections of the Senate bill, S. 2224.

The new section 36(b) added by the reported bill is basically the same as that which would be added by the Senate bill with two exceptions. First, the reported bill specifically requires that the shareholder bring an action for breach of fiduciary duty by a "bona fide shareholder" and be "acting in good faith and with justifiable cause." This is intended, not as a substantive change, but as a clarification of

the fact that the courts should only entertain such actions by bona fide shareholders who are acting in good faith. Secondly, the reported bill requires that the plaintiff in an action under section 36(b) shall have the burden of proving the breach of fiduciary duty by clear and convincing evidence. This increased burden of proof was added by your committee to prevent the harassment of investment advisers by ill-founded and nuisance law suits, the so-called strike suit. It is not intended to hamper the well-founded law suit, and it is not intended to negative the traditional concept of fiduciary duty.

2. Performance Fees

Section 25 of the reported bill would permit performance fee arrangements (subject to certain restrictions) with respect to investment advisory contracts with (1) an investment company, (2) a trust, collective trust fund, or separate account if the contract relates to investment of assets in excess of $5 million, and (3) any person entering into a contract for investment advice relating to assets in excess of $1 million. The reported bill would, however, limit performance fees to those compensation arrangements based on the value of the assets under management averaged over a specific period of time and increasing and decreasing proportionately with the investment performance of the assets under management in relation to the investment record of an appropriate index. The reported bill makes it clear that the point from which increases and decreases in compensation can be measured shall be the fee which is paid when the performance of the fund under management is equal to that of the index chosen. The reported bill would also add a new subsection 205(b) to the Investment Advisers Act to exempt investment advisory contracts with certain foreign-based funds from the performance fee restrictions discussed above.

BANKING AND INSURANCE

The answer to the question of whether or not bank administered commingled agency accounts (really a bank "mutual fund") could operate under existing federal laws has been unclear. In 1963, the Comptroller of the Currency issued a regulation which, for the first time, authorized national banks to create and maintain commingled agency accounts. pursuant to that regulation, a national bank decided to organize such an account and registered the fund as an investment company under the Act. The bank requested that the Securities and Exchange Commission grant them certain exemptions from the Act, including exemption from section 10(c) in order to enable the bank to comply with the banking laws and with the Comptroller's regulations. The Commission granted the necessary exemptions (First National City Bank, Investment Company Act Release #4538, March 9, 1966), and the way seemed to be cleared for the proposed operation. Judicial review was sought, however, of the determinations reached by the government agencies. The Investment Company Institute sought review of the Comptroller's determinations, and the National Association of Securities Dealers sought review of the Commission's determinations. The District Court for the District of Columbia held that section 21 of the Banking Act of 1933 (commonly known as the Glass Steagall Act) precludes banks from engaging in this type of activity (*Investment Company Institute* v. *Camp*, U.S.D.C., 274 F. Supp. 624

1967). However, the Court of Appeals unanimously reversed the District Court and upheld both the Commission's exemptive order and Comptroller's regulations. The Court of Appeals held that the actions taken by the Commission and the Comptroller were fully consonant with the statutes committed to their regulatory jurisdictions (*National Association of Securities Dealers, Inc.* v. *Securities and Exchange Commission*, 420 F. 2d 83, 1969). A petition for certiorari was filed to the Supreme Court, and the Court granted the petition for certiorari in both cases on March 23, 1970. Oral arguments have not yet been held.

Your committee has determined that, should existing provisions of law permit banks to maintain commingled agency accounts, the banks should do so subject to the regulatory pattern of the Investment Company Act, with certain exceptions. The exceptions are basically the same as the exemptions granted administratively by the Commission in March, 1966 and relate mainly to the composition of the Board of Directors. Therefore, section 5 of the reported bill provides that a registered investment company which is a collective or other pooled fund maintained by a bank may have a board of directors all of the members of which, except one, are interested persons of the investment adviser. However, the section also provides that such investment company shall be an open-end company, that the investment adviser of the company shall e registered under the Investment Advisers Act, that no sales load shall be charged on the securities issued by the investment company, that any premium over net asset value charged by the company on the issuance of the security plus any discount from net asset value charged on redemption thereof shall not in the aggregate exceed 2 percent, that no sales or promotion expenses be incurred by the investment company, that the investment adviser be the only investment adviser to the company, that the investment adviser pay certain expenses of the investment company, and that the investment company have only one class of securities outstanding.

Section 12 of the reported bill would add a new subsection 22(h) to the Act which would make it clear that, if no other provision of State or Federal law prohibits the operation by a bank or savings and loan association of an investment company, such investment company could be operated subject, in the case of banks, to applicable regulations of the Comptroller of the Currency, and, in the case of savings and loan associations, to applicable regulations of the Federal Home Loan Bank Board. In addition, the section provides that the public offering price of the securities should not include a sales load and that the securities should be sold only by officers and employees of the banks and savings and loan associations who meet the standards set by the banking authorities (who, in prescribing rules and regulations in this regard should make them consistent with similar rules and regulations for other salesmen of registered investment companies promulgated by the Commission).

This treatment of commingled agency accounts in the reported bill is the same in all respects except one with the treatment given these accounts in the Senate bill. The Senate bill, while setting up the same restrictions and requirements, would specifically authorize these accounts notwithstanding any other provision of law. This

contrasts with your committee's decision not to specifically authorize banks and savings and loan associations to create and maintain these accounts, but rather to provide that, should they be permitted to do so under existing provisions of law, they should do so subject to certain limitations.

The reported bill also deals with the question of the Federal regulation which should apply to bank collective trust funds and insurance company separate accounts for corporate pension plans and for "Smathers-Keogh" plans (commonly referred to as H.R. 10 plans). These products require some special attention in order to fit them properly into the regulatory pattern of the Act partially due to the fact that they are also regulated under other provisions of law. On this subject the reported bill basically codifies existing administrative treatment. The bill would exempt both bank and insurance administered corporation pension plans from the registration and reporting requirements of the Federal Securities Acts, but it does not exempt them from the antifraud provisions of those acts. With respect to H.R. 10 plans the reported bill provides exemptions from the Investment Company Act and from the reporting requirements of the 1934 act, but does not provide exemptions for these plans and from the registration requirements of the 1933 act, and the broker-dealer requirements of the 1934 act. These plans are not exempt from the antifraud provisions of the Federal securities laws.

FUND HOLDING COMPANIES

Section 7 of the reported bill would amend section 12 of the Act to limit the creation and operation of new fund holding companies. These companies are investment companies whose investment portfolio consists either entirely or largely of securities of other investment companies. Since before the enactment of the Act there were several closed-end investment companies that invested in other closed-end companies, section 12(d)(1) of the Act sought to deal with the regulatory problems posed. That section, however, does not attempt to deal with the problems that have recently arisen in this area and that may become more acute in the future. For example, the section applies only to purchases by registered investment companies. Therefore, a fund holding company organized under the laws of a foreign jurisdiction and not subject to regulation under the Act, can buy unlimited quantities of securities of registered investment companies. The reported bill would meet this problem by permitting investment company securities to be purchased by other investment companies, but only in specified limits and subject to detailed restrictions.

The Commission has stated that fund holding companies, in its opinion, are of doubtful utility and that their operation may be unnecessarily costly to investors and may have a disruptive effect on the portfolio funds. This reflects the Commission's concerns, expressed in their report on the Public Policy Implications of Investment Company Growth, that: (1) there is a danger of control by the fund holding company of portfolio companies of underlying mutual funds and, (2) there is a layering of costs to investors in terms of duplication of administrative expenses, sales charges and advisory fees. As a result, the Commission has urged that fund holding companies be prohibited.

The reported bill, however, would give limited relief to existing fund holding companies and to any others created subject to the restrictions set forth in the reported bill. This would be done by exempting from the provisions of section 12(d) (1) securities purchased or otherwise acquired by a registered investment company where (1) immediately after the purchase or acquisition, the registered investment company and all of its affiliated persons owned not more than 3 percent of the total outstanding stock of the acquired company and (2) the fund holding company (either itself or through its principal underwriter or other distributor) does not charge a sales load which, when added to the maximum sales load applicable to the acquisition of its portfolio securities, is excessive within the meaning of section 22(b) of the Act.

The restrictions are designed (1) to prevent the problems which can be created by the pyramiding of control, and (2) to insure that the total sales load, that is, the load paid on the shares of the fund holding company together with the load paid by the fund holding company on the investment company shares placed in their portfolio, does not exceed the sales load which would be permitted by section 22(b) of the Act. These restrictions are similar to the restrictions placed on these companies by the Senate bill, S. 2224, except that, with respect to the sales load, the Senate version would have restricted the load to 1½ percent. Your committee determined to tie the permissible sales load on fund holding company shares into the standard set forth in section 22(b) of the Act, as amended, rather than to set some fixed maximum percent.

OIL AND GAS FUNDS

Considerable attention has been given to the question of including oil and gas funds in the regulatory pattern of the Investment Company Act. In 1940, at the time of the enactment, oil and gas funds were not as significant a factor as they are today. More importantly, at that time sales of them were directed almost exclusively to wealthy, sophisticated investors who were not in as great a need of the protections of the Act. Because of this, the Act contains an exemption in section 3(b)(11) for these funds.

In recent years, however, there have been strong indications that the sales pattern for oil and gas funds has changed substantially. In some cases this has been along the lines of directing the sale of these interests to the small investor. Because of this change, your committee directed its attention to the question of whether or not the existing exemptions for these funds should be modified or deleted. In the bill approved by the Senate a modification would be made to this exemption. It would provide that oil and gas funds issuing redeemable securities, periodic payment plan certificates, or face-amount certificates of the installment type would not be exempt from the Act. Initially the SEC urged that position, but when the Chairman of the Commission testified before your committee on December 11, 1969, he stated that, in the Commission's opinion, the best way to handle this matter might be for the representatives of the Commission to "sit down with (representatives of the oil and gas fund industry) and work out a separate piece of legislation which would be submitted to the Congress before 18 months after the passage" of mutual fund legisla-

tion. The chairman further indicated that this course of action was being suggested because of a growing acceptance by the Commission of the industry's position that, although some additional protections to investors would be highly desirable in this area, there might be difficulties in fitting the oil and gas fund operations into the regulatory scheme of the Investment Company Act—certainly it was a matter which deserved thoughtful attention.

In light of the industry arguments and the position taken by the Commission in its testimony, your committee determined not to make any change in the existing exemption for oil and gas funds. At the same time, your committee recognizes the need for protection of investors in this area. Your committee has reached this decision only because of the assurances of the Commission and industry representatives that the will work diligently and expeditiously toward the goal of recommending an effective scheme for providing investors protection in this area and that those recommendations will be available to the Congress before 18 months after the enactment of this mutual fund legislation. Your committee understands that preliminary contacts and discussions have already begun between interested industry groups and the Commission.

FINGERPRINTING

Thefts of securities have increased dramatically in recent years and have become a serious problem in the securities business. Various studies of securities thefts indicate that a large majority of individual cases involve inside employees who were used to serve the interests of more organized and dishonest persons. Careful screening of personnel is certainly one way to help prevent thefts and this screening process can be aided substantially by a fingerprinting program. Within the past year the State of New York has imposed the requirement that employees in the securities business be fingerprinted, and that program has proved to be a powerful weapon in the efforts to solve this problem. Your committee has included, therefore, a provision in section 29 of the reported bill which would require partners, officers, directors and employees of national securities exchanges and of registered broker-dealers to be fingerprinted as a condition of employment. The bill grants the Commission broad rulemaking power to provide for the appropriate processing and use of these fingerprints.

AMENDMENTS TO THE INVESTMENT ADVISERS ACT OF 1940

The Investment Advisers Act of 1940 (the Advisers Act) is a companion statute to the Investment Company Act. It regulates the activities of those who receive compensation for advising others with respect to investments in securities or who are in the business of issuing analyses or reports concerning securities. Like other Federal securities statutes, the Advisers Act prohibits fraudulent practices and requires those subject to its provisions to register with the Commission and to keep books and records in accordance with Commission rules. It also empowers the Commission to make regular inspections and to take administrative remedial action against applicants for registration and registered advisers.

The proposed amendments to the Advisers Act have two purposes. First, they would remove provisions of the Advisers Act which now afford investment advisers to investment companies special exemptions from regulations under the Advisers Act. In connection with these changes the Commission would be given broad exemptive authority to administer the Advisers Act in a flexible manner. Second, they would strengthen existing disciplinary controls over registered investment advisers by making them more comparable to the provisions of section 15(b) of the Securities Exchange Act relating to broker-dealers in securities and to the proposed amendments to section 9 of the Investment Company Act.

SECTION-BY-SECTION ANALYSIS

(Amendments are to the Investment Company Act of 1940 unless otherwise noted.)

Section 2(a)(1)—Amending Section 2(a)(5)—Change in Reference to Another Statute Which Has Been Amended

Section 2(a)(1) of the bill would substitute in section 2(a)(5) of the act the words "under the authority of the Comptroller of the Currency" for the words "section 11(k) of the Federal Reserve Act, as amended." Section 11(k) of the Federal Reserve Act has been repealed, and as a result certain authority over banks formerly exercised by the Federal Reserve Board is now exercised by the Comptroller of the Currency.

Section 2(a)(2)—Amending Section 2(a)—Renumbering of Paragraphs

Section 2(a)(3)—Amending Section 2(a)—Adding Definition of New Term "Interested Person"

Section 2(a)(3) of the bill would add a new section 2(a)(19) to the Act defining the term "interested person" to include persons who have close family or substantial financial or professional relationships with investment companies, their advisers, principal underwriters, officers, and employees.

Section 10 of the Act now provides that at least 40 percent of a registered investment company's directors must be persons who are neither officers nor employees of the company and who neither serve as, nor are "affiliated" with, its investment adviser. It 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 function of these provisions with respect to unaffiliated directors is to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.

Your committee believes that the definition of an "affiliated person" in section 2(a)(3) of the Act does not adequately meet this purpose. Under this definition a director who has strong ties with the company's managers may be classified as "unaffiliated." For example, a director is presently deemed "unaffiliated" even though he owns up to 4.99 percent of the adviser-underwriter's stock, has substantial business

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or professional relationships with the investment company or its adviser-underwriter, or is closely related by blood or marriage to the company's managers.

Section 2(a)(3) of this bill seeks to remedy the Act's deficiencies in this regard by adding a new section 2(a)(19) to the Act which would define the term "interested person." Other sections of the bill would substitute that new term for the present term "affiliated person" in the following sections of the Act: (1) section 10, relating to the composition of boards of directors (amended by sec. 5 of the bill); (2) section 15, relating to the approval of advisory and underwriting contracts (amended by sec. 8(c) of the bill); and (3) section 32(a), relating to the selection of independent public accountants (amended by sec. 18 of the bill). The new "interested person" concept will not widen the scope of sections 10(f) and 17 of the Act, which prohibits transactions between investment companies, on the one hand, and the companies' affiliated persons as well as the affiliated person of such affiliated persons on the other hand, absent prior Commission approval. These sections remain unchanged.

Under the bill the new term "interested person" would include affiliated persons of an investment company, its investment adviser and principal underwriter, as well as members of the immediate family of such affiliated persons and persons who have beneficial interests or legal interests as fiduciaries in securities issued by the investment adviser, principal underwriter and their controlling persons. The term would also include any broker-dealer registered under the Securities Exchange Act of 1934, and affiliated persons of any such broker-dealer. In addition, the definition would classify as an interested person legal counsel for an investment company, its investment adviser and principal underwriter and partners and employees of such legal counsel.

Interested person would also include persons who have any material business or professional relationships with an investment company, or another investment company having the same investment adviser or principal underwriter, controlling persons of the investment adviser or principal underwriter, or the principal executive officer of such investment companies, and the principal executive officer of the investment adviser or principal underwriter of an investment company.

Under this proposed section, a person would be deemed an interested person because of a business or professional relationship only if the Commission, by order, determines that he has, at any time during the prior 2 fiscal years, had a material business or professional relationship with persons specified in the statute. Such order would not be retroactive. It would take effect 60 days after the entry thereof and would not affect the status of a person for the purpose of the Act or for any other purpose for any period prior to the effective date of the order.

Under the proposed amendment the Commission could issue an order determining that a director of an investment company is an interested person if it should find that a business or professional relationship was material in the sense that it might tend to impair the independence of such director. Ordinarily, a business or professional relationship would not be deemed to impair independence where the [illegible] to the other

relationship with the investment adviser simply because he is a brokerage customer who is not accorded special treatment. A business relationship arising solely from the fact that the chief executive officer of an investment adviser to an investment company and a director of that investment company are directors of another company, whether that company is an investment company managed by the same investment adviser or a separate industrial corporation ordinarily would not be deemed material. Similarly, a director of one investment company would not ordinarily be deemed an interested person of that company by reason of being a director of another investment company with the same adviser. This case-by-case method of implementing the material business and professional relationship test would eliminate any danger of inadvertent violations of the requirements of the Act and adequately implement your committee's basic intent.

Finally, the section provides that no person is to be deemed to be an interested person of an investment company solely by reason of his being a member of its board of directors, advisory board, an owner of its securities, or a member of the immediate family of such a person.

The committee believes that the Commission has adequate exemptive authority under section 6(c) of the Act to administer these amendments in a flexible manner. For example, all broker-dealers and legal counsel for an investment company would be defined as interested persons, but the Commission could exempt any such person upon an appropriate showing that he, in fact, is in a position to act independently on behalf of the investment company and its shareholders in dealing with the company's investment adviser or principal underwriter.

Situations may arise where persons involuntarily become interested persons. For example, a fund director may find that he is named the executor of an estate which holds stock in the investment adviser or is the beneficiary of a trust which unknown to the beneficiary holds or acquires such stock. Your committee expects the Commission to enact rules prior to the effective date of this amendment to deal with such situations.

Section 2(a)(4)—Amending Section 2(a)—Amending Definition of Term "Separate Account"

Section 2(a)(4) of the bill would add to the Act a new subsection 2(a) (37) which defines the term "separate account" established and maintained by an insurance company. The purpose of adding this new subsection is to provide a definitional base for the exclusion from the Act of certain separate accounts provided for in section 3(b) (6) of the bill.

The definition in the new subsection is based on the definition in Commission Rule 3c-3 promulgated under the Act which, in turn, is based on the definitions in separate account legislation of certain States, including New York. The definition expressly includes separate accounts established and maintained pursuant to the laws of Canada or any Province thereof, but includes such separate accounts of Canadian insurance companies only if such companies are subject to supervision by State insurance officials as provided in section 2(a)(17) of the Act. (See also section 27(a) of the bill).

Section 2(a)(5)—Amending Section 2(a)—Adding Definition of "Savings and Loan Association"

Section 2(a) (5) of the bill would add to the Act a new subsection 2(a)(45) which defines the term "Savings and Loan Association." The purpose of this new subsection is to provide a definitional base for including managing agency accounts sold on a no-load basis by savings and loan associations under section 12(d) of the bill.

Section 2(b)—Amending Section 13(b)—Changing Paragraph Reference

Because of the renumbering of paragraphs in section 2(a) of the Act, it becomes necessary to change a paragraph reference to section 2(a) of the Act in section 13(b) of the Act.

Section 3(a)—Amending Section 3(b)(2)—Requirement of Good Faith

Under section 3(b)(2) of the Act any issuer, other than a registered investment company, may file an application for an order of the Commission declaring it to be exempt from regulation under the Act in accordance with the standards of that section. The filing of such application provides an automatic 60-day exemption from all provisions of the Act; during this 60-day period, an applicant may engage in activities prohibited under the act even though the Commission may ultimately deny the application.

Section 3(a) of the bill would amend section 3(b)(2) to specify that this automatic 60-day exemption is available only if the application is filed in "good faith."

While a requirement of "good faith" is implicit in the statute, the existing statutory language does not so provide. By making the requirement an explicit one, companies would be placed on notice that an automatic exemption cannot be obtained by the filing of a frivolous application not presenting a colorable claim to the exemption from regulation provided for by section 3(b)(2).

Section 3(b)(1)—Amending Section 3(c)—Deletion of Superfluous Reference

Section 3(b)(1) of the bill would amend section 3(c) of the Act by deleting reference to subsection 3(b) of the Act. Section 2(c) excludes certain categories of companies from the definition of an investment company which is found in subsection (a) of section 3. Since only subsection (a) defines an investment company and subsection (b) merely contains exceptions from that definition, the reference to subsection (b) in subsection (c) is meaningless.

Section 3(b)(2)—Amending Section 3(c)—Deletion of Exclusion for Company 90 Percent or More of Whose Securities Are Those of Certain Single Issuers

Section 3(c)(8) of the Act excludes from the statutory definition of an investment company a company 90 percent or more of the value of whose investment securities are those of any single bank, insurance company, or other financial institutions of the types enumerated in sections 3(c) (5), (6), and (7) of the Act. Section 3(b)(3) of the bill would delete this paragraph from the Act.

The availability of the section 3(c)(8) exemption to companies which hold, solely as an investment, securities of certain types of financial institutions appears to be wholly inconsistent with the statutory policy

of the coverage of the Act and should be removed. Its deletion from the act will not affect existing exclusions for companies which control or manage the enterprises whose securities they hold.

In addition to deleting section 3(c)(8) this section of the bill would also renumber paragraphs (5) through (7) and (9) through (15) of subsection 3(c) to reflect the deletion of paragraph (4) thereof by Public Law 89-418, 89th Congress, second session (1966).

Section 3(b)(3)—Amending Redesignated Section 3(c)(5)—Modification of Exclusion for Companies Engaged in Factoring, Discounting and Real Estate Businesses

Under the existing provisions of section 3(c)(6), redesignated section 3(c)(5), companies engaged primarily in factoring, discounting and real estate are excluded from the definition of an investment company unless they are engaged in the business of issuing face-amount certificates of the installment type or periodic payment plan certificates. These limitations reflect widespread abuses prior to 1940 in sales of such securities on an installment basis, usually to relatively unsophisticated investors of modest means.

Section 3(b)(3) of the bill would amend section 3(c)(6), redsignated [sic] section 3(c)(5), of the Act to provide that, in addition to existing limitations, the exclusion from the definition of an investment company provided by that section would be unavailable to any such company issuing a security redeemable at the election of the holder.

Although the companies enumerated in section 3(c)(6), redesignated section 3(c)(5), have portfolios of securities in the form of notes, commercial paper, or mortgages and other liens on and interests in real estate, they are excluded from the act's coverage because they do not come within the generally understood concept of a conventional investment company investing in stocks and bonds of corporate issuers. The proposed amendment would have the effect of extending the regulatory provisions of the Act to certain of these companies which in recent years have attempted to capitalize on the popularity of open end companies by issuing redeemable securities.

A redeemable security is defined in section 2(a) (31) of the Act as "any security other than short-term paper, under the terms of which the holder, upon its presentation * * * is entitled * * * to receive approximately his proportionate share of the issuer's current net assets or the cash equivalent thereof." Thus, the proposed amendment would in no way affect companies which issue securities redeemable at the option of the issuer—the conventional form of redeemable security commonly used in corporate financing. The amendment applies only to those companies which purport to model themselves after open end companies by issuing a security redeemable at the option of the holder.

Section 3(b)(4)—Amending Redesignated Section 3(c)(8)—Clarification of Exemption for Holding Company Registered Under Public Utility Holding Company Act of 1935

Section 3(c) (10) of the Act, redesignated Section 3(c) (8), now excludes from the coverage of the Act any company "with a registration statement in effect as a holding company under the Public Utility Holding Company Act of 1935." Section 3(b) (4) of the bill would amend section 3(c) (10), redesignated section 3(c) (8), to make the

exclusion provided by that section available to companies "subject to regulation under the Public Utility Holding Company Act of 1935."

A holding company may register under the Holding Company Act and subsequently obtain an order exempting it from all or substantially all of the provisions of that act. It has been contended that such a company is still "registered" under the act even though it is no longer regulated thereunder. The proposed amendment would make it clear that a company which is in fact unregulated under the Holding Company Act is not excluded from the coverage of the Investment Company Act.

Section 3(b)(5)—Amending Redesignated Section 3(c)(11)—Exclusions for Certain Bank Collective Trust Funds and Insurance Company Separate Accounts

Section 3(b)(5) of the bill would expand a present exclusion from the definition of "investment company" in section 3(c)(13), redesignated section 3(c)(11), of the Act to cover certain bank collective trust funds and certain insurance company separate accounts funding pension or profit-sharing plans which meet the requirements of section 401 of the Internal Revenue Code. As a purely technical matter the amendment would also delete the reference to section 165 of the code and substitute a reference to section 401 of the code which replaced it.

The amendment in section 3(b)(5) of the bill would codify the Commission's current basic position that bank collective trust funds, which consist solely of assets of employees' plans and which meet the conditions of section 401 of the code, are entitled to the exclusion which the act presently provides for "[a]ny employes' stock bonus, pension, or profit-sharing trust which meets the conditions of section 165 [now, 401] of the Internal Revenue Code, as amended."

The amendment would exclude only those bank collective trust funds which are maintained solely for the funding of employees' stock bonus, pension or profit-sharing plans including so-called H.R. 10 plans, and which are not used as a vehicle for direct investment by individual members of the public. For example, the amendment would not exclude a bank collective fund maintained for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as managing agent.

The amendment in section 3(b)(5) of the bill would also exclude from the definition of "investment company" under the Act certain insurance company separate accounts, as defined in section 2(a)(4) of the bill. The purpose of this amendment is to give life insurance companies the same treatment with respect to employees' pensions and profit-sharing plans, which meet the requirements of section 401 of the code as is provided for banks. Despite certain differences both in the regulatory pattern now applicable to banks and insurance companies, and, in some instances, the manner in which these interests are offered and sold, your committee recognizes the fact that bank collective trust funds and insurance company separate accounts are very similar to each other and serve essentially the same purpose. Accordingly, the amendment is intended to grant banks and insurance companies equal treatment under the Federal securities laws to the extent that they compete with each other to serve as funding media for employees' pension or profit-sharing plans.

Sections 3 (c) and (d)—Amending Sections 8(b)(2) and 13(a)(3)—Clarifying Investment Policies Which May Not Be Deviated From Without Prior Shareholder Approval

Section 8(b)(1) of the Act requires that every registered investment company, in its registration statement filed under the Act, specifically recite its policy with respect to certain investment and other enumerated activities. Section 8(b)(2) requires a recital in the registration statement of policies "in respect of matters, not enumerated in paragraph (1), which the registrant deems matters of fundamental policy and elects to treat as such."

Section 13 prohibits a registered investment company from deviating from the policies enumerated in section 8(b)(1) or from any policy which it has elected to treat as "fundamental" pursuant to section 8(b)(2) without prior shareholder approval.

The Commission has taken the position that "fundamental", as therein used, is simply a term which describes any investment policy which an investment company elects to make changeable only if authorized by shareholder vote, whether or not an investment company labels such a policy "fundamental".

However, it has been argued that section 13 is not violated when an investment company changes an investment policy without a required prior shareholder approval, unless that policy has been labeled "fundamental". In other words, it was argued that requiring prior shareholder approval for a change in investment policy does not make if "fundamental".

In *Green* v. *Brown*, 276 F. Supp. 753 (1967), the District court accepted this so-called "plain meaning" approach despite its "curious result". In a Brief filed *Amicus Curiae* with the Court of Appeals the Commission took the position that the term "fundamental" was simply a term which describes any investment policy which an investment company elects to make changeable only if authorized by shareholder vote. That Court, in *Green* v. *Brown*, 398 F. 2d 1006 (C.A. 2, 1968) remanded the case to the District Court with instructions to reconsider the matter with the benefit of the Commission's Brief.

Although the Commission has attempted to deal with this matter under its rulemaking power (see Investment Company Act Release No. 5565), to obviate further misunderstanding, your committee agrees that sections 8 and 13 should be amended to make it clear that deviation from an investment policy which is changeable only by shareholder vote constitutes a violation of section 13. The amendment would also allow investment companies the opportunity to afford shareholders similar protection from deviation with respect to any other policy.

Section 4 —Amending Section 9—Providing for Administrative Action Against Certain Persons Serving Investment Companies

Section 9(a) of the Act now prohibits any person from serving in certain capacities with a registered investment company if he has been convicted of any of the crimes set forth in section 9(a)(1) or, as set forth in section 9(a)(2), has been permanently or temporarily enjoined by a court from acing in certain capacities.

Section 4 of the bill would add a new subsection (b) to section 9 of the Act to 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 capacities enumerated in section 9 or as an employee of an investment company or as an affiliated person of its investment adviser, depositor, or principal underwriter. The Commission could take such action only if it found (1) that the individual in question had willfully violated, or had willfully participated in violation of any provision of the Securities Act, the Securities Exchange Act, the Investment Company Act or the Investment Advisers Act or any rule or regulation under those statutes; and (2) that the action was in the public interest.

The proposed amendment would supplement the existing provisions of section 9. It would provide grounds and procedures for disqualification from affiliation with an investment company of persons willfully violating the Federal securities laws. To some extent, the present section 9 is the counterpart to the provisions of section 203(d) of the Investment Advisers Act and section 15(b) of the Securities Exchange Act which empowers the Commission to disqualify persons who have committed certain types of misconduct from serving as a registered investment adviser or broker-dealer or as an associated person of a broker-dealer, if such action is found to be in the public interest.

Under the proposed amendment if the Commission finds that an investment adviser or broker-dealer or an associated person thereof has violated the antifraud or other provisions of the Investment Advisers Act or the Exchange Act and has barred or suspended him from serving as an investment adviser or broker-dealer or from association with a broker-dealer, it can also prevent him from being associated with an investment company, its adviser or its principal underwriter.

Like the provisions of section 15(b) of the Securities Exchange Act and section 203(d) of the Investment Advisers Act, the proposed amendment would provide for an administrative proceeding to determine whether persons have engaged in willful misconduct and whether the public interest requires that such persons be barred from serving an investment company.

The proposed amendment will correct another deficiency of section 9 which bars a person convicted of certain crimes or enjoined on the basis of misconduct specified in that section from serving as an officer, director, or investment adviser of an investment company, but permits such a person to be an employee of an investment company.

Further, under the proposed amendment, in appropriate cases, the Commission could proceed against an individual affiliated with a company's investment adviser, principal underwriter, depositor, or sponsor without naming or joining the individual's employer as a party in such proceeding. Moreover, the Commission could, where appropriate, institute private proceedings which would not be made public unless and until the parties so request or adverse findings are made against the individual or company involved.

Your committee does not expect the Commission to exercise its authority to expand administrative proceedings instituted under the other Federal securities laws prior to the effective date of this amendment. However, the Commission would not be precluded from exercising this authority in administrative proceedings instituted after

the effective date of the amendment based on violations which occurred before that date.

Sections 5(a) and (b)—Amending Sections 10(a) and (b)—Substitutions of New Concept of "Interested Person" for Former Concept of "Affiliated Person"

Section 10 of the Act requires that no more than 60 percent of the directors of a registered investment company may be affiliated persons within the meaning of the Act and that, if a registered investment company uses as principal underwriter a company with affiliated persons, then a majority of the directors of the registered investment company must be persons who are not affiliated with the principal underwriter. As discussed above in the explanation of section 2(a)(3) of the bill, the new term "interested person" introduced by this legislation is substituted for the concept of affiliated person in section 10 of the act. Your committee believes that the new concept of "interested person" meets the purposes of the act more adequately.

Section 5(c)—Amending Section 10(c)—Correcting Inconsistency in Prohibiting Persons From Serving as Directors of Investment Company

Section 10(c) of the Act prohibits a registered investment company from having a majority of its board of directors consist of officers or directors of any one bank. Section 5(c) of the bill would add the word "employee" to the first clause of section 10(c). The second clause of section 10(c) provides a limited exception from the prohibition for any registered investment company which on March 14, 1940, had as a majority of its board of directors, the officers, directors, or employees of any one bank. While the first clause does not include employees, the second clause does include them. The proposed amendment would correct this apparent inconsistency.

Section 5(d)—Amending Section 10(d)—Certain Exemptions for Bank Collective Funds for Managing Agency Accounts

Section 5(d) of the bill would amend section 10(d) of the Act to provide that, if bank collective funds for managing agency accounts are otherwise permitted by law, they shall be exempt from the provisions of sections 10(a), 10(b)(2), 10(b)(3), and 10(c) of the Act. Further, it would permit such a collective fund for managing agency accounts, maintained by a bank, to have only one director who is not an interested person of the bank. It merely extends to such collective funds, which would be required by section 12(d) of the bill to operate on a no-load basis, the same treatment accorded by section 10(d) of the Act to no-load funds managed by investment advisers who are principally engaged in the investment supervisory business. The amendment would also exempt such funds from section 10(a) of the Act, which requires that 40 percent of those persons performing the functions of directors be persons who are not officers or directors of, or otherwise affiliated with, the bank managing the fund. This amendment would also exempt such funds from section 10(b)(3) of the Act, which provides that at least a majority of the board of directors of an investment company shall be persons who are not affiliated with any investment banker.

This and other sections of the bill codify in certain respects the position of, and the administrative practice followed by, the Com-

mission in the *First National City Bank* case (Investment Company Act release No. 4538, March 9, 1966). Your committee recognizes the fact that an interest in a bank collective fund for managing agency accounts is a "security" within the meaning of the Federal securities laws and that both the disclosure and antifraud provision of the Securities Act and the broader regulatory pattern of the Act apply to such funds. This section of the bill also codifies certain exemptions from section 10(b) and 10(c) of the Act granted by the Commission in the *First National City Bank* case. Section 10(b) now requires that a majority of the directors of an investment company must consist of persons who are unaffiliated with the company's principal underwriter and with any investment banker. Section 10(c) requires that a majority of the directors consist of persons who are not officers or employees of any one bank. The statutory exemption from these provisions proposed by the committee would be consistent with the Commission's decision in the *First National City Bank* case.

In one respect, this amendment to section 10(d) differs from the holding in the *First National City Bank* case. Under section 10(a) of the Act, an investment company is require to have 40 percent of its board of directors consist of persons who are unaffiliated with the company's investment adviser. Under section 10(d), however, mutual funds which operate on a no-load basis and meet certain other conditions are permitted to have only one member of the board of directors who is unaffiliated with the investment adviser. The First National City Bank's collective fund for managing agency accounts did not qualify for this exemption, because the bank is not an investment adviser registered under the Investment Advisers Act. In addition, the bank was not primarily engaged in the business of investment counseling. Since it is expected that bank collective funds will be operated on a no-load basis, the committee believes they should be accorded the same treatment as section 10(d) provides for no-load funds. The amendment, therefore, permits a bank collective fund for managing agency accounts operated on a no-load basis to have a board of directors which includes only one director who is not an interest person of the bank.

Section 6—Amending Section 11(b)(2)—Deletion of Sales Charge in Exchange of Series Shares

Section 6 would delete from the Act 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. Section 11 (a) of the Act specifically prevents the imposition of sales charges when shareholders are induced to exchange their certificates for new certificates in the same or another investment company. This proposed amendment would merely subject series companies to the same treatment as other open end investment companies with respect to offers of exchange. This amendment is not intended to prohibit the imposition of reasonable transaction charges which approximate the administrative expenses incurred in connection with such transactions.

Section 7—Amending Section 12(d)(1)—Preventing the Creation and Enlargement of Fund Holding Companies

Section 7 of the bill would amend section 12(d)(1) of the Act to limit the creation and operation of new fundholding companies and the enlargement of existing companies of this type. These companies are investment companies whose portfolios consist either entirely or largely of the securities of other investment companies.

Before 1940 there were several closed-end investment companies that invested in other closed-end companies. Section 12(d)(1) of the Act sought to deal with the regulatory problems they posed by prohibiting (subject to certain exceptions) a registered investment company from purchasing more than 3 percent of the outstanding voting stock of another investment company unless it already owned 25 percent or more of such stock. This section, however, does not cope with the problems that have recently arisen in this area and that may become more acute in the future. Section 12(d)(1) applies only to purchases by registered investment companies. Hence, under existing law, a fundholding company organized under the laws of a foreign country and not subject to registration under the act can buy unlimited quantities of the securities of registered investment companies.

This gap in the statutory scheme has led to the creation of several unregistered, foreign-based fundholding companies that invest primarily in the securities of American mutual funds. The largest of these unregistered foreign-based companies, the Fund of Funds, Ltd., was organized in 1960. Its rapid growth has engendered interest in the formation of domestic registered fundholding companies that would be subject to the percentage restrictions of section 12(d)(1), and two such companies have recently registered under the Act.

The proposed amendment to section 12(d)(1) would meet these problems by permitting investment company securities to be purchased by other investment companies but only within specified limits and subject to the detailed restrictions spelled out in the section.

Under the proposed amendment to section 12(d)(1) of the act, subparagraph (A) would make it unlawful for a registered investment company and any company or companies controlled by such registered investment company to purchase or otherwise acquire securities issued by another investment company if, as a result of such transaction, the limitations contained in that subparagraph would be exceeded. It also places similar limitations on acquisitions of securities of registered investment companies by unregistered companies.

Subparagraph (B) would make it unlawful for a registered open end company, its principal underwriter or any broker-dealer registered under the Securities Exchange Act of 1934 to sell or otherwise dispose of a security issued by a registered investment company to any other investment company if, as a result of such transaction and to the knowledge of the seller, the limitations contained in that subparagraph would be exceeded.

Subparagraph (C) would make it unlawful for an investment company to purchase or otherwise acquire the securities of a registered closed en investment company if, as a result of such transaction, the limitations with respect to ownership of voting securities contained in that subparagraph would be exceeded. The stock of closed end companies is usually bought and sold in the secondary trading markets rather than through the issuance of new shares as in the case of open

end companies. Because of this fact, it would be much more difficult for a buyer or a seller to know how much of a closed end company's stock was owned by investment companies generally. Therefore, in this case, it is appropriate to have the prohibition apply to the buyer (rather than the seller as in the case of open end companies) and to apply the 10-percent test only to the holdings of the acquiring company, other investment companies with the same investment adviser, and companies controlled by such investment companies.

Subparagraph (D) would retain existing exceptions from the prohibitions against the transfer of investment company interests to other investment companies for securities received because of: *(a)* dividends; *(b)* exchange offers that have been approved by the Commission under section 11 of the act; and *(c)* plans of reorganization. None of these three items involve a new commitment by an investment company. The first item, the exception for dividends, covers only those which the issuer declares in terms of stock and not in terms of money. Dividends and capital gain distributions declared in terms of money, which the recipient may elect to apply to the purchase of additional shares, are not within this exception.

Subparagraph (E) would continue the present exception for acquisitions of interests in investment companies by unit trusts. This exception covers contractual plan companies which invest in a specific mutual fund. This subparagraph would also extend the exception to a security purchased by an investment company, the depositor of or principal underwriter for which is a broker-dealer registered under the Securities Exchange Act of 1934 or a controlled person of such a broker-dealer and investment portfolio of which consists only of that security. In the case of a purchase or acquisition by a nonregistered investment company, the recommended changes also would condition the availability of the exemption upon the existence of an agreement with the registered investment company or its principal underwriter governing *(a)* the voting of proxies and *(b)* the substitution of other securities for the underlying securities.

Subparagraph (F) would exempt from the provisions of paragraph (1) securities purchased or otherwise acquired by a registered investment company where immediately after the purchase or acquisition the registered investment company and all of its affiliated persons own not more than 3 percent of the total outstanding stock of the acquired company and neither the acquiring company nor its principal underwriter or other distributors charge a sales load which, when added to the maximum sales load applicable to the acquisition of its portfolio securities, is excessive within the meaning of section 22(b) of the Act. In order to provide protection for open-end companies and their shareholders where such companies' securities are acquired within the limitations of subparagraph (F), the subparagraph also provides that no issuer of any security purchased or acquired by a registered investment company under the subparagraph shall be obligated to redeem such securities in an amount exceeding 1 percent of the issuer's total outstanding securities during any period of less than 30 days. In addition, the restrictions on voting rights prescribed by this section would be applicable to the acquiring company.

Subparagraph (G) specifies that for the purposes of paragraph (1) of the section, the value of an investment company's total assets shall be computed as of the time of purchase or acquisition or as close

thereto as is reasonably possible. Under the Act as presently written, the Commission has the authority to institute actions in the proper U.S. district courts to seek injunctions against violations of the act and to enforce compliance with its provisions. It is contemplated that in a proper case the court would direct divestiture of securities acquired in a transaction which violated the act. Subparagraph (H) specifies that *(a)* the Commission may join as a party to an enforcement action under this section, the issuer of the security involved and *(b)* a court may issue such orders with respect to the issuer as may be necessary or appropriate for the enforcement of the statute. For example, if the court issues an order requiring divestiture, it might order, if appropriate, the issuer to withhold distribution of dividends and capital gains with respect to the securities acquired in the unlawful transaction pending compliance with the court's divestiture order. The amendment would not require any investment company to divest itself of any existing holding. Only in the case of an illegal acquisition resulting in new holdings or additions to preexisting holdings would the court have the power to direct divestiture. It will be able to do so under the proposed amendment in a flexible fashion that takes into account the varying circumstances of particular cases.

Section 7 of the bill would also make technical changes in section 12(d)(1) and 12(d)(2) of the Act to take into account the changed format of that section, but no substantive changes in section 12(d)(2) are intended.

Sections 8(a) and 8(b)—Amending Sections 15(a)(4) and 15(b)(2)—Assignment of Advisory and Underwriting Contracts

Section 15(a)(4) of the Act requires that an investment advisory contract provide for automatic termination upon its "assignment by the investment adviser." Similarly, section 15(b)(2) requires that underwriting contracts provide for automatic termination upon their "assignment by such underwriter."

Section 8(a) of the bill would amend section 15(a)(4) of the act to delete the words "by the investment adviser" and section 8(b) of the bill would amend section 15(b)(2) to delete the words "by such underwriter."

Section 2(a)(4) of the Act defines the term "assignment, " among other things, as occurring when some action is taken by persons other than the investment adviser or underwriter. Thus, under the definition, assignment includes any direct or indirect transfer of a controlling block of outstanding voting securities by a security holder of the adviser or underwriter. Section 15, however, introduces an ambiguity into the act because it refers only to an "assignment" by the adviser or underwriter itself and not by a person holding a controlling block of stock of the adviser or underwriter. The proposed amendment will remove this possible ambiguity without making a substantive change in the existing law.

Section 8(c)—Amending Section 15(c)—Approval of Advisory and Underwriting Contracts

Section 15 of the Act provides for renewal of advisory contracts and for approval and renewal of underwriting contracts by the board of directors of an investment company. The section does not require the attendance in person of the members of the board of directors at

meetings where required action is taken, even though their vote is necessary to meet the statutory requirements.

Sections 8(c) and 18 of the bill would amend section 15(c) of the Act to substitute the new concept of “interested person” for the former concept of “affiliated person” (see bill Sec. 2(a)(3)) and to provide that the voting requirements of the section can be satisfied only by directors who are personally present at a meeting at which their votes are taken. The proposed amendment is intended to assure informed voting on matters which require action by the board of directors of registered investment companies.

In addition, this section of the bill requires the investment adviser to furnish to the directors information reasonably necessary to evaluate the management contract and confirms the duty of the directors to evaluate such information in accordance with the best interests of the fund and its shareholders.

Sections 8(c) and 8(d)—Amending Sections 15(c) and 15(d)—Elimination of Outdated Reference and Section

In addition to the substantive changes, section 8(c) of the bill would delete the words “except a written agreement which was in effect prior to March 15, 1940,” in section 15(c) of the act. Section 8(d) of the bill would delete section 15(d) from the Act. That section prohibits any person after March 15, 1945, from acting as investment adviser to, or principal underwriter for, any registered investment company pursuant to a written contract in effect prior to March 15, 1940, unless such contract was renewed prior to March 15, 1945, in such form as to make it comply with sections 15(a) or 15(b). The 1940-45 period mentioned in sections 15(c) and 15(d) passed long ago, and references to it are meaningless today. There are no persons who are or will hereafter be affected by section 15(d) or the above clause of section 15(c).

Section 9(a)—Amending Section 17(f)—Cash Assets Included Under Bank Custody

Under section 17(f) of the Act, an investment company of the management type must place “its securities and similar investments” in the custody of (1) a bank, (2) a stock exchange firm subject to rules prescribed by the Commission or (3) itself, subject to rules or orders prescribed by the Commission. If a company chooses to retain the custody of its securities, it must deposit them with certain specified institutions for safekeeping, subject to certain rules as to access, earmarking, and inspection.

Section 9(a) of the bill would amend section 17(f) of the Act to provide that if an investment company employs a bank as custodian for “securities and similar investments,” then all of its cash assets, including proceeds from the sale of its own securities and income on its holdings shall likewise be held by a bank, subject to appropriate direction as to expenditure and disposition by proper company officials.

The proposed amendment would not require an investment company to employ a bank as custodian. If, however, a company chooses to use a bank as custodian, its shareholders would appear entitled to expect that the cash held by the company would be afforded a degree of protection similar to that given to securities. The proposed amendment would permit maintenance of a checking account or accounts in one or

more banks in amounts not to exceed the amount of the fidelity bond covering persons authorized to draw on the accounts, as required under section 17(g) of the act. It also provides that more than one bank may act as custodian. The Commission would have authority to allow specified amounts of petty cash to be held apart from bank custody.

In view of the amendments in section 5(d) and 12(d) of the bill which would facilitate the entry into the mutual fund business of collective funds maintained by banks subject to appropriate restrictions, section 9(a) of the bill would also amend clause (1) of section 17(f) of the Act to make it clear that a registered investment company which is a collective fund maintained by a bank could keep its securities and similar investments in the custody of the sponsoring bank.

The amendments to section 17(f) would also make it clear that, subject to the rulemaking power of the Commission, a registered management company or its custodian (with the consent of the management company) could deposit the securities of the management company in a central certificate depository established by a national securities exchange or a registered national securities association.

Section 9(b)—Amending Section 17(g)—Custody of Assets of Bank Collective Funds for Managing Agency Accounts

Section 9(b) of the bill would amend section 17(g) of the Act to codify the position taken administratively by the Commission in the *First National City Bank* case. It permits an officer or employee of a bank collective fund for managing agency accounts to have access to assets of the fund held in the custody of the bank if such access if "solely through position as an officer or employee of a bank."

Section 9(c)—Adding New Section 17(j)—Insider Trading in Investment Company Portfolio Securities

Section 9(c) of the bill would add a new subsection (j) to amend section 17 of the Act which would prohibit insider trading in securities held or to be acquired by a registered investment company, in convention of such rules and regulations as the Commission may adopt to define fraudulent, deceptive, and manipulative practices and to prescribe means reasonably necessary to prevent such practices. The section also would provide the Commission with specific authority to adopt rules with respect to minimum standards for codes of ethics governing trading by insiders of investment companies and with the authority to prevent such practices.

This proposal represents a response to the widely recognized need for the development of adequate restraint on the trading of investment company insiders in the companies' portfolio securities. This section would not be self-executing, but would require the adoption of rules or regulations by the Commission. Such rules or regulations could affect transactions involving securities of any issuer whose securities are owned by a registered investment company or of securities of any issuer which the investment company is contemplating purchasing, by any affiliated person of such registered investment company, any affiliated person of an investment adviser or such company, or any affiliated person of such underwriter.

The section would permit the Commission to make rules affecting transactions by such insiders involving any securities of an issuer whose securities are owned by the investment company, or which the investment company contemplates purchasing. Thus the Commission's rules could apply to insider trading in the convertible securities, options, and warrants of issuers whose underlying securities are owned by an investment company with which the insider is affiliated.

The ability to deal with such transactions by rule is intended to permit the Commission to draw flexible guidelines to prohibit persons affiliated with investment companies, their advisers and principal underwriters, from engaging in securities transactions for their personal accounts when such transactions are likely to conflict with the investment programs of their companies.

Section 10—Amending Section 18(f)(2)—Modification of Definition of Senior Security

Section 18(f) of the Act makes it unlawful for any registered open end investment company to issue or sell any senior security. The term "senior security" does not, under section 18(f)(2), include shares of a particular "series" the holders of which are preferred over the holders of all other series in respect of assets specifically allocated to that series.

A number of "series companies" existed at the time the Act was passed, and new "series companies" have subsequently been created. Each of these companies is a single registered investment company. Thus, at present, matters affecting the interests of holders of share of a particular series are voted on by the holders of shares of all existing series and such vote may be controlled by the holders of an unaffected series. In effect, the shareholders of different series, whose interests may be inconsistent, are lumped together.

Section 10 of the bill would amend section 18(f)(2) to give the Commission specific power by rule, regulation, or order to require that any matter affecting shareholders of any series of shares issued by such companies, including the election of directors, be voted upon separately by such series.

Although it is contemplated that any such rule may provide that approval of stockholders holding a certain percentage of stock is necessary for the election of directors, it is not intended that the authority granted by this amendment would be used to require that a company set up groups of individuals for each series with functions similar to those of the company's overall board of directors. Similarly, it is not intended that any rule would relieve the company of any requirements with respect to voting that may be applicable under State law. A majority of the outstanding voting securities of a class or series would be computed in the manner set forth in section 2(a)(40) of the Act.

Section 11—Adding New Section 19(b)—Distribution of Long-Term Capital Gains

Section 11 of the bill would amend section 19 of the Act by adding a new subsection (b), which would prohibit registered investment companies from distributing realized long-term capital gains more frequently than once every 12 months except as the Commission may

permit by rule, regulation, or order in the public interest and for the protection of investors.

At present the Act does not limit the frequency with which investment companies may distribute their realized long-term capital gains. Section 19 of the present Act, which would be designated section 19(a), prohibits investment companies from making any distribution in the nature of a dividend payment other than from certain defined sources unless such payment is accompanied by a written statement which adequately discloses the source or sources of such payment. It also empowers the Commission to prescribe the form of such statement by rules and regulations in the public interest and for the protection of investors.

This proposed amendment would incorporate into the act views expressed in the Investment Company Institute's "Guide to Business Standards." The guide states that no member should make a distribution of "realized capital gains to shareholders in a manner that would indicate that capital gains distributions are part of regular dividends from investment income" and recognizes that "distributions of capital gains other than at fiscal yearends, or soon thereafter, could have such an effect." This amendment would minimize any confusion on the part of investors which might arise from their failure to differentiate regular distributions of capital gains from distributions of investment income. It would not interfere with the ability of registered investment companies to comply with applicable provisions of the Internal Revenue Code. In addition, the Commission could be [sic] rule or regulation permit registered investment companies to take advantage of the "spillover" provisions of the Internal Revenue Code under which certain distributions made after the close of a taxpayer year are considered as made during such taxable year. Among other things, the Commission by rule could likewise permit such a company to change its regular pattern of annual distributions.

Section 12(a)—Amending Section 22(b)—Sales Charges

Section 12(a) of the bill would amend section 22(b) of the Act to provide that a registered securities association may by rule prohibit its members from offering redeemable securities at a price which includes an "excessive" sales load and that the Commission may by its rules alter or supplement the rules of such association in the manner provided for by section 15A(k)(2) of the Securities Exchange Act. An underwriter of these type securities who is not a member of an association may elect to be governed either by the rules or an association or by rules prescribed by the Commission with respect to excessive sales loads.

To assure that fair consideration is given to the interests of both sellers and investors, your committee has directed that the association and the Commission, in formulating rules as to excessive sales loads, "shall allow for reasonable compensation for sales personnel, broker-dealers, and underwriters, and for reasonable sales loads to investors." This does not mean that such rules must preserve the current level of profitability of every salesman, broker-dealer, or underwriter in the business, irrespective of efficiency. It does mean, however, that consideration must be given to

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the nature and quantity of services necessary to effect the proper distribution of fund shares to the public.

The provision for "reasonable loads to investors" is intended to assure that the sales loads fixed by the principal underwriters (which continue to be protected against price competition by section 22(d) of the Act) will be established at levels which recognize the interests of investors. These provisions also contemplate that, if warranted, the rules might include provisions for higher sales loads in situations where relatively more selling effort is required. They will also permit flexible treatment of the problem of sales loads on automatic investment of dividends, which involve little or no new selling effort.

It is contemplated that the adoption of rules defining and prohibiting excessive sales loads will be based on a prompt study by the National Association of Securities Dealers, Inc., of all relevant factors. For this reason, the authority of the Commission to alter or supplement the rules of a securities association commences 18 months after the effective date of the Act.

The provisions of this proposed section shall prevail over any conflicting provisions of Federal law. This provision, which is identical to section 15A(n) of the Securities Exchange Act, is designed to make it clear that no other provision of Federal law, including the antitrust laws, prevents a registered securities association from adopting rules consistent with, and necessary to effectuate, the purposes and provisions of this section.

Section 12(b)—Amending Section 22(c)—Clarifying Commission's Authority to Regulate the Pricing of Investment Company Shares for the Purpose of Sale, Repurchase, and Redemption

Section 22(a) of the Act authorizes a registered securities association to make rules respecting the method for pricing of mutual fund shares for sales, redemptions, and repurchases for the purposes of "eliminating or reducing so far as reasonably practical any dilution of the value of such purchase, redemption, or sale, which is unfair to holders of such other outstanding securities. . . ."

Section 22(c) of the Act authorizes the Commission to make rules and regulations, applicable to both members and nonmembers of the NASD, covering the same subject matter and for the accomplishment of the same ends prescribed in Section 22(a). Section 22(c) further provides that any rules and regulations made by the Commission supersede any NASD rules made on the same subject matter.

Section 22(c) provides that the Commission's rules shall be applicable to "principal underwriters of and dealers in, the redeemable securities of any registered investment company. . . ." The section does not specifically state that such rules shall be applicable to the registered investment company. Because of this wording, it has been suggested that the Commission's rule-making power with respect to pricing of mutual fund shares does not extend to the registered investment company itself.

Your committee believes that the rule-making power given in section 22(c), together with the general rule-making power given in section 38(a), extends to registered investment companies. Indeed, to interpret the section otherwise would allow mutual funds to fix the times as of when net asset value of their shares are to be computed in circumvention of the Commission's regulation of underwriters' and

dealers' time of pricing of the same shares. For example, in some cases the Commission rules would apply to the timing of the calculation of net asset value of shares for sale and repurchase by dealers and underwriters, and a different time might be used for calculation of net asset value for redemptions of shares of the same company, subverting one of the main purposes of the section.

Argument on this question will be obviated, however, by the proposed amendment to section 22(c) which makes it clear that the Commission's rulemaking power extends to the registered investment company.

Section 12(c)—Amending Section 22(d)—Deletion of Language Required by Proposed Amendments

Section 12(c) of the bill would amend section 22(d) of the Act to conform that section to the proposed amendment to section 11(b) of the act by deleting reference to clause (2) of section 11(b) in section 22(d) of the Act. Section 22(d) of the Act provides, in relevant part, that it shall not prevent a sale made "pursuant to an offer of exchange permitted by section 11 hereof including any offer made pursuant to clause (1) or (2) of section 11(b)." Section 6 of the bill would delete clause (2) of section 11(b) from the Act.

Section 12(d)—Adding New Subsection 22(h)—Limitations on Banks and Savings and Loan Associations Engaging in Certain Investment Company Activities

Section 12(d) of the bill would add a new subsection 22(h) to the Act which would provide that, if banks and savings and loan association are not prohibited by other provisions of law from creating or operating a registered investment company which is a collective fund for the investment of managing agency accounts and for funding direct investments by individual members of the public, they shall do so subject to certain requirements; namely, that the bank or savings and loan associations issue the securities at no sales load and comply with applicable regulations of the Comptroller of the Currency and the Federal Home Loan Bank Board.

These collective funds for managing agency accounts are essentially the same as mutual funds. Accordingly, this subsection recognizes that investors in such collective funds for managing agency accounts ought to receive the same protections under the Securities Act and the Act as do mutual fund shareholders. This amendment provides that any such fund shall be a "registered investment company," and proposed sections 5(d) and 9(a) of the bill amend the Act with specific reference to requirements regarding such funds. Since the exemption from the registration requirements of the Securities Act in section 27(b) and the exemptions of this bill do not include securities issued by such funds, they are subject to all provisions of those acts.

This section would also allow banks and savings and loan companies to participate in the underwriting, distribution, and sale of securities issued by registered investment companies for sale through such banks if the securities are sold at a price which does not include a sales load.

Interests in all accounts under this section can only be sold by bank and savings and loan employees who meet standards with respect to training and experience as the Comptroller of the Currency and the Federal Home Loan Bank Board shall prescribe. These regulations

shall be consistent with the rules and regulations promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934.

Section 13(a)—Amending Section 24(d)—Updating of a Statutory Reference

Section 13(a) of the bill would amend section 24(d) to refer to section 4(3) of the Securities Act of 1933. Among other things, section 24(d) of the Act states that the exemption provided by clause 3 of section 4(1) of the Securities Act of 1933 shall not be applicable to face amount certificate companies, open-end management companies, or unit investment trusts. When the Securities Act of 1933 was amended in 1964, what had previously been the third clause of section 4(1) became section 4(3).

Section 13(b)—Adding Section 24(f)—Permitting Retroactive Registration of Investment Company Securities

Occasionally, due to inadvertence, a registered investment company making a continuous offering of its securities, sells more shares than are covered by its registration statement under the Securities Act of 1933. Although the number of shares sold in excess of those registered are not registered under the act, in practical effect no investor is harmed if each offeree or purchaser is given a current prospectus. However, the inadvertence may result in a violation of Section 5 of the Securities Act and any person who can show that his shares were not actually registered might be entitled to the rescission rights given by Section 12 of the Securities Act.

Section 13(b) of the bill would add a new Section 24(f) to the Act to permit the Commission to adopt rules allowing retroactive registration of securities sold in excess of the number of securities included in an effective registration statement upon payment of three times the normal registration fee for such shares. The section also permits the Commission additional flexibility, if it so desires, to adopt rules to permit certain types of investment companies to register an indefinite number of shares.

Section 14—Amending Section 25(c)—Reorganization Standards

Section 25(c) of the Act now authorizes any district court of the United States, upon proceedings instituted by the Commission, to enjoin the consummation of any plan of reorganization of a registered investment company only "if such court shall determine any such plan to be grossly unfair or to constitute gross misconduct or gross abuse of trust on the part of the officers, directors, or investment advisers of such registered company or other sponsors of such plan."

Section 14 would amend section 25(c) of the Act to provide that a court may, upon proceedings instituted by the Commission, enjoin the consummation of any plan of reorganization of a registered investment company which the court finds not "fair and equitable" to all persons affected.

The proposed amendment would eliminate a standard which unduly restricts courts from passing upon plans of reorganization of registered investment companies. It would replace this standard with the "fair and equitable" standard which has had a long history of judicial interpretation in equity receiverships and reorganizations under section 77B and chapter X of the Bankruptcy Act and section 11(e) of

the Public Utility Holding Company Act. It would thus place the courts in a better position to carry out the congressional intent of protecting the security holders of the investment company when a plan or reorganization is filed.

Section 14(a)—Amending Section 26—Substitution of Underlying Investments of Unit Investment Trust

Section 26(a)(4)(B) of the Act now requires that the trust instrument of a unit investment trust provide that the sponsor or trustee will notify the shareholders of the unit investment trust within 5 days after a substitution of the underlying securities.

Section 15(a) of the bill would add a new subsection (b) to section 26 of the Act to make it unlawful for any depositor or trustee of a registered unit investment trust holding the security of a single issuer to substitute underlying securities without Commission approval.

The proposed amendment recognizes that in the case of a unit investment trust holding the securities of a single issuer notification to shareholders does not provide adequate protection since the only relief available to the shareholders, if dissatisfied, would be to redeem their shares. A shareholder who redeems and reinvests the proceeds in another unit investment trust or in an open-end company would under most circumstances be subject to a new sales load. The proposed amendment would close this gap in shareholder protection by providing for Commission approval of the substitution. The Commission would be required to issue an order approving the substitution if it finds the substitution consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

Section 15(b)—Amending Redesignated Section 26(c)—Technical Corrections

Section 15(b) of the bill makes only technical corrections to redesignated section 26(c) of the act.

Section 16—Amending Section 27—Periodic Payment Plans

Under the current provisions of section 27(a), the total sales load on a contractual plan may not exceed 9 percent of the total payments to be made under the plan, but can include up to 50 percent of the investors total payments made during the first year. This means, for example, that under a 10-year, $6,000 plan involving a total sales load of $540, more than half of the total sales load, or $300, can be deducted from the $600 paid by the investor during the first year. This arrangement imposes a disproportionate burden on an investor who is unable or unwilling to continue making payments over the full life of the plan.

The first alternative would alleviate this problem by providing that not more than 20 percent of any one year’s payments may be deducted for sales load, and the entire deduction during the first 4 years may not exceed 64 percent. This change would permit the seller of a plan to continue to collect approximately the same amount of sales load over the first 3 or 4 years (at the seller’s election) as he does under the present law. However, the load would be spread out more evenly over that period. For example, instead of the present situation in which typical deductions might be 50 percent in the first year and 4.5 percent in each of the next 3 years (averaging 15.9 percent), a seller would be

permitted to deduct 16 percent over the entire 4-year period or 20 percent in each of the first 3 years and 4 percent in the fourth year (in each case averaging 16 percent).

Under this alternative it would not be necessary that the same sales load be imposed during each of the first 4 years of the plan, but the sales load deductions from all of the monthly payments within any one of those years would have to be uniform, as would the sales load on all payments after the 48th monthly payment. This provision, which corresponds to a provision found in the present law, is designed to discourage unduly complicated sales load schedules which investors might have difficulty in understanding.

This proposed section does not change the provision of present law which limits the sales load on the entire plan to 9 percent of the total payments to be made.

The problem inherent in the front-end load are presented in aggravated form when the investor is induced to make a number of monthly payments in advance. For example, if an investor in a $50-a-month plan is induced to make a lump-sum payment of $600 —equivalent to his entire first year's payments—at the inception of the plan, he may pay a sales load of $300. Even under the changes proposed in this bill, he could still be required to pay a sales load of $120, which is more than twice the generally prevailing sales load for direct purchases of mutual fund shares. Your committee believes that this practice is totally inconsistent with the industry's justification of the front-end load—that it is necessary to provide adequate compensation for the sale of mutual fund shares to people who are only able to invest small amounts of money at a given time.

Accordingly, this section would provide that the sales load on the excess paid by an investor in any month over the minimum monthly payment called for by the plan may not exceed the sales load applicable to payments subsequent to the first 48 monthly payments under the plan. For example, if an investor bought a 10-year $50-a-month plan with a sales load of 16 percent on the first 48 monthly payments and 4 percent on subsequent payments, and made an initial payment of $600, the sales load would be $30, obtained by adding $8, or 16 percent of the first $50, to $22, or 4 percent of the remaining $550. Of course, plan sellers are not required to accept prepayments. This provision is not intended to apply to normal and minor variations, such as payment on a quarterly, rather than monthly basis, or the payment of arrears by an investor who is delinquent in his scheduled payments.

The committee understands that there are unusual situations in which it may be to the advantage of the investor to make a lump-sum payment under a plan rather than to invest the same amount directly in the underlying shares. We do not intend to discourage plan sellers from soliciting or accepting prepayments under these circumstances, an we expect the Commission, under its power to grant exemptions by rule, regulation, or order, to deal with this problem.

As an alternative to the "spread load" provision described above, the bill provides that a contractual plan may retain the presently authorized front-end load, that is, 50 percent of the first year's payments, provided that if an investor elects for any reason whatsoever to redeem his underlying shares for cash during the first year, he is entitled to receive a refund of the amount by which all sales charges paid by him exceed 20 percent of the total payments made under his plan. Under

this alternative, contractual plan sponsors are required to give plan holders notification of their refund privileges.

The bill provides rulemaking power for the Commission to assure that the contractual plan sponsor has adequate reserves with reasonable flexibility under the net capital rule to meet the contingent liability which may occur under the refund provision. The Commission has further rulemaking authority to require adequate and meaningful notice to investors regarding their rights under the refund provision.

This section of the reported bill further provides that investors may receive a full refund of all sales charges if they choose to cancel the plan within 30 days of the mailing of the notice specified by section 27(f) of the Act. The notice of the refund provision under section 27(f) would have to be sent within 60 days after the issuance of the certificate.

Section 17—Amending Section 28 of the Act—Face-Amount Certificates

Unlike contractual plans, the face-amount certificate plans dealt with in section 28 of the Act are debt securities. However, the loading arrangement in the face-amount certificate plan is analogous to that of the contractual plan.

The issuer of a face-amount certificate promises to pay its holder a fixed sum of money upon the maturity of the certificate, and certain lesser fixed sums if the certificate is surrendered prior to maturity. Section 28 of the Act requires a face-amount certificate company to establish certain minimum reserves and to pay into those reserves stipulated percentages of the certificate holders' gross payment or payments. The difference between the investor's payment or payments and the portion of those payments that must be put into the reserve is available to the company (the issuer) to meet its expenses, including sales expenses and administrative costs.

Section 28(a)(2)(A) now limits that difference by providing that payments into the reserve for the first certificate year shall amount to at least 50 percent of the purchaser's required gross annual payment. It also provides for reserve payments in the second to fifth certificate years, inclusive, of at least 93 percent of the gross annual payment and for reserve payments of at least 96 percent of each subsequent year's gross annual payment. The aggregate reserve payments must amount of at least 93 percent of the aggregate payments to be made under the certificate.

Section 17 of the bill would add a new subsection (i) to section 28 under which:

(1) The existing provisions of section 28 will continue to apply in all respects to all face amount certificates issued prior to the subsection's effective date as well as to new certificates issued pursuant to the terms of such outstanding certificates.

(2) With respect to certificates issued after the effective date of the subsection—

> *(a)* The reserve payment or payments for the first 3 certificate years must amount to at least 80 percent of the required gross annual payment for those years, instead of the present 50 percent in the first year, with 93 percent in the second to the fifth years, inclusive.

(b) The reserve payment or payments for the fourth certificate year must amount to at least 90 percent of the gross annual payment required in the fourth year.

(c) The reserve payment or payments for the fifth certificate year must amount to at least 93 percent of the gross annual payment required in this year.

(d) Reserve payments for years subsequent to the fifth certificate year must amount to at least 96 percent of the required gross annual payments.

Section 18—Amending Section 32(a)—Selection of Independent Auditors

Section 32(a) of the Act provides for the selection of independent auditors by the board of directors of an investment company. Section 18 of the bill would amend this section of the Act to substitute the new concept of "interested person" for the former concept of "affiliated person" (see bill section 2(a)(3) and to provide that the voting requirements of section 32 can be satisfied only by directors who are personally present at a meeting at which their votes are taken. The proposed amendment is intended to assure informed voting on matters which require action by the board of directors of registered investment companies.

Section 19—Amending Section 33—Transmission to the Commission of Papers Filed in Shareholder Actions

Section 33 of the Act now requires registered investment companies and their affiliated persons who are defendants in derivative suits involving "an alleged breach of official duty" to transmit to the Commission copies of the pleadings and the record in such actions after a verdict or final judgment on the merits has been rendered or a settlement or compromise of the action has been approved by a court of competent jurisdiction.

Section 19 of the bill would amend section 33 of the Act to require prompt filing with the Commission of copies of all pleadings, settlements, discontinuances, or judgments served or filed in suits by a registered investment company or a security holder thereof against an officer, director, investment adviser, trustee, or depositor of such company. In addition, the section would require that copies of motions and other documents be filed with the Commission if it requests them.

The proposed amendment would permit the Commission to be kept informed of the progress of the litigation from its outset at the trial court, and would make it possible for the Commission to promptly take such action as may be appropriate.

It is contemplated that the proposed amendment would be administered to eliminate, insofar as possible, duplicative filings in cases involving multiple defendants.

Section 20—Amending Section 36—Breach of Fiduciary Duty

Section 36 of the Act presently authorizes the Commission to bring an action in the U.S. district courts to enjoin persons from acting in relation to an investment company if such a person has been guilty of gross misconduct or gross abuse of trust.

The structure of the existing section seriously impairs the ability of the courts to deal flexibly and adequately with wrongdoing by certain

affiliated persons of investment companies. Therefore, proposed section 36(a) would authorize actions to enjoin breaches of fiduciary duty involving personal misconduct. It also empowers the courts to grant such relief as it finds necessary or appropriate. The amended section will enable the Commission to move against officers, directors, and advisory board members of an investment company and its investment advisers or principal underwriters if they engage or are about to engage in conduct which violates prevailing standards of fiduciary duty involving personal misconduct.

This section is intended to deal only with such violations committed by individuals. It is not intended to provide a basis for the Commission to undertake a general revision of the practices or structures of the investment company industry. On the other hand, your committee does not intend to limit the Commission under this section to situations where an actual intent to violate the law can be shown or to acts of affirmative misconduct. In appropriate cases, nonfeasance of duty or abdication of responsibility would constitute a breach of fiduciary duty involving personal misconduct.

In the area of management fees, your committee has added a new section 36(b) to the Act which imposes on the mutual fund adviser a fiduciary duty with respect to compensation or payments paid by the investment company, or by its security holders, to the investment adviser or to an affiliated person of such adviser. It provides a judicial remedy for breach of such fiduciary duty. It also authorizes suit against certain other persons who have a fiduciary duty with respect to payments made to them by the investment company.

In the event that court action is brought to enforce this fiduciary duty of the investment adviser as to compensation or payments received by him, it is intended that the court look at all the facts in connection with the determination and receipt of such compensation, including all services rendered to the fund or its shareholders and all compensation and payments received, in order to reach a decision as to whether the adviser has properly acted as a fiduciary in relation to such compensation. In the case of fund complexes, this could, under certain circumstances, include consideration of services rendered by such investment advisers to other funds in such complex and compensation or payments made by such other funds for such services.

The directors of a fund have the initial responsibility of approving management contracts. Section 36(b)(2) therefore instructs the courts to consider the approval given by the directors of the fund to such compensation and provides that their approval shall be given such consideration as the court deems appropriate under all the circumstances. Among other things, the court might wish to evaluate whether the deliberations of the directors were a matter of substance or a mere formality. (However, such consideration would not be controlling in determining whether or not the fee encompassed a breach of fiduciary duty.) To assist the directors in discharging their duties, section 15(c) of the Act (see bill section 8(c) above) requires the investment adviser to furnish to the directors information reasonably necessary to evaluate the management contract and confirms the duty of the directors to evaluate such information in accordance with the best interests of the fund and its shareholders.

The approval by shareholders of the management fee is also to be given such consideration as the court may deem appropriate under all the circumstances. Thus, upon a challenge in court to compensation or payments, the ultimate test, even if the compensation or payments are approved by the directors and stockholders, will not be whether it involves a "waste" of corporate assets but will be whether the investment adviser has fulfilled his fiduciary duty to the mutual fund shareholders in determining the fee.

Section 36(b) authorizes the Commission and also a shareholder acting on behalf of the fund to institute an equitable action involving a claim of breach of fiduciary duty. The section makes it explicit that the Commission or any other plaintiff has the burden of proving to the satisfaction of the court that the defendant has committed a breach of fiduciary duty. This burden of proof is used in order to attempt to eliminate nuisance suits designed to harass defendants.

An action for breach of fiduciary duty may be brought not only against the investment adviser but also against any officer, director, member of any advisory committee, depositor, or principal underwriter of the investment company who, under the circumstances, may also have a fiduciary duty in respect to the payments received. The fiduciary duty of the investment adviser is extended not only to compensation paid to the investment adviser but also to payments made by the investment company or its shareholders to an affiliated person of the investment adviser. This provision affords a remedy if the investment adviser should try to evade liability by arranging for payments to be made not to the adviser itself but to an affiliated person of the adviser.

Section 36(b) authorizes an action only against the recipient of the compensation or payments. Damages may be recovered only from a recipient of the payments and are not recoverable for any period prior to 1 years before the action was instituted. An award of damages against any recipient is limited to actual damages resulting from the breach of fiduciary duty and may not exceed the amount of the payments received by such recipient from the investment company or its security holders. Action under this section may be brought only in an appropriate Federal court.

Although section 36(b) provides for an equitable action for breach of fiduciary duty as does section 36(a), the fact that subsection (b) specifically provides for a private right of action should not be read by implication to affect subsection (a).

Sections 21 and 22—Amending Sections 43(a) and (44)—Updating Statutory References

Sections 21 and 22 of the bill would amend sections 43(a) and 44 of the Act, respectively, to conform references to the Judicial Code with the present designation of the sections involved. Section 43(a) provides for court review of Commission orders. It refers to sections 239 and 240 of the Judicial Code which have been redesignated section 1254 of title 28 of the United States Code, as amended. Similarly, section 44, which gives the district courts of the United States jurisdiction of violations of the act or rules and regulations thereunder, refers to sections 128 and 240 of the Judicial Code, as amended, which have been redesignated as sections 1254 and 1291—1294 of title 28 of the United States Code.

Section 28(b)—Adding New Subsection 3(a)(19) to the Securities Exchange Act of 1934—Definition of "Investment Company," "Affiliated Person," Insurance Company," and "Separate Account"

Section 28(b) of the bill would add a new subsection 3(a)(19) to the Securities Exchange Act which provides that the terms "investment company," "affiliated person," "insurance company," and "separate account" have the same meaning as in the Investment Company Act (Section 2(a)(4) of the bill would add the definition of the term "separate account" to the Investment Company Act, and the description of section 2(a)(4) of the bill discusses that definition.)

Section 28(c)—Adding New Subsection 12(g)(2)(H) to the Securities Exchange Act of 1934—Exemption for Certain Bank Common and Collective Trust Funds and Insurance Company Separate Accounts

Section 28(c) of the bill would add new subsection 12(g)(2)(H) to the Securities Exchange Act to exempt from the registration requirements of section 12(g) of the act certain bank common trust funds, and certain bank collective trust funds. Certain insurance company separate accounts issuing interests or participations with respect to corporate plans or H.R. 10 plans which meet the requirements for qualification under section 401 of the code would also be exempt.

Section 29 (a) and (b)—Amending Section 6 and 15(b)(1) of the Securities Exchange Act of 1934—Fingerprinting of Securities Industry Personnel

Section 29(a) of the bill would add a new subsection 6(g) to the Securities Exchange Act of 1934 to require that personnel of any national securities exchange should, as a condition of employment, be fingerprinted. The amendment would also grant the commission broad rule-making power to provide for the effective functioning of this section. Your committee has been concerned with the reports of increasing stock certificate thefts, and it is believed that a fingerprinting program can be an effective method of dealing with this problem.

Section 29(b) of the bill would amend Section 15(b)(1) of the Exchange Act to impose the same fingerprinting requirement on personnel of all registered broker-dealers.

Section 30—Amending the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment company Act of 1940—Concerning Certain Life Insurance Benefits Issued Prior to March 23, 1959

Section 29 provides that the provisions of the Securities Act of 1933, Securities Exchange Act of 1934, and the Investment Company Act of 1940 shall not apply, except for definitional purposes, to any interest or participation in any contract, certificate or policy providing for life insurance benefits which included a separate account the proceeds of which were shared by all who completed the terms of the contract and which were issued prior to March 23, 1959, the date of the decision in *SEC V. Variable Annuity Life Insurance Company of America*, 359 U.S. 65. These exemptions apply if (1) the form of the contract, certificate, or policy was approved by the insurance commissioner, or similar official or agency, of a State, territory or the District of Columbia and (2) if under such contract, certificate, or policy not more than 49 percent of the gross premiums or other consideration paid

were to be allocated to a separate account or other fund providing for the sharing of income or gains and losses.

Section 31—Effective Dates

Bill sections 16 and 17 (front-end load on contractual plans and face-amount certificates) to be effective 6 months after enactment.

Bill sections 5 (a) and (b) (substituting new concept of "interested person" in Sections 10 (a) and (b) of the Act); section 5 (c) (correcting inconsistency in prohibiting persons from serving as directors of investment company); section 9(a) (cash assets included under bank custody); section 11 (distribution of long-term capital gains); section 18 (selection of independent auditors); section 24(a) (removing exemption in Advisers Act for investment advisers to investment companies); section 25 (investment advisory contract) and that part of bill section 5(d) which substitutes the concept of "interested persons" for the concept of "affiliated persons" in Section 10(d) of the Act to be effective one year after enactment.

That part of bill section 20 which adds section 36(b) to the act (breach of fiduciary duty) to be effective 18 months after enactment.

CONCLUSION

The reported bill, in addition to updating the Act and making many valuable technical changes, will provide significant safeguards to investors. This legislation has been very thoroughly and carefully studied, and extensive hearings have been held in both the 90th and the 91st Congresses. Your committee, having deliberated very carefully, urges passage of this bill.

The Department generally supports the objectives of S. 2224 and H.R. 8080. In our view, the provisions of S. 2224 relating to those issues on which we have expressed views are preferable to relevant provisions of H.R. 8060. We defer to the Securities and Exchange Commission concerning other, detailed, provisions of these bills.

The Bureau of the Budget has advised that there is no objection to the submission of this report from the standpoint of the Administration's program.

Sincerely,

RICHARD G. KLEINDIENST,
Deputy Attorney General.

DEPARTMENT OF JUSTICE,
OFFICE OF THE DEPUTY ATTORNEY GENERAL,
Washington, D.C., November 26, 1969.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your request for the views of the Department of Justice on H.R. 12867[1] a bill to amend the Investment Company Act of 1940 and the Investment Advisors Act of 1940. This Department recently commented to the Committee on a similar bill, S. 2224.

H.R. 12867 would provide that if a mutual fund which has at least 50 percent of the board of directors made up of unaffiliated and disinterested person obtains approval of a management or distribution contract by a two-thirds vote of outstanding shares and all of the affiliated directors, the contract will be exempt from the review by the Securities and Exchange Commission and the National Association of Securities Dealers concerning management and sales commissions.

Our comments on S. 2224 indicated we believe that its provisions would allow sufficient scope for private management of funds while at the same time preventing unreasonable management compensation. The standard proposed by H.R. 12867 would appear to give immunity to the determination of management fees and compensation by mutual funds. Accordingly, we favor the provisions of S. 2224 as the more desirable.

H.R. 12867 would continue to effect the provisions of Section 22(d) of the Investment Company Act which prescribes a unique scheme of retail price maintenance for sales charges levied in distributing mutual fund shares to the public. We noted in our comments on S. 2224 that the Senate Banking and Currency Committee has asked the SEC for a report on the consequences of deleting Section 22(d), and has proposed that the section be amended to permit associations of securities dealers registered with the SEC to adopt rules prohibiting excessive mutual fund sales charges. We noted further that while these steps are not inappropriate as interim measures the Department believes that continued attention should be given to abolition or amendment of Section 22(d) and that price competition in sales commissions can be permitted with advantage to investors.

With reference to the other detailed provisions of the bill, the Department defers to the Securities and Exchange Commission.

The Bureau of the Budget has advised that there is no objection to the submission of this report from the standpoint of the Administration's program.

Sincerely,

RICHARD G. KLEINDIENST,
Deputy Attorney General.

SECURITIES AND EXCHANGE COMMISSION—JULY 9, 1969

MEMORANDUM OF THE SEC ON H.R. 11995 AND S. 2224 TO THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, HOUSE OF REPRESENTATIVES

This memorandum, written in response to a request by the Committee, sets forth the Commission's views on H.R. 11995 and S. 2224, which embody the pending mutual fund legislation. S. 2224 was favorably reported by the Senate Committee on Banking and Currency with no opposition and was passed by the Senate by unanimous voice vote on May 26, 1969.

Of course, your Committee is fully aware of the history of these efforts to achieve meaningful mutual fund legislation—which led to passage by the Senate

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[1] Superseded by H.R. 14737.

of S. 3724 in July 1968, and of S. 2224 on May 6, 1969. As Senator Sparkman pointed out during the floor debate last year, this has certainly been one of the most carefully studied pieces of legislation to come before the Conges in recent years.

This effort began more than a decade ago, in 1958, with the engagement of the Wharton School by the Commission to produce a study of the mutual fund industry. Their report was issued in 1969[1].

Subsequently, the Special Study of the Securities Markets examined mutual fund sales practices, especially the sale of contractual plans, and in 1963 that Study was forwarded to the Congress.[2] Among other things, that Study found the operation of contractual plans inimical to the interests of small investors and it recommended abolition of “front-end load” arrangements in the sale of fund shares, that is deduction of up to one half of the first year’s payments for sales charges. The Special Study led to significant amendments to the Securities Exchange Act of 1934,[3] but the legislation passed did not deal with the mutual fund industry; that was left for further study and examination by the Commission. Finally, in 1966, the Commission produced a comprehensive report— "Public Policy Implications of Investment Company Growth,”[4] which made legislative recommendations designed to cope with the serious problems which had developed in the fund industry since 1940 and to deal with a large number of “technical” points which had arisen over the years.

The Commission’s recommendations included: the abolition of the front-end load; the reduction of fund sales charges to a maximum 5% with the Commission empowered to increase such maximum under appropriate circumstances, as, for example, for small sales, instead of the currently prevailing 9.3%; and the establishment of a court enforced standard of reasonableness for fund management fees.

There followed the extensive consideration of these proposals by this Committee and also by the Senate Committee, referred to above. Following this, in July, 1968, the Senate passed S. 3724, which represented an effort to accomplish the major objectives of the Commission while, at the same time, meeting certain of the objections which the investment company industry had to the Commission’s proposals.

Earlier in this session, Senator Sparkman introduced S. 34, which was the same as S. 3724 in the prior session, and hearings on this legislation were held in the Senate in April. In connection with these hearings, it was suggested that the Commission and the investment company industry make a further effort to arrive at an understanding with respect to these problems and, as pointed out below, this was done and S. 2224 embodies these understandings. On June 10, 1969, Chairman Moss of your Committee’s Subcommittee on Commerce and Finance introduced H.R. 11995, which is identical to S. 2224.

In this memorandum we will not attempt a section-by-section analysis of these bills, since the Senate Committee in its report has already done this.[5] The important thing is that with respect to the principal areas of controversy between the Commission and the investment company industry, the front-end load, the sales charges and the management fees, the legislation now before you is generally acceptable both to the Commission and to the Investment Company institute.

FRONT-END LOADS

First, the bill as reported by the Senate Committee and as passed by the Senate, would not abolish the front-end load. Instead, two alternative methods for employing the front-end load are provided. Under the first alternative, contractual plans may still be sold with the presently authorized front-end load, under which up to 50% of the first year’s payments may be deducted for sales commissions, provided that if the investor elects for any reason to redeem his underlying shares for cash during the first three years he would also be entitled to receive a refund of the amount by which all sales charges paid exceed 15% of the total payments made under the plan. The Commission would be authorized to make rules and regulations specifying the form of refund notice required under this alternative and setting forth reserve requirements so that sellers may meet their refund obligations.

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[1] H. Rep. No. 2274, 37th Cong., 2d Sess. (1962).
[2] H. Doc. No. 95, 88th Cong., 1st Sess. (6 vols.) (1963).
[3] Public Law No. 467, 88th Cong., 2d Sess. (1964).
[4] H. Rep. No. 2337, 89th Cong., 2d Sess. (1966).
[5] S. Rep. No. 91-184, 91st Cong., 1st Sess. (1969).

In addition, contractual plan sellers could at their option elect a second alternative. Under this alternative, the bills specify a formula whereby the load could not exceed 20% of any payment nor average more than 16% over the first four years.

SALES LOADS

The Commission's proposals would have limited the sales load for investment company shares to five per cent of the amount received and invested by the investment company, subject to authority in the Commission to grant exemptions from this provision. Section 12(a) of H.R. 11995 and S. 2224 would replace this provision with a grant of jurisdiction to the National Association of Securities Dealers, Inc., to adopt rules designed to prevent "excessive sales loads" but allowing for reasonable compensation for sales personnel, broker-dealers, and underwriters and for reasonable sales loads to be charged to investors. The Commission would be authorized, after the expiration of 18 months from the enactment of the bill, to alter or supplement such rules of the NASD in the manner provided in Section 15A(k)(2) of the Securities Exchange Act and would also be granted authority, comparable to that of the NASD, with respect to sales loads charged by dealers who are not members of that Association, but such nonmember dealers would have an election to be governed either by the Commission's rules or by the NASD's rules.

MANAGEMENT FEES

The third major area in which the Commission made recommendations was that of management fees. The Commission had recommended that the Investment Company Act should be changed to specify that management fees should be reasonable and to provide for court enforcement of this standard. S. 3724, passed by the Senate in July 1968, substantially adopted that recommendation with certain additional changes designed to meet some of the objections of the industry. S. 34, precursor to the present bill, contained the same provisions. However, the industry continued to oppose the form of the management fee amendments, although no one objected to the basic proposition that management fees should be reasonable.

The Commission had consulted with industry representatives from time to time and had repeatedly expressed its willingness to attempt to work out provisions in this area which would be acceptable to the industry as well as the Commission. Following the April 1969 Senate hearings, the Commission and industry representatives resumed their discussions on this matter and in May 1969 agreed on and jointly submitted to the Senate Banking Committee, a provision in substitution of the reasonableness standard which would specify that the investment adviser has a fiduciary duty with respect to management fee compensation. This is in accord with the Commission's recommendation that the present effective standard of "waste" under state law, and gross abuse of trust under Section 36 of the Act as applied to management fees, be replaced with a more meaningful standard.

The Senate banking Committee and the Senate adopted the management fee proposal n substantially the language proposed by the Commission and the industry representatives. WE understand that the industry representatives do not oppose the adoption of these provisions.

Thus, H.R. 11995 and S. 2224 add a new Section 36(b) to the Investment Company Act to specify that the adviser has a fiduciary duty with respect to compensation for services or other payments paid by the fund or its shareholders to the adviser or to affiliated persons of the adviser. Other persons enumerated in Section 36(a) who may have a similar fiduciary duty with respect to compensation or payments received by them from the fund or its shareholders may also be sued for a breach of such duty. Subsection (b) also provides that payments by the fund to affiliated persons of the adviser are subject to challenge under this section. Approval of the management fee by the directors, and shareholder ratification is to be given such consideration as the court deems appropriate in the circumstances of a particular case.

The adoption of this standard precludes the assertion of a claim of ratification, although a vote of shareholders or directors approving a management contract may be considered by the court in determining the fairness of the contract. The difficult waste test previously prevailing under state law in cases of ratification, and gross abuse of trust under present Section 36 of the Act, have thus been replaced by the more realistic standard, breach of fiduciary duty. The Com-

mission view this as a significant and meaningful improvement over the existing law and at least as helpful as the reasonableness standard of S. 34.

The Commission therefore supports these provisions as a satisfactory and even more effective method than its original proposal to test the reasonableness of mutual fund management fees.

BANK-ADMINISTERED FUNDS AND GROUP VARIABLE ANNUITIES

H.R. 11995 and S. 2224 contain provisions to deal with certain questions as to the status under the Federal securities laws, and certain other laws, of bank administered, collective managing agency accounts and bank-administered pension and welfare plans, including H.R. 10 plans. Whether banks should be allowed to enter the field of collective managing agency accounts, which resemble mutual funds, is a matter of national policy within the primary jurisdiction of the Congress. The Commission does not consider that its responsibility extends to this question and it neither expresses nor implies any views thereon.

With respect to group variable annuities administered [sic] by insurance companies, we recognize and understand the reasons which led the insurance industry to advance these proposals. Basically, they seek exemptions comparable to those afforded to banks, both under the existing provisions of the Investment Company Act and under the proposals relating to bank-administered funds contained in H.R. 11995 and S. 2224. There are, however, differences, both in method of operation and in existing regulation, between banks and the insurance companies, and at the last session of Congress, the Commission expressed a preference for dealing with the problems of the insurance industry, including its competitive problem, administrate. As we then mentioned, we have been conducting extensive discussions with representatives of the insurance industry in an effort to arrive at a satisfactory solution, and on March 6, 1969 the Commission published for comment a proposed set of rules which would deal with the status of group variable annuities under the Investment Company Act and under the Securities Act. Problems under the Securities Exchange Act have been largely resolved by administrative action. We recognize, of course, that the insurance industry would prefer the broader exemptions contained in S. 224, particularly if the banks are to expressly receive comparable legislative exemptions.

OTHER MATTERS

The bills contain over 40 other amendments, some “technical” others of substantive significance. Thus, the “gross abuse of trust” language of present Section 36 is replaced in Section 36(a) by “breach of fiduciary duty involving personal misconduct.”

Three of the “technical” amendments were introduced in the Senate subsequent to the Senate Committee Report. These amendments, involving changes in Sections 22(c), 8(b)(2), 13(a)(3) and 24 of the Investment Company Aft, were recommended jointly by the Commission and the Investment Company Institute and are explained in the appendices attached to this memorandum.

In summary, we believe the controversy over the proper way to test investment company management fees has been satisfactorily resolved consistent with investor protection. With respect to sales loads and the front end load, the Commission believes that the proposals which it advanced at the last session of Congress would more effectively insure fair treatment to investment company shareholders. On the other hand, enactment of H.R. 11995 and S. 2224 would constitute an important reform. Consequently if your Committee prefers to accept H.R. 11995 and S. 2224 we would accept that decision and support the bill.

APPENDIX A—H.R. 11995 AND S. 2224, SECTION 12(B)

TECHNICAL STATEMENT IN SUPPORT OF A PROPOSED AMENDMENT TO SECTION 22(C) OF THE INVESTMENT COMPANY ACT OF 1940 CLARIFYING THE COMMISSION’S AUTHORITY TO REGULATE THE PRICING OF INVESTMENT COMPANY SHARES FOR THE PURPOSE OF SALE, REPURCHASE, AND REDEMPTION

Section 22(a) of the Investment Company Act authorizes a securities association registered under Section 15A of the Securities Exchange Act of 1934 (i.e., the National Association of Securities Dealers, Inc. [“NASD”], to make rules respecting the method for pricing of mutual fund shares for sales, redemptions, and repurchases for the purposes of “eliminating or reducing so far as reasonably

practical any dilution of the value of such purchase, redemption, or sale which is unfair to holders of such other outstanding securities. . . .”

Section 22(c) of the Act authorizes the Commission to make rules and regulations, applicable to both members and nonmembers of the NASD, covering the same subject matter and for the accomplishment of the same ends prescribed in Section 22(a). Section 22(c) further provides that any rules and regulations made by the Commission supersede any NASD rules made on the same subject matter.[1]

Section 22(c) provides that the Commission’s rules shall be applicable to “principle underwriters of and dealers in, the redeemable securities of any registered investment company. . . .” The section does not specifically state that such rules shall be applicable to the registered investment company. Because of this wording, it has been suggested that the Commission’s rule-making power with respect to pricing of mutual fund shares does not extend to the registered investment company itself.[2]

The Commission believes that the rule-making power given in Section 22(c), together with the general rule-making power given in Section 38(a), clearly extends to registered investment companies. Indeed, to interpret the section otherwise would allow mutual funds to fix the times as of when net asset value of their shares are to be computed in circumvention of the Commission’s regulation of underwriters’ and dealers’ time of pricing of the same shares. For example, in some cases Commission rules would apply to the timing of the calculation of net asset value of shares for *sale* and *repurchase* by dealers and underwriters, and a different times might be used for calculation of net asset value for *redemptions* of shares of the same company,[3] subverting one of the main purposes of the section.[4]

Argument on this question would be obviated if the Act were more explicit. Therefore, the Commission recommends that Section 22(c) be amended to insert the phrase “to registered investment companies and” after the phrase “the Commission may make such rules and regulations applicable” in the Section.

APPENDIX B—H.R. 11995 AND S. 2224, SECTIONS 3(c) AND 3(d)

TECHNICAL STATEMENT IN SUPPORT OF PROPOSED AMENDMENTS TO SECTIONS 8 (b) (2) AND 13 (a) (3) OF THE INVESTMENT COMPANY ACT OF 1940 CLARIFYING WHICH INVESTMENT POLICIES MAY NOT BE DEVIATED FROM WITHOUT PRIOR SHAREHOLDER APPROVAL

Section 8(b)(1) of the Investment Company Act of 1940 (“Act”) requires that every registered investment company, in its registration statement filed under the Act, specifically recite its policy with respect to certain investment and other enumerated activities. Section 8(b)(2) requires a recital in the registration statement of policies “in respect of matters, not enumerated in paragraph (1), which the registrant deems matters of fundamental policy and elects to treat as such.”

Section 13 prohibits a registered investment company from deviating from the policies enumerated in Section 8(b)(1) or from any policy which it has elected to treat as “fundamental” pursuant to Section 8(b)(2) without prior shareholder approval.

The Commission believes that “fundamental”, as therein used, is simply a term which describes any investment policy which an investment company elects to make changeable only if authorized by shareholder vote, whether or not an investment company labels such a policy “fundamental”.

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[1] Rule 22c-1, adopted October 16, 1968, effective January 13, 1969, superseded NASD Rules 26(e) and 26([illegible]).

[2] In most cases sales and repurchases are handled through a dealer and underwriter, but redemptions are normally handled directly by the fund. Also, many no-load funds sell and redeem shares without using a separate underwriter or dealer.

[3] Many mutual funds designate underwriters and dealers around the country as their agents for “voluntary repurchase” of their shares. This enables shareholders to shorten the period otherwise required to transmit the actual stock certificates to the fund for statutory “redemption.”

[4] Section 1(b) of the Act requires the Commission to interpret the Act to mitigate and, so far as is feasible, to eliminate the conditions enumerated in the section which adversely affect the national public interest and the interest of investors. Section 1(b)(5) of the Act states that the national public interest and the interest of investors are adversely affected when investment companies in computing the asset value of their securities, employ unsound or misleading methods.

However, it has been argued that Section 13 is not violated when an investment company changes an investment policy without a required prior shareholder approval, unless that policy has been labeled "fundamental". In other words, it was argued that requiring prior shareholder approval for a change in investment policy does not make it "fundamental".

In *Green* v. *Brown*, 276 F. Supp. 753 (1967), the District court accepted this so-called "plain meaning" approach despite its "curious result". In the Brief, filed *Amicus Curiae* with the Court of Appeals, the Commission took the position that the term "fundamental" was simply a term which describes any investment policy which an investment company elects to make changeable only if authorized by shareholder vote. That Court, in *Green* v. *Brown*, 398 F. 2d 1006 (C.A. 2, 1968) remanded the case to the District Court with instructions to reconsider the matter with the benefit of the Commission's Brief.

Therefore, while the Commission believes that it has the authority to effect a clarification by rule,[1] to obviate further misunderstanding, it recommends that Sections 8 and 13 be amended to make it clear that deviation from an investment policy which is changeable only by shareholder vote constitutes a violation of Section 13. The amendment would also allow investment companies the opportunity to afford shareholders similar protection from deviation with respect to any other policy. Thus the amended sections would read as follows:

"Sec. 8.

(b) Every registered investment company shall file with the Commission, within such reasonable time after registration as the Commission shall fix by rules and regulations, an original and such copies of a registration statement, in such form and containing such of the following information and documents as the Commission shall by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors:

* * * * * * * * * * *

(2) [a recital of the policy of the registrant in respect of matters, not enumerated in paragraph (1), which the registrant deems matters of fundamental policy and elects to treat as such;] *a recital of all investment policies of the registrant, not enumerated in paragraph (1), which are changeable only if authorized by shareholder vote;*

* * * * * * * * * * *

(3) a recital of all policies of the registrant, not enumerated in Paragraphs (1) and (2), in respect of matters which the registrant deems matters of fundamental policy;

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[(3)] *(4)*.

(Present Paragraph (3) renumbered (4)).

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[(4)] *(5)*.

(Present Paragraph (4) renumbered (5)).

Sec. 13.

(a) No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities—

* * * * * * * * * * *

(3) deviate from its policy in respect of concentration of investment in any particular industry or group of industries as recited in its registration statement, [or deviate from any fundamental policy recited in its registration statement pursuant to Section 8(b)(2); or] *deviate from any investment policy which is changeable only if authorized by shareholder vote, or devate [sic] from any policy recited in its registration statement pursuant to Section 8(b)(3);*

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[1] In Investment Company Act Release No. 5565 (Securities Act Release No. 4939) the Commission proposed revisions of its instructions to Form N-8B-1 (and Form N-5) to effect this clarification.

TECHNICAL STATEMENT IN SUPPORT OF PROPOSED AMENDMENT TO SECTION 24 OF THE INVESTMENT COMPANY ACT OF 1940 TO ADD A NEW SUBSECTION (F) TO PERMIT RETRO-ACTIVE REGISTRATION OF INVESTMENT COMPANY SECURITIES

Occasionally, due to inadvertence, a registered investment company making a continuous offering of its securities, sells more shares than are covered by its registration statement under the Securities Act of 1933. Although the number of shares sold in excess of those registered are not registered under the act, in practical effect no investor is harmed if each offeree or purchaser is given a current prospectus. However, the inadvertence may result in a violation of Section 5 of the Securities Act and any person who can show that his shares were not actually registered might be entitled to the rescission rights given by Section 12 of the Securities Act.

This suggested Section would permit the Commission to adopt rules allowing retroactive registration of securities sold in excess of the number of securities included in an effective registration statement upon payment of three times the normal registration fee for such shares. The Section also permits the Commission additional flexibility, if it so desires, to adopt rules to permit certain types of investment companies to register an indefinite number of shares.

The text of the proposed amendment follows:

Section 24 of the Investment Company Act of 1940 is amended by adding a new Subsection (f) to read as follows:

"(f) In the case of securities issued by a face-amount certificate company or redeemable securities issued by an open-end management company or unit investment trust, which are sold in an amount in excess of the number of securities included in an effective registration statement of any such company, such company may, in accordance with such rules and regulations as the Commission shall adopt as it deems necessary or appropriate in the public interest or for the protection of investors, elect to have the registration of such securities deemed effective as of the time of their sale, upon payment to the Commission, within six months after any such sale, of a registration fee of three times the amount of the fee which would have otherwise been applicable to such securities. Upon any such election and payment, the registration statement of such company shall be considered to have been in effect with respect to such shares. The Commission may also adopt rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors to permit the registration of an indefinite number of the securities issued by a face-amount certificate company or redeemable securities issued by an open-end management company or unit investment trust."

SECURITIES AND EXCHANGE COMMISSION,
OFFICE OF THE COMMISSIONER,
Washington, D.C., November 21, 1969.

Re: H.R. 13754, 91st Congress.
Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce, House of Representatives, Rayburn House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: In the absence of Chairman Budge, I am replying to your request of September 15, 1969 for the Commission's comments on H.R. 13754. As requested, we are pleased to submit three copies of the memorandum setting forth the views of the Securities and Exchange Commission on H.R. 13754. If additional copies are desired, we will be pleased to furnish them to the Committee.

This bill supplements pending mutual fund reform legislation by eliminating the front-end load and equivalent surrender charges on future sales of an installment face-amount certificates. Our memorandum incorporates as part thereof the "Report of the Securities and Exchange Commission on Face-Amount Certificate Companies" dated August 1969, together with a summary of such report, which was prepared at the request of, and submitted to, the Senate Committee on Banking and Currency.

The Bureau of the Budget has advised that there is no objection to the submission of this memorandum from the viewpoint of the Administration's program.

Sincerely,
HUGH F. OWENS, *Commissioner.*

OCTOBER 22, 1969.

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION ON H.R. 13754 TO THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, HOUSE OF REPRESENTATIVES

This memorandum, written in response to a request by the Committee, sets forth the Commission's views on H.R. 13754, which supplements the pending mutual fund legislation (H.R. 11995 and S. 2224) by eliminating the front-end load and equivalent surrender charges on future sales of installment face-amount certificates.

The Investment Company Act of 1940 ("Act") presently limits the total sales charge on a face-amount certificate to 7 percent of the aggregate gross annual payment to maturity, but it permits as much as 50 percent of the total payments to be made from the first year's scheduled installment payments. The provisions of S. 2224 dealing with the front-end load on installment face-amount certificates would permit a front-end load if it does not exceed more than 20 percent in the first three certificate years and 10 percent in the fourth certificate year. Those provisions would not affect the front-end loads charged on most installment face-amount certificates presently sold in the United States.

The Commission has previously recommended that the Act be amended to prohibit the front-end load on the future sale of face-amount certificates. In its Report "Public Policy Implications of Investment Company Growth",[1] the Commission analyzed the payment experience on face-amount certificates as of the end of 1961 for 2,000 fifteen-year installment face amount certificates sold during July 1941 and January 1945. That data indicated that only one-third of those purchasers of face-amount certificates completed their payments. Since large portions of the first year's payment on those face-amount certificates had been taken as sales charges, "substantial numbers of face-amount certificate investors who did not complete their plans lost money because of the front-end sales load deduction."[2]

During debate of S. 2224 on the floor of the Senate, it was indicated that the Committee on Banking and Currency of the Senate had considered an amendment which would have eliminated the front-end load on face-amount certificates. However, that Committee felt that further study was needed and on May 27, 1969, it requested that we conduct an in-depth study of face-amount certificate companies and report back within three months.

It specified our study should reveal the current redemption rates on face-amount certificates, the percentage of investors who suffered losses on their purchases of these certificates, the sales techniques used by face-amount certificates, the sales techniques used by face-amount certificate companies and the economic classifications of those persons purchasing such certificates, the after-tax yields obtainable on similar alternative investments, and the economic impact on the securities industry which would result if the front-end load on face-amount certificates were abolished. We conducted such a study and our Report was submitted as requested. A copy of that Report including a summary of it is attached to this statement. (See the report of the Securities and Exchange Commission on Face-Amount Certificate Companies, dated August 1969, on p. 267 this hearing.)

When Chairman Moss of your Committee's Subcommittee on Commerce and Finance introduced H.R. 13754, he mentioned the Report and some of its conclusions. Our study reconfirmed our original conclusion that front-end load charges on face-amount certificates should not be continued. We found that the investment yield on face-amount certificates held to maturity is less than that realized on other savings programs and that the majority of purchasers of installment face-amount certificates do not continue payments under the plans to their stated maturity dates. It indicated that a large portion of those people who buy face-amount certificates lose money and that their losses are caused by the deduction of the front-end load from the early years' payments. For example, more than 55 percent of those persons who purchased the most popular 20-year face-amount certificates scheduled to mature from 1965 through 1968 lost money, by redeeming prior to the breakeven point, and more than 84 percent (face amount) failed to reach maturity as scheduled.

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[1] H. Rept. No. 2337, 89th Cong., 2d Sess. (1966).
[2] H. Rept. No. 2337, 89th Cong., 2d Sess., p. 248 (1966).

In 1965, in an effort to develop a more saleable and retainable certificate, Investors Syndicate of America, Inc., which accounts for about 95 percent of face-amount certificate companies' assets and sales, stopped issuing certificates with a 50 percent first year front-end load and began issuing certificates with lower front-end loads, an improved yield to maturity and improved first year and immediate cash values. Despite this change, the surrender experience of this company on the certificates sold during 1965 through 1968 has continued at about the same rate as prior thereto. Thus, large numbers of face-amount certificate investors having continued to experience losses on their installment certificate investments. an investors does not reach the breakeven point on most of the certificates presently sold until after eight years' payments have been made. Since the front-end load on most installment face-amount certificates is less than 20 percent in each of the first three years and less than 10 percent in the fourth year, S. 2224 would not prevent such losses.

Therefore, after examination of the information disclosed by our in-depth study, we reasserted our earlier belief that the front-end load on installment face-amount certificates is contrary to the public interest and the interest of investors and that such practice and the practice of equivalent surrender charges be discontinued. The enactment of H.R. 13754 would implement this recommendation.

SECURITIES AND EXCHANGE COMMISSION,
OFFICE OF THE COMMISSIONER,
Washington, D.C., November 24, 1969.

By Special Messenger
Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce, House of Representatives, Rayburn House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: In the absence of Chairman Budge, I am replying to your request of July 17, 1969 for the Commission's comments on H.R. 12867.[1] As you requested, we are pleased to submit three copies of the memorandum setting forth the views of the Securities and Exchange Commission on H.R. 12867. If additional copies are desired, we will be pleased to furnish them to the Committee.

This is the bill introduced by Congressman Stuckey on July 15, 1969 as a substitute for H.R. 11995. Our memorandum indicates the reasons why the Commission prefers the latter rather than Mr. Stuckey's bill.

Some portions of this comment reflect certain understandings between the Commission and representatives of the industry which we thought were firm at the time the comment was prepared but which were later renounced by industry. The areas affected by this subsequent development are explained in Chairman Budge's testimony before your Subcommittee on Commerce and Finance at its hearings on November 12, 1969. This being so, it will perhaps suffice for present purposes to state that the differences resulting from industry's change in position relate essentially to front-end sales loads and to the criteria which should govern management fees.

The Bureau of the Budget has advised that there is no objection to the submission of this memorandum from the viewpoint of the Administration's program.

Sincerely,

HUGH F. OWENS, *Commissioner.*

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION ON H.R. 12867 (NOVEMBER 5, 1969)

This memorandum, prepared in response to a request by the Committee, sets forth the Commission's views on H.R. 12867, introduced by Congressman W. S. ("Bill") Stuckey in the House of Representatives on July 15, 1969, to amend the Investment Company Act of 1940, the Investment Adviser Act of 1940, the Securities Act of 1933 and the Securities Exchange Act of 1934. To summarize the conclusions of the detailed discussion which follows, the Commission strongly opposes the adoption of this bill since it would in many important respects be contrary to the Commission's major legislative recommendations for improving investor protection and in some cases, would significantly reduce present standards of investor protection, under the Investment Company Act.

[1] Superseded by H.R. 14737.

The Commission's recommendations were the results of a long series of studies of the investment company industry culminating in the Commission's 1966 Report to Congress of the Public Policy Implications of Investment Company Growth in 1966.[1] On May 26, 1969, the Senate passed S. 2224 and sent it to the House of Representatives. In addition to the adverse consequences mentioned above, H.R. 12807 in effect, eliminates the progress which resulted from the negotiations between representatives of the Commission and the investment company industry, which were undertaken at the suggestion of the chairmen and members of the Congressional committee concerned with this legislation. The agreement between the Commission and major segments of the mutual fund industry is represented by S. 2224, the bill that passed the Senate without opposition and is now before your Committee as H.R. 11995. We support HR. 11995.[2]

With the exception of the discussion of front-end loads which follows the section on sales loads, the discussion below generally is organized to follow the categories of matters referred to by Mr. Stuckey in his explanatory statement of July 15, 1969, which appears at page E 5925 of the Congressional Record of that date (copy attached).

INVESTMENT ADVISORY CONTRACTS

Section 8(b) of H.R. 12867 would provide that a mutual fund which has at least 50% of its board of directors made up of unaffiliated and disinterested persons and which has obtained approval of its management contract within a year by a vote of two-thirds of its outstanding shares and all of the unaffiliated and disinterested directors would be exempt from private and SEC-initiated court actions to test the reasonableness of the advisory fee.

As the Commission's studies and the Report of the Senate Banking and Currency Committee point out, and as further explained below, presently the majority of directors of most mutual funds are unaffiliated with their investment adviser.[3] The Senate Committee in its Report on S. 2224 stated:

"Mutual funds, with rare exception, are not operated by their own employees. Most funds are formed, sold, and managed by external organizations, that are separately owned and operated. These separate organizations are usually called investment advisers. These advisers select the funds' investments and operate their businesses. For these services they receive management or advisory fees. These fees are usually calculated at a percentage of funds' net assets and fluctuate with the value of the funds' portfolio.

"Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy."[4]

The Investment Company Act of 1940 ("Act") presently includes a requirement that at least 40% of the fund's directors be unaffiliated with the investment adviser and that a majority of the fund's directors be unaffiliated with the fund's principal underwriter. Since the adviser and underwriter are usually the same or related entities, a majority of the directors of most funds are unaffiliated with their managers.

As stated in the Senate Committee Report:

"The provisions did not provide any mechanism by which the fairness of management contracts could be tested in court. Under general rules of law, advisory contracts which are ratified by the shareholders, or in some States approved by a vote of the disinterested directors, may not be upset in the courts except upon a showing of 'corporate waste.' As one court put it, the fee must 'Shock the conscience of the court.' Such a rule may not be an improper one when the protections of arm's-length bargaining are present. But in the mutual fund industry where these marketplace forces are not likely to operate as effectively, your committee has decided that the standard of 'corporate waste' is unduly restrictive and recommends that it be changed."[5]

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[1] H. Rep. No. 2337, 89th Cong., 2d Sess. (1966).

[2] The Commission's favorable vies [sic] on S. 2224 and H>R. 11995 are set forth in its memorandum to your Committee dated July 9, 1969.

[3] Senate Rep. No. 91-184, 91st Cong., 1st Sess. (1969) ("Senate Committee Report"), p. 5.

[4] Id.

[5] Id.

To solve these problems, Section 20 of S. 2224, in substantially the form passed by the Senate, was jointly submitted to the Senate Banking Committee by the Commission and the Investment Company Institute after extensive negotiations. The Section provides that the mutual fund investment adviser has a specific fiduciary duty with respect to management fee compensation. The Commission considers this section of S. 2224 to be an important and vitally needed improvement over the present provisions of the Act. Section 8(b) of H.R. 12867, on the other hand, would reject the industry-supported solution and in effect provide complete immunity for investment advisory fees if the approvals specified in that section have been obtained. This bill not only rejects the agreement reached by the Commission and the industry, it would even go so far as to negate the present common law prohibition against the adviser taking a management fee amounting to waste as well as vitiating the gross abuse of trust provision of present Sec. 36 of the Act, in so far as it relates to fees.

With respect to advisory fees based on performance, H.R. 12867 deletes the amendment in Section 24(a) of S. 2224 and H.R. 11995 to Section 204(b) of the Investment Advisers Act of 1940 requiring registration under that Act of investment advisers whose only clients are investment companies. H.R. 12867 also provides in Section 25 that incentive management fees charged to an investment company based on performance which increase and decrease proportionately will not be required to decrease below the level of no compensation or operating costs, if the parties agree.[6]

S. 2224 and H.R. 11995 would permit a performance fee for the investment adviser if the fee increases or decreases proportionately on the basis of investment performance measured against an appropriate index of securities prices or other appropriate measure of performance. Although the Commission had originally recommended a flat prohibition on performance based fees, it later agreed to this compromise because of industry objections.[7]

Section 25 of H.R. 12867 would permit an adviser, for example, to have a base fee set at ½ of 1%, if the fund's performance equaled that of a securities index, to go upwards to an unlimited amount depending upon the fund's performance, but go down only to the adviser's actual operating cost (including unrestricted salaries for the advisers top officials). Thus, while the adviser could participate to an unlimited amount in the fund's profits, if the fund suffered a loss or if its performance was below the appropriate index, the adviser would lose nothing since he would be able to recover all of his expenses while paying substantial salaries to top officials. Such a fee arrangement would not only be unfair to the fund's shareholders, it would provide a strong incentive for the adviser to gamble with the fund's portfolio on extremely speculative securities since the adviser has little to lose and everything to gain from the fund's performance.

H.R. 12867 would have another anomalous and perhaps unintended result, arising from its failure to amend Section 203(b) of the Investment Advisers Act to require registration under the Act of investment advisers whose only clients are investment companies. The effect of this would be to exempt such investment advisers from the provisions of Section 203 of that Act, as amended by H.R. 12867 to place limits on investment company performance fees. The net result would be: (1) an investment adviser whose only clients were investment companies would not be subject to the limitations on performance fees in Section 203 of the Advisers Act as amended by the bill (although still subject to the substantially weakened fiduciary standards contained in Sections 8(b) and 36(b) of H.R. 12867); but, (2) an investment adviser registered or subject to registration under the Advisers Act because of the adviser's having other non-investment company clients could not charge an investment company a performance fee unless it complied with the limitations in Section 23 of H.R. 12867.

SALES LOADS

Section 8 of H.R. 12867 provides that the sales charge for the sale of mutual fund shares is conclusively presumed to be fair and equitable providing that the underwriting contract has within a year been approved by a 2/3 vote of the outstanding shares and all of the unaffiliated directors.

[6] See additional discussions of performance fees charged noninvestment company clients, p. 16 below.

[7] See *Public Policy Implications of Investment Company Growth*, pp. 344-345 and Senate Committee Report, pp. 45-46. See also Hearings Before the Subcommittee on Commerce and finance of the Committee on Interstate Commerce on H.R. 9510 and H.R. 9511, October 10, 1967, 90th Cong., 1st Sess. at pp. 86 and 92-93.

This provision rejects the solution reached by the Senate Committee and the Senate with the mutual fund industry and the National Association of Securities dealers, Inc. ("NASD"), embodied in Section 12 of S. 2224, which would authorize the NASD to make rules to prohibit excessive sales loads on the sale of mutual fund shares, with Commission oversight.

In discussing the problems created by the present mutual fund sales load structure, the Senate Committee Report on S. 2224 stated:

"The function of selling mutual fund shares is almost always contracted out by the fund to an organization called a principal underwriter. In most cases the principal underwriter is either the adviser itself or a close affiliate of the adviser's. Principal underwriters use two different distribution techniques. Some confine themselves to wholesaling and leave the actual retail selling to independent broker-dealers. Others have their own retail sales organizations called captive sales forces. In both instances, the principal underwriter regards the retail seller as the key figure in the distribution process. The principal underwriter's interest therefore, is to make the price of the shares it distributes as attractive as possible to dealers and salesmen. Since the underwriter is either the same person or organization as the investment adviser this underwriting function—which is the supplying to selling dealers of sales materials and the shares offered—may be performed at cost or even at a loss. The real financial return to the underwriter or the affiliated investment adviser in these instances is the management fee which increases automatically as the fund grows in size.

"The basic sales commission charged for mutual fund shares is in most instances about 8½ percent of the total payment or 9.3 percent of the amount invested. This charge is protected by section 22(d) of the Investment Company Act which provides for a unique scheme of retail price maintenance. Under this section, all dealers, regardless of the source of the shares they sell, are prohibited by law from cutting the sales charge fixed by the mutual fund underwriter. Price cutting in this field is a Federal crime."[8]

When the Act was originally passed in 1940 and as presently written it does not require that underwriting contracts be submitted for shareholders vote. Congress recognizes that a mutual fund shareholder, after he buys the security, has little further interest in the distributor or distribution contract. In this situation, it is the function of the director of the fund, and not the shareholders, to select the person to distribute its securities and to determine what the compensation should be. H.R. 12867 overlooks this distinction, by making the approval of present shareholders, a group of persons who have already paid a sales load and therefore generally have no further interest in it, except to the extent that they might wish to buy additional shares, binding on a much larger group of prospective purchasers.

H.R. 12867 would not only permit a general increase in the sales loads of mutual fund shares but also give sellers complete immunity to charge any rate no matter how excessive or unreasonable. Indeed in cases where the requisite shareholders' and directors' approval were obtained it would even remove the present inadequate protection given by Section 22(b) of the act, which permits the NASD and the Commission to make rules to prohibit "unconscionable or grossly excessive" sales loads. As the Commission's Report and the testimony before Congress have demonstrated, present competition is perverse in that it affects mutual fund sales loads by driving the loads up to gain the favor of dealers rather than driving them down to gain the favor of investors.

FRONT-END LOADS

The Commission had originally recommended abolition of the front-end load, that is, a method of deducting sales commissions by which up to one-half of the investor's first year's payments is taken for such commissions.

As the Senate Report succinctly states:

"It is of course obvious that such an arrangement is usually detrimental to the investor, particularly if for any reason he discontinues his payments at an early date. Unless the stock market rises rapidly, he is almost certain to lose money."[9]

However, S. 2224 and H.R. 11995 would not abolish the front-end load. Instead, two alternative methods for employing the front-end load are provided. Under the first alternative, contractual plans may still be sold with the presently authorized front-end load, under which up to 50% of the first year's payments

[8] Senate Committee Report, pp. 7-8.

[9] Senate Report, p. 9.

may be deducted for sales commissions, provided that if the investor elects for any reason to redeem his underlying shares for cash during the first three years he would also be entitled to receive a refund of the amount by which all sales charges paid exceed 15% of the total payments made under the plan. The Commission would be authorized to make rules and regulations specifying the form of refund notice required under this alternative and setting forth reserve requirements so that sellers may meet their refund obligations.

In addition, contractual plan sellers could at their option elect a second alternative. Under this alternative, the bills specify a formula whereby the load could not exceed 20% of any payment nor average more than 16% over the first four years.

We are aware that contractual plan sponsors oppose certain provisions of S. 2224 and H.R. 11995, particularly the three-year refund provision, and we have been discussing the matter with them to see if it is possible to arrive at modifications which would be acceptable both to the sponsors and to the Commission. We think it likely that this can be done. We would not, however, be prepared to go so far as H.R. 12867 in reducing protections to investors in contractual plans, and it is our belief that the contractual plan sponsors themselves would not insist on such extensive reductions from the investor protections provided in S. 2224 and H.R. 11995.

RESTRICTIONS ON COMMISSION OFFICERS AND EMPLOYEES

Section 2 of H.R. 12867 would expand the definition of "interested person" of an investment company, its investment adviser and principal underwriter contained in S. 2224 to include any person who had been an employee of the Commission during the last two fiscal years of the investment company. The effect of this provision, among other things, might be to prevent a former Commission employee from becoming a director of an investment company, depending upon how many other directors were interested persons. This result is due to the fact that Section 10 of the Act as amended by both S. 2224 and H.R. 12867 would provide that (1) no registered investment company could have a board of directors more than 60 percent of whose members are interested persons of such company and (2) if any officer, director, or employee of the investment company acts as, or is an interested person of, its principal underwriter or regular broker, a majority of the board must consist of persons other than those who are interested persons of such principal underwriter or regular broker.[10] Moreover, Section 20 of the Bill would impose criminal penalties of SEC personnel who, within two years after termination of their employment, acted as agent or attorney in any capacity in a matter involving any party subject to jurisdiction of the Commission while they were employed by the Commission.[11]

Assuming that these provisions were not designed primarily to penalize persons who have worked for the Commission, the bill would appear to be intended to prohibit conflicts of interest between former Commission personnel and mutual funds. The bill, however, does not accomplish a great deal other than penalizing persons for working at the Commission. This is the case because the function of provisions limiting the number of interested persons on an investment company board of directors is to supply an individual check on management and to provide a means for the protection of shareholders interests in investment company affairs. Unlike other interested persons, as that term is defined in S. 2224 (e.g. persons having beneficial interests in the investment adviser or principal underwriter), whose conflict of interest positions arise from their relationship to management or to benefits which they may receive from business dealings with the company or its management, there would appear to be no conflict of interest between former SEC personnel and mutual funds that would adversely affect mutual funds or their shareholders.

Other kinds of possible conflicts of interest, those which might affect a Commission employee's performance of his official duties while he is employed by the Commission, are adequately covered by the federal conflict-of-interest statutes and the Commission's rules of conduct.

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[10] See Senate Committee Report, pp. 32-34.

[11] This provision as presently written prohibits such conduct if it occurs "within a period of two years *prior* to the termination of such employment" (emphasis added), but this appears to be a drafting error.

SUITS AGAINST MUTUAL FUNDS AND OTHER MATTERS AFFECTING COMPANIES UNDER THE JURISDICTION OF THE COMMISSION

Section 20(b)(7) of H.R. 12867 would also impose federal criminal penalties on any person who knowingly acts as attorney or agent in connection with any judicial, administrative or other proceeding or matter involving any party subject to the jurisdiction of the Commission, if he acts "without justifiable cause." As far as we could determine, there is no parallel provision in any other regulatory statute.

This provision is apparently designed to protect mutual fund managements from unjustifiable harassing litigation. Leaving open the questions of whether the provision would be consistent with the protection of free speech and the right to counsel contained in the First and Sixth Amendments to the Constitution, and whether present judicial procedure does not adequately prevent unjustifiable litigation, Section 20 is written so broadly that it could have startling and drastic effects. For example: (1) no attorney, even one *defending* a party in an administrative proceding [sic] before the Commission could do so without fear of arrest and imprisonment if he failed in his defense, because he could then be accused of acting "without justifiable cause;" and (2) no attorney or accountant could write a letter to the Commission staff asking for an interpretation of the federal securities laws or participate in the preparation or filing of an application for relief from a provision of the federal securities laws without fear that if his request for a favorable interpretation or application for relief were denied he could be fined and imprisoned for acting "without justifiable cause."

In any event, with respect to harassing litigation against mutual fund managements, we believe that any disadvantages of allowing shareholders full access to the courts are far outweighed by the protections such access gives against abuses which might otherwise find no remedy. Moreover, if any restrictions are needed in addition to those provided by the Federal Rules of Civil Procedure and similar State rules against unfounded shareholder suits, we believe that the adverse effects of the approach taken in this bill greatly exceed any possible benefits it might give to the public.[12]

INVESTMENT ADVISERS ACT

Section 25 of H.R. 12807 would provide that Section 205 of the Investment Advisers Act of 1940 would not be applicable to advisory agreements between non-United States clients and registered United States investment advisers, and that registered United States investment advisers would not be prohibited from having incentive contracts including performance fees with unregistered investment companies. We believe that the provisions in the Investment Advisers Act concerning investment advisory contracts and fees between registered investment advisers and their clients should not be altered so that any group of clients would be adversely affected and lose the protection of that Act.

Investor confidence in the activities of registered investment advisers is enhanced by the belief among investors that these advisers are prohibited from engaging in activities harmful to the interest of their clients and from over-reaching in setting their advisory fees. If foreign investors are to be encouraged to seek the advice of United States registered investment advisers, the confidence to seek the advice of United States registered investment advisers, the confidence which is engendered by the present regulatory system should be retained. However, we would not oppose a modification of S. 2224 to allow registered investment advisers to charge foreign unregistered investment companies a performance fee subject to the same limitations as those imposed on fees charged registered investment companies.

OIL AND GAS

H.R. 12867 would continue the present exemption from the Act for any investment company all of whose business is holding oil, gas, or other mineral royalties or leases. Section 3(b)(5) of S. 2224 and H.R. 11995 would amend Section 3(c)(11) to delete the exclusion for oil and gas investment companies when these companies issue redeemable securities, periodic payment plan certificates, or face-amount certificates of the installment type. As explained at pages 328 and 329 of the Commission's Report on the Public Policy Implications

[12] See letter dated April 22, 1969 to Senator John Sparkman from Commissioner Hugh F. Owens setting forth the Commission's position on the advantages of shareholder derivative litigation. Senate Banking and Currency Committee Hearings on S. 34 and S. 296, 91st Cong., 1st Sess. (1969) at p. 30.

of the Investment Company Growth, when the Act was originally written, certain companies in the factoring, discounting and real estate business, as well as companies holding oil, gas, or other mineral royalties or leases were excluded from the definition of "investment company", although it was clear that were it not for these exclusions, they would have been subject to the registration and other regulatory provisions of the Act. When the Act was written, interests in oil, gas, and other mineral royalties and leases were generally sold in relatively large amounts to affluent, sophisticated investors.

The growth in number and dollar amount of offerings of interests in oil and gas programs registered with the Commission in recent years has been remarkable. Thus, in 1964 there were only 31 offerings aggregating $78,000,000, but in 1968 there were 90 filings aggregating $604,000,000 and in the first 6 months of 1969 there have been 60 offerings aggregating $649,500,000, which is an annual rate exceeding one billion dollars.

Not all of these issuers would be affected by the deleted amendment, since oil and gas funds in which the investor makes only a single payment and does not receive a security redeemable at his option would still be excluded from the definition of investment company in the Act. However, a substantial proportion of these oil and gas funds would be subject to the Act. Many of them market their securities in the same manner as mutual funds and their shares are sold to relatively unsophisticated investors. Thus more than 64% of dollar amount in securities of oil and gas fund registered in the first six months of the calendar year have been offered in programs allowing for minimum investments of less than $10,000.

For example, one of these funds sells a $1,300 investment program in which the investor can make a down payment of as little as $150 with 21 subsequent monthly payments of $50. The prospectuses and sales literature of many of these funds are modeled on conventional mutual funds. Indeed, at a mutual fund convention in Washington several years ago, one of these oil and gas funds maintained a booth from which it distributed sales literature to mutual fund salesmen and to others.

We realize that applying the provisions of the Investment Company Act might raise substantial problems for this industry. However, the provisions of S. 2224 and H.R. 11995 postpone the effective date of the section dealing with oil and gas funds to 18 months from the date of enactment. As indicated in the Senate consideration of S. 2224, during that period the Commission is to work together with the oil and gas fund industry to devise a regulatory scheme to fit the unique characteristics of that industry through the use of the Commission's exemptive powers. The Commission staff has already had several meetings with representatives of this industry in an effort to work out an equitable arrangement for regulation that would protect and safeguard the investors, and would not impose an unreasonable burden on the industry.

In this connection, representatives of the industry have suggested a further amendment to the section, embodied in S. 2224 and H.R. 11995 as Section 3(b)(5). This amendment would continue the present complete exclusion for oil and gas companies if their investment contract (1) require the participants to pay $10,000 or more during every consecutive 12 months, (2) do not afford the participants any cash surrender or redemption rights, and (3) provide that there be no front-end load or other disproportionate charges. The Commission supports these modifications rather than the complete deletion of the amendment provided by H.R. 12867.

ADMINISTRATIVE PROCEDURE ACT

Sections 12(a) and 20 of H.R. 12867 among other things specify that the Administrative Procedure Act "(APA)" would be applicable to certain Commission activities. Thus, under Section 12(b) of the bill (page 26, lines 24 and 25) in a Commission rulemaking proceeding to limit excessive sales loads on mutual fund shares, pursuant to Section 22(b) of the Act, the proceeding would have to be conducted "in accordance with the Administrative Procedure Act (5 U.S.C. 553, 556)."[13] However, Commission rule-making is presently subject to the APA, so no specific reference to the APA in the bill is necessary.

Section 20 of the Bill (page 44, lines 10-14) would also provide that before the Commission instituted court proceedings to enjoin a breach of fiduciary duty

[13] We assume that any rules adopted under this section of the bill would not apply where management obtained shareholder approval and other approvals specified in Section 8 of the bill (page 19, lines 5-13; see pages 8-10 above).

involving personal misconduct, the Commission shall have afforded "the defendant a far [sic] opportunity to comply in accordance with the Administrative Procedure Act (5 U.S.C. 558)."

While this provision is by no means clear it would seem to have the effect of removing protection from investors rather than increasing them. In a situation in which the Commission had enough evidence of abuse of trust involving personal misconduct to request a court to enjoin such conduct, the Commission might first be required to hold an administrative hearing, thus giving the propective [sic] defendants an opportunity to continue such activities unabated during the pendancy of the hearing.[14]

We are in full accord with the principle that before any person is deprived of a license, e.g., an effective registration as a broker-dealer under the Exchange Act or as an investment adviser under the Advisers Act, he should be afforded all the protections given by the Administrative Procedure Act and the Commission Rules of Practice. On the other hand, an entirely different though sometimes parallel procedure is appropriate when it appears necessary for the protection of investors that activities detrimental to investors and in violation of the federal securities laws be stopped by court injunction, as presently specifically provided in Section 214 of the Investment Advisers Act and Section 27 of the Exchange Act. Of course, all of the procedural safeguards applicable to court proceedings are available even in those cases for protection of defendants.

OTHER MATTERS

H.R. 12867 contains a number of other modifications of S. 2224 and H.R. 11995. These modifications would remove needed investor protection, add needless procedural complications or unnecessarily limit Commission discretion.

We will not discuss all of these modifications in detail, since all of them are summarized in the comparative table attached to this memorandum together with summaries of the matters discussed above. however, three examples of these changes are:

(1) H.R. 12867 deletes Section 3(b)(3) of S. 2224 and H.R. 11995 which would subject to the provisions of the Investment Company Act certain factoring, discounting and real estate companies which issue redeemable securities (see discussion of similar provision respecting oil and gas funds at pp. 17-19 above).

(2) Section 2(3) of H.R. 12867 appears to require the Commission to hold a hearing in each case in which the Commission determines any person is an interested person, whether the affected person wants it or not, rather than "notice and opportunity for hearing" as presently required by Section 40 of the Investment Company Act.

(3) Section 4(b) of H.R. 12867 authorizes the Commission to bar persons guilty of specified types of misconduct from acting in certain capacities for an investment company "for such period of time as is reasonable under the circumstances" rather than "either permanently or for such period of time as it in its discretion shall deem appropriate in the public interest." as provided by Section 4(b) of S. 2224 and H.R. 11995, but the difference in language would tend to set the stage for needless arguments on the matter.

CONCLUSION

As the foregoing makes clear, H.R. 12867 would in fact cut back the protections now offered by the Investment Company Act of 1940 and the Investment Advisers Act of 1940. The voluminous record already adduced before your Committee, as well as the Commission's own studies and reports fully support the proposition

[14] Section 558(c) (1) and (2) of the APA require that the agency give the licensee notice and an opportunity to comply with all lawful requirements in connection with a proposed "withdrawal, suspension, revocation or annulment of a license." No such proceeding would be involved in an action to enjoin a breach of fiduciary duty under Section 36(a) of the Investment Company Act as amended by Section 20 of H.R. 12867. However, for purposes of this discussion we assume that the intent of H.R. 12867 is to require such notice and opportunity for compliance as a prerequisite to all Section 36(a) injunctive cases. Nevertheless, presumably the Commission could rely on the exception contained in Section 558 of the APA which allows the institution of proceedings without prior notice or opportunity for compliance "in cases of willfulness or those in which public health, interest or safety requires otherwise."

that present regulation must be augmented, at least to the extent contemplated by S. 2224 and H.R. 11995. H.R. 12867 is not only inadequate in this regard, but seriously erodes present protections.

In our opinion, the enactment of H.R. 12867 would represent a substantial setback for fund shareholders which might have the effect of undermining vital shareholder confidence in the mutual fund industry—without which the industry could not long survive in its present state. The proposed bill, in effect, eliminates the progress, negotiation and agreement represented by S. 2224 and H.R. 11995, the bill that passed the Senate without opposition and is now pending before your Committee. The major industry groups have supported the Senate passed bill and, as we have previously informed your committee, the Commission supports that bill because, despite the revision of our original recommendations, S. 2224-H.R. 11995 still represents a major improvement in existing mutual fund regulation in meeting the needs of investors in the critical areas of concern indicated by the Commission's study of the fund industry.

There is no reason to substitute for S. 2224 and H.R. 11995, the products of such long negotiation, having the support of major industry groups and the Commission, and having passed the Senate, a bill which so substantially lessens key elements of mutual fund shareholder protection.

(From the Congressional Record, July 15, 1969)

ADDRESS OF HON. W. S. (BILL) STUCKEY, OF GEORGIA, IN THE HOUSE OF REPRESENTATIVE, TUESDAY, JULY 15, 1969

AMENDMENT OF INVESTMENT COMPANY ACT

Mr. STUCKEY, Mr. Speaker, on May 26 the Senate passed S. 2224, a bill proposing to amend the Investment Company Act of 1940 in many significant ways. As I indicated in remarks when I introduced H.R. 8980 on March 13, 1969, many of the features of this bill will update the mutual fund laws and will provide more investor protection without interfering with the right of shareholders and directors to manage their mutual funds. However, some of the provisions of that bill are so far reaching in their consequences that I thought it important to introduce my own bill in the House as a basis for discussion when this legislation comes before the committee of which I am a member

The legislative process invites compromise and accommodation and we seek to resolve conflicting views in order to promote a broader public purpose and serve the common good. Now that I have studied S. 2224 in comparison to my own bill, I believe it will further advance the legislative process to revise my bill to include as much as possible of the bill passed by the Senate and introduced in the House by our committee chairman, John Moss, as H.R. 11995. The revised bill I am introducing today differs from the Senate bill in these important areas.

first, mutual funds which have at least 50 percent of the broad [sic] of directors made up of unaffiliated and disinterested persons and which obtain approval of their management or distribution contracts by a two-thirds vote of outstanding shares and all of the unaffiliated directors within 1 year will be exempt from having the SEC and the NASD review management compensation and sales commissions if such approval is not obtained, these agreement will be subject to SEC review. Second, formed SEC personnel along with lawyers and accountants will be included among a new category of "interested persons" barred from affiliation with mutual funds for a reasonable period of time. Third, incentive management fees based on performance and which increase and decrease proportionately will be encouraged, but will not be required to decrease below the level of no compensation or actual operating costs, if the parties agree. Fourth, the Investment Adviser Act of 1940 will not be applicable to advisers' agreements between non-U.S. entities and U.S. investment advisers registered under the act. Fifth, U.S. investment advisers will not be prohibited from having incentive contracts including performance fees with unregistered companies. Sixth, penalties will be imposed on those who bring lawsuits against mutual funds, without justifiable cause. Seventh, former SEC personnel will be prohibited for 2 years from suing mutual funds. Eighth, the existing exemption from the 1940 act—but not the 1933 and 1934 acts—for oil exploration funds will be continued. These funds are completely regulated under Federal securities laws. I see no reason to try and treat them as mutual funds when they are not. Ninth, I have tried to treat front-end-load

contractual plans a little more equitably. They must compete with insurance policies where salesmen get from 65 to 120 percent front-end load and sell with no prospectus.

There are other minor differences in my bill, most of which involve a requirement that the SEC conform to the Administrative Procedure Act in its administrative activities, and that its actions be reasonable. The SEC now is permitted to exercise its discretion without the checks and balances required by due process under the Federal Constitution. I am hopeful that Members of Congress will review my revised bill with care, as I believe it is important we bring the controversy surrounding this legislation to a close. High interest rates, uncertainties in our fiscal and monetary policy, and unsettled conditions in Vietnam are rapidly eroding investor confidence as reflected in the sharp decline in securities prices in recent weeks. Far-reaching policy changes in antitrust law enforcement have added to investor unrest, and have caused share declines in the prices of securities of conglomerates. Actions of the Securities and Exchange Commission and the New York Stock Exchange respecting minimum rates, customer-directed commission sharing, access of nonmembers to the exchange markets and reciprocal business arrangements, are all taking their toll of investor confidence. I urge my colleagues to be thoughtful and to be reasonable and above all to remember that securities salesmen are entitled to earn a fair living in these times of inflation along with everyone else. My bill will preserve their income at approximately the present level with an added opportunity for increased earnings. The Senate bill in its present form will, in my opinion, cut the income of mutual fund salesmen by approximately 50 percent. I think any such action by Congress at this time would be highly discriminatory and inconsistent with our ideas of equal protection under the law. I do not believe it is the function of the SEC or minority shareholders to second-guess majority shareholders or directors of companies as to the value of management compensation or the level of sales commissions. Competition in the mutual fund industry fixes the price of these services at a level considered reasonable by the buyers and sellers involved. My bill will protect this principle of corporate democracy and at the same time protect the right of investors to make their own decision as to the value of the services for which they pay.

COMPARISON BETWEEN H.R. 12867 (CONGRESSMAN STUCKEY) AND SENATE PASSED S. 2224—IDENTICAL H.R. 11995

H.R. 12867				S. 2224			
Page	Lines	Bill section	Statute ( )	Page	Lines	Bill section	Change in S. 2224 made by H.R. 12867
2	22-24	2(3)	New 2(a)(19)(A)	2	18-21	2(3)	Expands definition of interested person to include certified public accountant for company and former employee of SEC during last 2 years.
3	4	2(3)	New 2(a)(19)(A)	[illegible]	[illegible]	[illegible]	Requires hearing in each case in which Commission determines any person is an interested person (sec. 40 of Act presently requires only notice and opportunity for hearing, which is retained by S. 2224).
4	18-22	2(3)	New 2(a)(19)(B)	[illegible]	[illegible]	[illegible]	Expands definition of "interested person" as applied to interested persons of investment adviser or principal underwriters in new 2(a)(19)(A) to include former employee of SEC during last 2 years.
5	14-15	2(3)	2(a)(10)(B) new	5	6	2(3)	Nonsubstantive renumbering change.
[illegible]	[illegible]	[illegible]	3(c)(16), redesignated 3(a)(5).	6	22-24	3(b)(3)	Deletes S. 2224 amendment. (S. 2224 removes exclusion for factoring, discounting, and real estate companies for companies which issue "redeemable securities.")
7	6 9	3(b)(3)	3(c)(10), redesignated 3(c)(8).	7	1-4	3(b)(4)	Identical—merely change in bill section.
7	10-23	3(b)(4)	3(c)(3), redesignated 3(c)(11).	7-8	15(p. 7)-4(p.8)	3(b)(6)	Identical—merely change in bill section.
[illegible]	[illegible]	[illegible]	3(c)(11), redesignated 3(c)(9).	7	5-14	3(b)(5)	Deletes S. 2224 amendment. (S. 2224 modifies exclusion for companies holding oil, gas, or other mineral royalties or leases)
8-9	18(p.8)-2(p.9)	3(d)	13(a)(3)	8-9	18(p.8)-2(p.9)	3(d)	Changes present law such that sec. 13 violated only if registered investment company "deviate(s) substantially" from policies it deems fundamental, those respecting concentration of investments and those changeable only by shareholder vote. (S. 2224 merely clarifies present law to make clear that deviation from investment policy changeable only by shareholder vote violates sec. 13. No requirement that deviation be "substantial.")
9	7-8	4(b)	new 5(b)	9	13-14	4(b)	Eliminates SEC's explicit option (as provided in S. 2224) in actions under sec. 9 to "permanently" prohibit persons described in new sec. 9(b)(1)-(3) from serving in certain capacities for registered investment company or affiliate; changes language used in S. 2224, which provides that the duration of such prohibition may be for such period of time as the SEC "in its discretion shall deem appropriate in the public interest," to such period of time as is "reasonable under the circumstances and appropriate in the public interest."
11	1-5	5(c)	10(c)	11	6-16	5(c)	Eliminates exception from prohibition for registered investment company which on Mar. 14, 1940, had as a majority of its board of directors, the officers, directors, or employees of any 1 bank. (S. 2224 merely corrects inconsistency in statutory text—retains exemption)

[illegible]....	[illegible].....	[illegible]......	10(d)..........................	11-12.......	19(p.11)-1(p.12).	5(d)..........	Deletes S. 2224 amended. (S. 2224 adds exemptions for bank collective funds for managing agency accounts operated on a no-load basis, similar to treatment presently accorded under sec. 19(d) of act to no-load funds.)
17..............	23-24............	8(a)...	15(a)(1).......................	20..........	10 11...............	8(a)...........	Requires that investment advisory contracts describe “all compensation to be paid thereunder for investment advisory and other services.” (S. 2224 makes no change in requirement that such contracts “precisely describe all compensation to be paid thereunder.”)
19..............	5-13..............	8..................	15(a) and (b)..................	[illegible].	[illegible]..........	[illegible]...	Provides that advisory contracts and underwriting contracts for investment companies shall be “conclusively presumed to be fair and equitable” if approved by all of the independent directors and by two-thirds of the shareholders, provided that no more than 50 percent of the members of the board of directors are interested persons.
20...............	3-4..............	8(c)..............	15(c)............................	22............	4-10..................	8(c)..........	Adds phrase “in their judgment” before “evaluate” in corresponding section of S. 2224 (which imposes specific duty on directors to request and on advisers to furnish information necessary to evaluate terms of advisory contract)
[illegible]....	[illegible].....	[illegible]......	17(f)............................	22...........	20 22.................	9(a)...........	Deletes S. 2224 amendment (S. 2224 provides for bank custody of investment company cash assets in the case of a registered investment company which is a collective fund maintained by a bank.)
[illegible]....	[illegible].....	[illegible]......	17(g)............................	24............	17-19...............	9(b)...........	Deletes S. 2224 amendment (S. 2224 provides for custody of assets of bank collective funds for managing agency accounts.)
25...............	4 and 21 24..	12(a)............	22(b)(1).........................	[illegible].	[illegible]..........	[illegible]...	Adds requirement that NASD, in exercise of authority to prohibit “excessive” and to prescribe “reasonable” sales loads, may adopt [illegible] only after hearing and must be “supported by substantial evidence”; also provides that no sales load included in a distribution agreement in effect when amendment becomes effective shall be deemed “excessive” except after “hearing and upon findings supported by substantial evidence.”
26................	24-25............	12(a)..............	22(b) adding new, 22(b)(3)	[illegible].	[illegible]..........	[illegible]...	Adds requirement that SEC comply with Administrative Procedure Act as well as with sec. 15A(k)(2) of 1934 Act in exercise of authority to alter of supplement NASD regulations on sales loads under 22(b)(1).
[illegible]....	[illegible].....	[illegible]......	Adds new, 22(h)............	30-31......	22 (p 30)-23 (p 31).	12(d)..........	Deletes S. 2224 amendment (S. 2224 would permit banks to engage in certain investment company activities.)
32, 33...........	23, 2.............	16(b)...........	New, 27(c)...................	36............	5, 9..................	16(b)..........	Changes term 3 years (in S. 2224) to 1 year during which purchaser of a contractual plan may surrender his certificate and obtain refund; changes the amount paid for sales loading which may be received in refund from the excess over 15 percent (in S. 2224) to excess over 20 percent of gross payments made by holder.
43................	6, 9................	19...............	33..................................	46...........	13,16................	19.............	Lengthens time allowed to transmit to SEC papers filed in certain civil actions from 5 to 15 days (if such papers are delivered to investment company or party defendant) and from 2 to 10 days (if such papers are filed in court by investment company or party defendant).

See footnotes [illegible]

COMPARISON BETWEEN H.R. 12867 (CONGRESSMAN STUCKEY) AND SENATE PASSED S. 2224—IDENTICAL H.R. 11995—Continued

H.R. 12867				S. 2224			
Page	Lines	Bill section	Statute ( )	Page	Lines	Bill section	Change in S. 2224 made by H.R. 12867
44	7	20	new 36(a)	47	14	20	Changes language regarding suits under new 36(a) standard such that the court may award relief "as may be reasonable and appropriate in the circumstances", in place of "in its discretion deems appropriate in the circumstances" (as in S. 2224)
44	10-14	20	new 36(a)	[illegible]	[illegible]	[illegible]	Adds requirement that the SEC accord defendant a "fair opportunity to comply" with the Administration Procedure Act before suing under new 36(a).
44	23, 24	20	new 36(b)	[illegible]	[illegible]	[illegible]	Adds term "bona fide" before "security holder of such registered investment company;" adds requirement that such person must be "acting in good faith and with justifiable cause" in derivative suits under 36(b).
45	12	20	new 36(b)(1)	[illegible]	[illegible]	[illegible]	Adds requirement that plaintiff's burden of proof in suits under 36(b) must be met by "clear and convincing evidence"
45	22	20	new 36(b)(2)	[illegible]	[illegible]	[illegible]	Adds language excepting from provision in 36(b)(2) those contracts approved by all independent directors and shareholders where less than 50 percent of members of board of directors are not interested persons. (See sec. 8 of this bill.)
47	1-13	20	New 36(b)(7)	[illegible]	[illegible]	[illegible]	Prohibits former SEC employees from acting in any capacity in connection with any matter involving a party subject to the jurisdiction of the Commission for 2 years after termination of employment; prohibits anyone from so acting "without justifiable cause," imposes $10,000 fine or 2 years imprisonment or both if these prohibitions are violated.
[illegible]	[illegible]	[illegible]	203(b), Investment Advisory Act.	51-52	14 (p 51), 8 (p 52).	24(a)	Deletes S. 2224 amendment. (S. 2224 repeals exemption for investment companies to Investment Advisers Act) Effect would be to continue to permit investment advisory contract with investment companies that provide for investment advisory fees on basis of a share of capital gains upon or capital appreciation of the funds or any portion of the fund of the client, unless adviser is registered under Advisers Act (see sec. 25 of bill)
50	14	24(d)	203(d), redesignated 203(a), Investment Advisors Act	[illegible]	[illegible]	[illegible]	Adds requirement that a false or misleading statement on an application or report by an investment adviser be "material" before it can be a ground for exercise of SEC's disciplinary controls under sec. 203(e)
51	6	24(d)	203(d), 8 Investment Advisors Act, redesignated 203(e).	[illegible]	[illegible]	[illegible]	Adds requirement that any injunction, judgment other court decree against an investment adviser be "on the merits" before such decree can be a ground for exercise of SEC's disciplinary controls under secs. 203(e) and (l)..
53	5	24(e)	Adds new 203(l)				

55....................	12.....................	25.....................	205 Investment Advisors Act	[illegible]	[illegible]	[illegible]	Adds specific requirement for "notice and hearing" before SEC can issue order determining that an "index of securities prices" (that are used as a measure of performance as permitted by exception to sec. 205[illegible] for certain "performance" fee arrangements in advisory contracts with registered investment companies) is not appropriate.
55....................	13-17................	25......................	205 Investment Advisors Act	[illegible]	[illegible]	[illegible]	Adds provision stating that the phrase "increasing and decreasing proportionately" (used in connection with the exception from sec. 205(l) for certain "performance" fee arrangements in advisory contracts with registered investment companies) shall not be construed to prohibit a limitation on a decrease to "actual operating costs" or to "no compensation," as the parties may agree.
....	17-20..............	25......................	205 Investment Advisors Act	[illegible]	[illegible]	[illegible]	Adds provision that sec. 205 not be construed to apply to contracts with non-U.S. citizens or non-U.S. residents, nor to prohibit incentive contracts with unregistered investment companies

1 Section numbers of Investment Company Act of 1940, unless otherwise noted.
2 Bill sections ob both H.R. 12867 and S. 2224 amend same section of act, unless otherwise noted.
3 No corresponding provision in sec. 2 of this bill.
4 No corresponding provision in sec. 3 of this bill.
5 No corresponding provision in sec. 5 of this bill.
6 No corresponding provision in sec. 8 of this bill.
7 No corresponding provision in sec. 9 of this bill.
8 No corresponding provision in sec. 12 of this bill.
9 No corresponding provision in sec. 20 of this bill.
10 No corresponding provision in sec. 24 of this bill.
11 No corresponding provision in sec. 24(d) of this bill.
12 No corresponding provision in secs. 24(d) and 24(e) of this bill.
13 No such language in sec. 25 of this bill.
14 No such provisions in corresponding sec. 25 of this bill.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., December 10, 1969.

Re. H.R. 14737, 91st Congress.
Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce, House of Representative, Rayburn House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: In response to your request of November 12, 1960, I am pleased to submit herewith three copies of the memorandum setting forth the Commission's report on its study and examination of H.R. 14737. It may be noted that, except for our comments with respect to Section 28 of the bill, the memorandum generally follows the positions which the Commission has previously submitted with respect to an earlier bill also introduced by Mr. Stuckey on mutual fund legislation, H.R. 12867. However, as I will point out during my testimony before the Subcommittee on Commerce and Finance of your Committee, on December 11, 1969, and as indicated on page 11 of the memorandum, the Commission would not object at this time if the oil and gas amendment in Section 3(b)(5) of the Committee's bill H.R. 11995, were deleted, since the Commission is planning with the cooperation of the oil and gas industry representatives to work out a draft of a separate statute for submission to Congress to regulate oil and gas funds in a reasonable manner consistent with investor protection.

The Bureau of the Budget has advised that there is no objection to submission of this report from the standpoint of the Administration's program.

With kind regards, I remain

Sincerely,

HAMER H. BUDGE, *Chairman.*

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION ON H.R. 14737

This memorandum, prepared in response to a request by the Committee, sets forth the Commission's views on H.R. 14737, introduced by Congressman W. S. ("Bill") Stuckey in the House of Representatives on November 6, 1969, to amend the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933 and the Securities Exchange Act of 1934.

In many respects, this bill is identical to H.R. 12867, which was introduced by Congressman Stuckey on July 15, 1969 and which was the subject of our memorandum of November 5, 1969 addressed to the Committee. To the extent that these bills are similar we adhere to the comments made in our November 5, 1969 memorandum opposing adoption of the bill. We comment in detail on H.R. 14737 only to the extent that it differs from H.R. 12867.

The discussion below generally is organized to follow the categories of matters referred to in our memorandum of November 5, 1969 on H.R. 12867. The Commission strongly opposes the adoption of H.R. 14737 since, as we indicated in our comments on H.R. 12867, it would in many important respects be contrary to the Commission's major legislative recommendations for improving investor protection and in some cases, would significantly reduce present standards of investor protection under the Investment Company Act.

INVESTMENT ADVISORY CONTRACTS

Section 8(b) of H.R. 14737, like H.R. 12867, provides for outright immunity from suits brought under Section 36(b) of the Investment Company Act to question management fees, if the management contract is approved by all of the unaffiliated members of the board of directors and by two-thirds of the shareholders of a mutual fund, if no more than 50 percent of the board are interested persons.[1] H.R. 12867 did this by raising a "conclusive presumption" that fees were fair and equitable if the required approvals were obtained, without mentioning Section 36(b). H.R. 14737 takes a slightly different approach by explicitly making Section 36(b) (imposing a fiduciary duty on the investment adviser with respect to the receipt of compensation for securities) inapplicable to the contract approved as specified in Section 15(b) of the Act as amended by H.R. 14737. H.R. 14737 goes on to provide that if such contract receives the requisite approvals, the fee would also "be presumed to be both fair and equitable and not in breach of any fiduciary duty with respect to the receipt of compensation for services or of payments of a material nature." Although this presumption would not be

[1] Our objections to the substantially identical provision in H.R. 12867 are expressed in our memorandum of November 5, 1969 (see pages 3-5).

"conclusive" as in H.R. 12867, the substantive result would probably be the same as under H.R. 12867.

Moreover, Section 8(b) of H.R. 14737 might achieve the following anomalous result in suits against advisers, officers, and directors of funds for breach of fiduciary duty involving personal misconduct under Section 36(a) of the act, as amended: It would raise a presumption that an advisory fee is fair and equitable even though a breach of fiduciary duty involving personal misconduct was committed by an officer, director, or investment advisor in connection with negotiating or otherwise setting the management fee.

The provision that a fee be presumed fair and equitable for the purposes of Section 36(a), as well as the provision for immunity under certain conditions from suits under Section 36(b) of the Act would not only fail to provide the protections for investors intended to be secured by S. 2224 and H.R. 11995, but would even go so far as to negate the present common law prohibition against an investment adviser, or an officer, or director of an investment company receiving or approving a management fee amounting to waste or fraud and vitiate the gross abuse of trust provision of present Section 26 of the ct, in so far as it relates to fees.

H.R. 14737 thus removes existing protections and effectively insulates fund managers from actions relating to unreasonable or excessive fees-or even from suits charging waste. It erodes the present gross abuse standards of Section 36 in the fee area. Nothing in the record before this Committee justifies such a cutback in investor protection.

With respect to advisory fees based on performance, H.R. 14737, as does H.R. 12867, deletes the amendment in Section 24(a) of S. 2224 and H.R. 11995 to Section 203(b) of the Investment Advisors Act of 1940 requiring registration under that Act of investment advisers whose only clients are investment companies. However, H.R. 12867 deletes the amendment to Section 205 of the Investment Advisers Act contained in Section 25 of S. 2224 and H.R. 11995, which would permit a performance fee for an investment adviser only if the fee increases or decreases proportionately on the basis of investment performance against an appropriate index of securities prices or other appropriate measure of performance. H.R. 14737 also abandons the modification of this amendment contained in Section 25 of H.R. 12867, which we opposed in our memorandum of November 5, 1969 (see pages 5-7). The effect of this deletion, together with its deletion of Section 24(a) of S. 2224, would be to continue to permit investment advisers to investment companies to receive compensation on the basis of a share of the capital gains or capital appreciation or any portion of the funds of the client.

We are opposed to these deletions from S. 2224 and H.R. 11995 and reaffirm our support for the approach taken in those bills. As the Report of the Senate Banking and Currency Committee points out, S. 2224 provides protection for shareholders of investment companies against arrangements which give investment advisers special incentives to take undue risks but which would permit limited performance fee arrangements determined on a reasonable basis.

SALES LOADS

Section 8 of H.R. 14737 would exempt sales loads from regulation under Section 22(b) of the Act if the underwriting contract specifying such load were approved by all of the unaffiliated members of the board of directors and two-thirds of the shareholders, if no more than 50 percent of the board members are interested persons. Our opposition to substantially the same proposal in H.R. 14737 was expressed in our memorandum of November 5 at pages 8-10 and the reasons for such opposition are equally applicable here. Section 8 in H.R. 14737 differs from Section 8 of H.R. 12867 to the extent that it also provides for a presumption, rather than a "conclusive" presumption, that a sales load is fair and equitable if the requisite approval is secured, but we believe the substantive effects would be the same.

Section 12(a) of H.R. 14737 would require that the NASD in setting sales loads should allow for "reasonable profitability for brokers and dealers, and underwriters". Section 12(a) of S. 2224 and H.R. 11995 provides for "reasonable compensation" for these persons. We are opposed to the profitability standard because it would place profitability of fund sellers about investor protection.

[2] Senate Rep. No. 91-184, 91st Cong., 1st Sess. (1969) ("Senate Committee Report"), p. 45.

Then Chairman Cohen in his supplementary statement to your Subcommittee on October 24, 1967, put it very well when he said:

"Selling mutual funds is an easy occupation to enter. Almost anyone not found guilty of a serious crime can become a mutual fund salesman. And since fund salesmen are, with rare exceptions, compensated on a pure commission basis, another salesman adds little to the employer's costs. Any sales that the new salesman makes (no matter how large or small) produce income for the employer. It is a case of the more, the merrier. There is a typical pattern. Each new salesman makes—or tries to make—sales to his friends and relatives. Carrying his selling efforts beyond that is more difficult. Prospects aren't that numerous because the ratio of salesmen to prospective investors is so high. In this connection, I might point out that Mr. Cornelius Roach of Waddell & Reed, Inc., estimated before this Committee that there are about 90,000 people selling mutual funds. Since there are approximately 4,000,000 mutual fund shareholders, there is, by Mr. Roach's estimate, a mutual fund salesman for every 44 existing mutual fund shareholders. Even if one were to estimate that there are only 50,000 mutual fund salesmen, there would be a mutual fund salesman for every 80 mutual fund investors. So it is inevitable that many full-time salesmen find it very hard to earn a good livelihood solely from the sale of fund shares. When a salesman does manage to unearth somebody who could invest in a mutual fund, he often finds that one of the army of part-time salesmen or a full-time salesman from a large New York Stock Exchange firm has already made the sale. Hence the turnover rate among salesmen is very high.

"in few other areas of the American economy does the labor force rotate at a comparable rate. New recruits who believe—or who are led to believe—that selling mutual funds is an open road to riches, or at least a dignified way in which to add a meaningful supplement to an income primarily derived from some other source, are offset by equal numbers of dropouts who have found that it isn't quite as easy to make money selling mutual funds as the recruiter said it was.

"Just as it is relatively easy to become a mutual fund salesman, it is not difficult to become a mutual fund dealer. All it takes is $2,500 which can be borrowed, Many salesmen, who tire of sharing what they produce with their employers, venture into business for themselves. But the same obstacles that proprietors of these new mutual fund retailing firms faced as salesman still confront them and their sales recruits. Hence the high entry rate among mutual fund dealers in counterbalanced by a high departure rate.

"The essential question thus becomes whether federal law should continue to insulate mutual fund sales organizations, which have probably grown oversized and inefficient in terms of production, from both price competition and price regulation.

"*The Commission is not insensitive to the legitimate needs of the mutual fund salesman and of the small mutual fund dealer for compensation.* Indeed, as I have pointed out, the present system provides the seed for such failure. *However, we must also consider—indeed, we must give priority to—the interests of some 4 million investors, most of whom are far from affluent themselves.*

"All of us are interested in minimizing unemployment. But investors should not have to combat unemployment by paying artificially high prices—prices protected by law, not produced by market forces—for mutual fund shares. . . ." (emphasis added).[3]

Section 12(a) of H.R. 14737 would also add a provision to Section 22(b) to grant the Commission authority upon application or otherwise to give "smaller companies . . . subjected to relatively higher operating costs," qualified exemptions from rules made.

This provision appears to be superfluous in view of the Commission's broad exemptive authority under Section 6(c) of the Act. (See page 9 of this memorandum which discusses a similar provision).

FRONT-END LOADS

Section 16(a) of H.R. 14737 would modify the corresponding Section in 16(b) of S. 2224 and H.R. 11995 by reducing the time during which the purchaser of a contractual plan may surrender his certificate and obtain a refund of sales

[3] House Hearings on H.R. 9510 and H.R. 9511 before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, 90th Cong., 1st Sess., pages 701-702.

charges from three years to one year. It also changes the refund from the excess over 15 percent to the excess over 20 percent of the gross payments made by the holder.

Section 16(a) of H.R. 14737 also changes the times at which contractual plan holders must be sent notice of surrender and payment rights after payments have been missed to conform to the reduced refund period.

H.R. 14737 also reduces from 60 to 30 days the period of time during which a contractual plan holder has a right to withdraw and get back all sales and loading charges. The bill also adds language to the effect that SEC rules prescribing reserve requirements be "reasonable" and "reasonably necessary" to carry out the refund and withdrawal provisions. It also provides that no reserve requirement specified by Commission rules shall be taken into account in computing "net capital" of any one investment company issuing periodic plan certificates under Commission rules and regulations.

We oppose these changes from the reasons given in pages 11-12 of our memorandum of November 5, 1969.

H.R. 14737 also would delete Section 16(a) of S. 2224 and H.R. 11995 that Section would repeal present Section 27(b) of the Act under which the Commission has authority to relax the requirements of Section 27(a) in the case of smaller investment companies. In this connection, the Senate Committee Report points out:

"Since there is no evidence that the operating costs of the smaller contractual plan sponsors are any higher than those of their larger competitors, it is hard to see how the Commission could ever properly grant a 27(b) application for permission to charge higher loads. If in an unusual case such an application were to be supported by a substantial showing of merit, your committee directs the Commission to grant such application by exercising the exemptive authority under Section 6(c) of the Act. Section 27(b) is therefore surplusage and it is recommended that it be deleted"[4]

We agree with the judgment of the Senate on this provision.

RESTRICTIONS ON COMMISSION OFFICERS AND EMPLOYEES

Section 2 of H.R. 14737 is identical with Section 2 of H.R. 12867. Our opposition to this proposal is expressed in our memorandum of November 5, 1969, at pages 12-14.

SUITS AGAINST MUTUAL FUNDS AND OTHER MATTERS AFFECTING THE JURISDICTION OF THE COMMISSION

Section 19(b)(7) of H.R. 14737 is identical with Section 20(b)(7) of H.R. 12867 which we discuss in our November 5, 1969, memorandum at pages 12-15.

INVESTMENT ADVISERS ACT

H.R. 14737 deletes the provision in Section 25 of H.R. 12867 (which provides that Section 205 not be construed to apply to advisory contracts with non-U.S. citizens and residents nor to prohibit registered investment advisers from having incentive contracts with unregistered investment companies). Therefore, the discussion on Page 16 of our November 5, 1969, memorandum is not applicable to H.R. 14737.

OIL AND GAS FUNDS

H.R. 14737, as does H.R. 12867, deletes Section 3(b)(5) of S. 2224 and H.R. 11995 and therefore retains the present exemption in the Act for any investment company all of whose business is holding oil, gas or other mineral royalties or leases. As indicated in Chairman Budge's testimony of December 11, 1969 we would not object if Section 3(b)(5) of H.R. 11995 is deleted, since we now plan with oil and gas industry co-operation, to try to work out a separate statute or submission to Congress to regulate oil and gas funds in a reasonable manner consistent with the protection of investors.

ADMINISTRATIVE PROCEDURE ACT

H.R. 14737 deletes the provision in Section 12(a) of H.R. 12867 which would have specified that the Administrative Procedure Act ("APA") would be appli-

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[4] Senate Committee Report, p. 20.

cable in a Commission rule-making proceeding to limit excessive sales loads pursuant to Section 22(b) of the Act. We commented in our November 5, 1969 memorandum that since Commission rule-making is presently subject to the APA, no specific reference to the APA is necessary.

Section 19 of H.R. 14737, however, retains the requirement in corresponding Section 20 of H.R. 12867 that the Commission afford "the defendant a fair opportunity to comply in accordance with the Administrative Procedure Act (5 U.S.C. 558)," before it can institute court proceeding to enforce a breach of fiduciary duty involving personal misconduct. Our comments opposing this provision appear on pages 20-21 of our November 5, 1969, memorandum.

FACE-AMOUNT CERTIFICATES

H.R. 14737 completely deletes Section 17 of S. 2224 and H.R. 11995, which would provide investors in face-amount certificates greater protection by limiting the sales loads on future sales of face-amount certificates to 20% during the first three years and 10% in the fourth certificate year. The effect of H.R. 14737 would be to continue present law allowing up to 50% of the first year's payments to be deducted for sales charges.

As your Committee is aware, Chairman Moss has introduced H.R. 13754 to eliminate the front-end load and equivalent surrender charges on future sales of installment face-amount certificates, as a supplement to S. 2224 and H.R. 11995. On November 12, 1969, Chairman Budge testified in favor of H.R. 13754 before your Subcommittee on Commerce and Finance. He pointed out that our recent study conducted at the request of the Senate Banking and Currency Committee[5] reconfirmed our original conclusion contained in our December, 1966 Report that front-end load charges on face-amount certificates are contrary to the public interest and the interests of investors. As Chairman Budge pointed out in his testimony:

"We found that the investment yield on face-amount certificates held to maturity is less than that realized on other savings programs and that the majority of purchasers of installment face-amount certificates do not continue payments under the plans to their stated maturity dates. It indicated that a large portion of those people who buy face-amount certificates lose money and that their losses are caused by the deduction of the front-end load from the early years' payments. For example, more than 55 percent of those persons who purchased the most popular 20-year face-amount certificates scheduled to mature from 1965 through 1968 lost money, by redeeming prior to the breakeven point, and more than 84 percent (by face-amount) failed to reach maturity as scheduled."

In view of these facts, it would be a setback to future investors in face-amount certificates if H.R. 14737 were enacted since it fails to adopt even the minimal improvements provided by Section 17 of S. 2224 and H.R. 11995.

ATTENDANCE AT DIRECTORS' MEETINGS.

Sections 8(c) and 17 of H.R. 14737 would delete the amendments provided by Sections 8(c) and 18, respectively, which would require that the voting requirements of Sections 15 (b), (b), (c) and 32(a) of the Act for approval and renewal of advisory and underwriting contracts and for the selection of independent auditors can be satisfied only by directors who are personally present at a meeting at which their votes are taken. In our 1966 Report on the Public Policy Implications of Investment Company Growth, we found that in some investment companies absentee approval by board members is not uncommon.[6]

The purpose of these amendments is to "assure informed voting on matters which require action by the board of directors of registered investment companies,"[7] which is a practical necessity if unaffiliated directors are to effectively protect the interests of shareholders.

H.R. 14737 also achieves the somewhat inconsistent result of requiring advisory and underwriting contracts and the selection of independent accounts to be approved by a majority of the disinterested members of the board but not requiring that such directors be present at the meetings when these votes are taken. This would erode an important potential safeguard for shareholders.

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[6] See our memorandum to your Committee dated October 22, 1969, which supports the passage of H.R. 13754 and discusses this report.

[7] Public Policy Implications on Investment Company Growth, pp. 334-335.

[8] Senate Committee Report, page 30.

SECURITIES EXCHANGE ACT OF 1934

Section 29 of H.R. 14737 would amend the Securities Exchange Act of 1934 to provide that no flat fixed minimum commission charged by a national securities exchange by its members on all transactions on such exchange and adopted in accordance with the procedures of the Act shall be considered in violation of the antitrust laws, provided that the commission rate is reasonable and further provided that the exchange provides reasonable access and commission rate differentials for bona fide nonmembers.

On May 28, 1968 the Commission announced the institution of public hearings to give extensive consideration to various aspects of the commission rate structures of the registered national securities exchanges. These hearings were initiated in July 1968 and thus far involve approximately 5,000 pages of testimony plus numerous extensive written submissions on matters including (i) commission rate levels for exchange members (intra-member rates) and for nonmembers, (ii) the services for which such commission rates pay and the costs allocated thereto, (iii) give-ups and reciprocal practices among different categories of members and non-members, (iv) membership by financial institutions, (v) economic access to exchange markets by non-member broker-dealers, (vi) competition among exchanges and among exchanges and other markets, and (vii) the necessity for restrictions on access of exchange members to the third market. These issues are before the Commission in connection with its oversight responsibility, provided in Section 19(b)(9) of the Exchange Act to assure that commission rates fixed by national securities exchanges are reasonable.

The issues to which the provisions of Section 28 of H.R. 14737 relate—reasonable access and commission rate differences for bona fide non-members, reasonable fixed minimum commission rates and the applicability thereto of the antitrust laws are matters which are involved in this proceeding and now under active consideration by the Commission. The matter of reasonable commission rates is most complex and is bound up with the important related issues of public ownership of member firms, institutional membership, non-member access and competition among markets.

While the Commission has reached no conclusions on the merits of these questions, it does believe that existing Section 19(b) of the Exchange Act provides an adequate framework for balancing the antitrust and other issues of public policy. We urge that the Commission be given an opportunity to complete its inquiry and attempt to resolve the issues pursuant to its powers under Section 19(b) of the Exchange Act before any attempt is made to enact further legislation in this area. Such legislative action at this juncture would be premature and disrupt the present proceedings being conducted pursuant to our authority under the Exchange Act.

OTHER MATTERS

The provisions of H.R. 12867 on which we commented under this subject heading in our November 5, 1969 memorandum have been substantially conformed to S. 2224 and H.R. 11995 by H.R. 14737. However, H.R. 14737 does contain a number of other modifications which would remove needed investor safeguards and add needless procedural complications or unnecessarily limited Commission discretion. We will not discuss all these modifications in detail, since all of them are summarized in the comparative table attached to this memorandum. However, three examples of these changes are:

(1) Section 19 of H.R. 14737 would add a requirement that derivative suits under Section 36(b) of the Act, as amended, is brought by shareholders "acting in good faith and with justifiable cause." This is similar to the requirement in paragraph (7) of Section 36(b) of the Act, as proposed to be amended by H.R. 14737, which would impose federal criminal penalties on any person who knowingly acts as attorney or agent in connection with any judicial, administrative, or other proceeding matter involving any party subject to the jurisdiction of the Commission, if he acts "without justifiable cause." Although a shareholder would not be subjected to criminal penalties by Section 19 of H.R. 14737, we believe that this requirement would impose a needless obstruction to derivative suits. As we stated in our November 5, 1969, memorandum, we believe that any disadvantages of allowing shareholders full access to the courts are far outweighed by the protections such access gives against abuses which otherwise would find no remedy.[8]

[8] See additional comments in our November 5, 1969, memorandum at pages 14-15.

(2) Section 19 of H.R. 14737 provides that the Court may award relief "as may be reasonable and appropriate in the circumstances" in Commission suits brought under Section 36(a) of the Act, as amended, for breach of fiduciary duty involving personal misconduct. This changes the language in corresponding Section 20 of S. 2224 and H.R. 11995 which provides that a court may award relief which "in its discretion deems appropriate in the circumstances." The grant of discretion in S. 2224 and H.R. 11995 closely follows the language of present Section 36 of the Act with respect to injunctive relief. We do not believe that Section 19 of H.R. 14737 enunciates a substantive standard any different from the equivalent provision in the latter two bills, but the difference in language would tend to set the stage for needless arguments on the extent of the courts' discretion in framing relief.

(3) Section 8(a) of H.R. 14737 deletes the requirement specified in Section 15(a)(1) of the Act, that investment advisory contracts "precisely" describe compensation to be paid thereunder. Section 8(a) of S. 2224 and H.R. 11995 retain the present requirement that such compensation be precisely described. We believe that H.R. 14737 in this respect would represent a significant weakening of an essential disclosure requirement, which the Congress in enacting the Investment Company Act of 1940 deemed necessary to permit the independent directors and shareholders of mutual funds to make an informed and intelligent decision when considering approval of the contract.

CONCLUSIONS

As the foregoing makes clear, and as we stated with respect to H.R. 12867, H.R. 14737 would in fact substantially cut back the protections now offered by the Investment Company Act of 1940. The voluminous record already adduced before your Committee, as well as the Commission's own studies and reports fully support the proposition that present regulation must be augmented, at least to the extent contemplated by S. 2224 and H.R. 11995. H.R. 14737 is not only inadequate in this regard, but seriously erodes present protections.

In our opinion, the enactment of H.R. 14737 would represent a substantial setback for fund shareholders which might have the effect of undermining vital shareholder confidence in the mutual fund industry—without which the industry could not long survive in its present state. As we have previously informed your Committee, the Commission supports S. 2224 and H.R. 11995 because, despite the revision of our original recommendations, they still represent a major improvement in existing mutual fund regulation in meeting the needs of investors in the critical areas of concern indicated by the Commission's study of the fund industry.

There is no reason to substitute for S. 2224 and H.R. 11995, the products of such long negotiation, which have passed the Senate without opposition, a bill which so substantially lessens key elements of mutual fund shareholder protection.

COMPARISON BETWEEN H.R. 14737 (CONGRESSMAN STUCKEY) AND SENATE PASSED S. 2224—IDENTICAL H.R. 11995

H.R. 14737				S. 2224			
Page	Lines	Bill section	Statute ( )	Page	Lines	Bill section	Change in S. 2224 by H.R. 14737
2	21-23	2(3)	New 2(a)(19)(A)	2	18-21	2(3)	Expands definition of interested person with respect to an investment company to include certified public accountant for company and former employee of SEC during last 2 years.
3	4 5	2(3)	New 2(a)(19)(A)	3	1	2(3)	Adds requirement for notice and opportunity for hearing in each case in which Commission determines any person is an interested person within the meaning of 2(a)(19)(A). (Sec. 40 of act presently requires notice and opportunity for hearing, which is retained by S. 2224.)
4	14 16	2(3)	New 2(a)(19(B)	4	7-11	2(3)	Changes definition of "interested person" with respect to an investment adviser or principal underwriter to include any person or partner or employee of any person who at any time since beginning of last 2 fiscal years of the investment company has acted as legal counsel or as certified accountant for the investment company, or who has been an employee of the SEC. (S. 2224 includes in its definition those persons specified that acted as legal counsel for the investment adviser or principal underwriter of the investment company.)
4	21-22	2(3)	New 2(a)(19(B)	4	16	2(3)	Adds requirement for notice and opportunity for hearing as under 2(a)(19)(A). (See comment above.)
[illegible]	[illegible]	[illegible]	New 2(a)(45)	5-6	23(p5) 7(p6)	2(5)	Deletes S. 2224 amendment. (S. 2224 adds definition of "savings and loan association.")
6	24-25	3(b)(5)	3(c)(13), redesignated 3(c)(9)	7	15-16	3(b)(6)	Identical, renumbering change.
[illegible]	[illegible]	[illegible]	3(c)(11), redesignated 3(c)(9)	7	5-14	3(b)(5)	Deletes S. 2224 amendment. (S. 2224 modifies exclusion for companies holding oil, gas, or other mineral royalties or leases.)
13	17	7	New 12(d)(1)(E)	16	9	7	Extends exception from provisions of sec. 12(d)(1) to case where a unit
13-14	24(p13) 5(p4)	7	New 12(d)(1)(E)	16	16	7	investment trust owns more than one security if the investment trust issues two or more classes or series of securities, each of which provides for the accumulation of shares of a different investment company.
[illegible]	[illegible]	[illegible]	10(d)	11-12	19(p11) 1(p12)	5(d)	Deletes S. 2224 amendment. (S. 2224 adds exemptions for bank collective funds for managing agency accounts operated on a no-load basis, similar to treatment presently accorded under sec. 10(d) of act to no-load funds.)
17	21-24	[illegible]	15(a)(1)	20	10-11	[illegible]	Requires that investment advisory contracts describe "all compensation to be paid thereunder for investment advisory and other services." (S. 2224 makes no change in present requirement that such contracts "precisely describe all compensation to be paid thereunder.")

See footnotes at end of table.

COMPARISON BETWEEN H.R. 14737 (CONGRESSMAN STUCKEY) AND SENATE PASSED S. 2224—IDENTICAL H.R. 11995—Continued

H.R. 14737			Statute ( )	S. 2224			Change in S. 2224 by H.R. 14737
Page	Lines	Bill section		Page	Lines	Bill section	
19	5-19	8(b)	15(a) and (b) and new 22(b) and 36(b).	[illegible]	[illegible]	[illegible]	Provides sec. 36(b) and 22(b) shall not apply to advisory contracts and underwriting contracts for investment companies if approved by all of the independent directors and by two-thirds of the shareholders within 1 year, provided that no more than 50 percent of the members of the board of directors are interested persons, and that if so approved such contracts shall be presumed to be fair and equitable and not in breach of any fiduciary duty with respect to the receipt of compensation for services or of payments of a material nature. This presumption would apparently apply to action under sec 36(a) of act for breaches of fiduciary duty including personal misconduct.
20	[illegible]	8(c)	15(c)	22	2-3	8(c)	Deletes requirement that voting requirements of sec. 15 can be satisfied only by directors who are personally present at a meeting at which their votes are taken.
[illegible]	[illegible]	[illegible]	17(g)	24	17-19	9(b)	Deletes S. 2224 amendment (S. 2224 relaxes bonding requirements for bank officers and employees.)
22	12	9(b)	New 17(i)	24	23	9(c)	Identical – merely renumber change.
25	14-15	12(a)	22(b)(1)	28	2-3	12(a)	Provides that the NASD, in setting sales loads should allow for "reasonable profitability for brokers and dealers, and underwriters. (S. 2224 provides that the NASD should allow for reasonable compensation for same and for reasonable sales loads to investors)
25	15-20	12(a)	22(b)(1)	[illegible]	[illegible]	[illegible]	Adds provision for SEC authority to grant appropriate exemptions from 22(b)(!), upon application or otherwise, to "smaller companies . . . subjected to relatively higher operating costs."
[illegible]	[illegible]	[illegible]	Adds new 22(h)	30-31	22(p. 30) 23(p. 31)	12(d)	Deletes S. 2224 amendment (S. 2224 would permit banks to engage in certain investment company activities.)
[illegible]	[illegible]	[illegible]	Strikes 27(b), redesignates 27(c) as 27(b).	35	18-21	16(a)	Deletes S. 2224 amendment. (S. 2224 would repeal SEC authority to relax requirements of sec. 27(a) in case of smaller investment companies.
32, 33	19, 23	16(a)	New 27(d) corresponds to new 27(c).	36	5, 9	16(b)	Changes term 3 years (in S. 2224) to 1 year during which purchaser of a contractual plan may surrender his certificate and obtain a refund; changes the amount paid for sales loading which may be received in refund from the excess over 15 percent (in S. 2224) to excess over 20 percent of gross payments made by holder.
33	5, 6, 17, 21	16(a)	New 27(e) corresponds to new 27(d).	36-37	16, 17 (p. 36), 4, 8 (p. 37).	16(b)	Renumbering changes. (Note: Reference on p. 33, line 21 of H.R. 14737 to "subsection (c)" appears to be incorrect. Probably should be "subsection (d)".)

33	11-16	16(a)	do	36-37	22 (0. 36), 2 (p. 37)	16(b)	Provides that notice of surrender and refund rights be given to contractual plan investors who has missed 3 payments or more within 30 days of the expiration of 10 months after issuance of certificate and to contractual plan investors who have missed 1 payment or more after the 10 month period before the expiration of 1 year of the issuance of the certificate. (S. 2224 in the former case, provides for such notice within 30 days following expiration of 2 years and 6 months after issuance of certificate, and in the case of 1 or more missed payments after such 2 year 6 month period before, the expiration of 3 years after issuance of certificate.)
33	22	16(a)	New 27(c) corresponds to new 27(d).	37	8-10	16(b)	Adds requirement that SEC make "reasonable" rules specifying method, form, and contents of notice.
33	24	16(a)	New 27(f) corresponds to new 27(e).	37	8-10	16(b)	Renumbering changes.
34	5	16(a)	do	37	17	16(b)	Adds requirement that SEC make "reasonable" rules specifying form, method, content of notice of right of withdrawal to contractual plan investors.
34	7	16(a)	do	37	19	16(b)	Reduces from 60 to 30 days the time during which contractual plan investor can withdraw and get back all sales and loading charges.
34	15-16	16(a)	do	36	15	16(b)	Provides that SEC make "reasonable" rules specifying reserve requirements for issues of contractual plans as "may be reasonably necessary" to carry out refund obligations. (S. 2224 provides for such rule making as SEC "deems necessary and appropriate" to carry out such obligation.)
34	18-22	16(a)	New 27(f)	[illegible]	[illegible]	[illegible]	Provides that no reserve requirement specified by SEC rules shall be taken into account in computing "net capital" of any one investment company issuing periodic plan certificates under SEC rules and regulations.
34, 35	23, 24 (p. 34) 2 (p. 35).	16(a)	New 27(g) corresponds to new 27(f).	38	6, 7, 10	16(b)	Renumbering changes.
35	4, 5	16(a)	New 27(h) corresponds to new 27(g).	38	12, 13	16(b)	Do.
[illegible]	[illegible]		New 28(i)	40-43	10 (p. 40), 9 (p. 43).	17	Deletes S. 2224 amendment. (S. 2224 would limit sales loads on face-amount certificates.)
37	13, 23	17	32(a)	43-44	20 (p. 43), 6 (p. 44).	13	Deletes provision in S. 2224 that voting requirements for election of independent accountants be satisfied only by directors who are personally present at a meeting at which their votes are taken.
40	6, 9	18	33	46	13, 16	19	Lengthens time allowed to transmit to SEC papers filed in certain civil action from 5 to 10 days (if such papers are delivered to investment company or party defendant) and from 2 to 5 days (if such papers are filed in court by investment company or party defendant.
41	7-8	19	New 36(a)	47	14	20	Changes language regarding suits under new 36(a) standard such that the court may award relief "as may be reasonable and appropriate in the circumstances," in place of "in its discretion deems appropriate in the circumstances," (as in S. 2224).

See footnotes at end of table.

COMPARISON BETWEEN H.R. 14737 (CONGRESSMAN STUCKEY) AND SENATE PASSED S. 2224—IDENTICAL H.R. 11995—Continued

H.R. 14737				S. 2224			
Page	Lines	Bill section	Statute ( )	Page	Lines	Bill section	Change in S. 2224 by H.R. 14737
41....................	13......................	19....................	New 36(a)............................	[illegible]	[illegible]	[illegible]	Adds requirement that the SEC accord defendant a "fair opportunity to comply" with the Administrative Procedure Act before suing under new 36(a).
41....................	22-24................	19......................	New 36(b)..........................	48	1, 2	20	Adds term "bona fide" before "security holder of such registered investment company"; adds requirement that such person must be "acting in good faith and with justifiable cause" in derivative suits under new 36(b).
42....................	11.....................	19......................	New 36(b)(1)......................	48	13-14	20	Adds requirement that plaintiff's burden of proof in suits under 36(b) must be met by "clear and convincing evidence."
42...................	20-21................	19......................	New 36(b)(2).......................	[illegible]	[illegible]	[illegible]	Adds reference to sec 8(b) of bill (amending secs. 15(a) and (b) of act) which provides that sec. 36(b) shall not apply to compensation received by persons specified in 36(a) if approved by all of independent directors and by [illegible] of shareholders if no more than 50 percent of members of board are interested persons.
43-44..............	25 (p. 43), 12 (p. 44).	19.....................	New 36(b)(7)........................	[illegible]	[illegible]	[illegible]	Prohibits former SEC employees from acting in any capacity in connection with any matter involving a party subject to jurisdiction of the Commission for 2 years after termination of employment; prohibits anyone from so acting "without justifiable cause;" imposes $10,000 fine or 2 years imprisonment or both if these prohibitions are violated.
44....................	13......................	20...................	43(a)....................................	50............	3..........................	21...............	Identical, renumbering change.
44....................	18......................	21...................	44...	50.............	8.........................	22...............	Do.
45....................	8......................	22.....................	202(a), Investment advisers Act.	50.............	21.......................	23.................	Do.
[illegible]	[illegible]	[illegible]	203(b), Investment Advisers Act.	51-52........	14(p. 51) 8(p. 52).	24(a)..........	Deletes S. 2224 amendment. (S. 2224 repeals exemption for investment companies to Investment Advisers Act.) Effect would be to continue to permit investment advisory contracts with investment companies that provide for investment advisory fees on basis of a share of capital gains upon or capital appreciation of the funds or any portion of the fund of the client.
45....................	24...................	23(a)............	203(c), Investment Advisers Act.	52............	9............................	24(b)............	Identical, renumbering change.
46..................	9......................	23(b)..............	New 203(d), Investment Advisers Act.	52...........	18...........................	24(c)...........	Do.
46...................	24...................	23(c)...............	203(d) redesignated 203(e), Investment Advisers Act.	53..........	8.............................	24(d)...........	Identical, renumbering change. (p. 40, line 15 omits, apparently in error, lines 23-24, p. 51 of H.R. 12867.)

49................	21....................	23(d)................	New 203(f), Investment Advisers Act.	54............	3...........................	24(e)............	Identical, renumbering change.
[illegible]	[illegible]	[illegible]	205, Investment Advisers Act.	51-53.........	12 (p. 51), 8 (p. 53)	25..............	Deletes S. 2224 amendment. (S. 2224 would prohibit compensation to investment advisers of investment companies on basis of shares of capital appreciation but would permit advisory fee based on performance under certain conditions.)
50...................	23......................	24...................	206A, Investment Advisers Act	59............	3...........................	26..............	Identical, renumbering change.
51 [illegible]	12......................	25..................	Amendments to Securities Act	59............	17.........................	27.................	Do.
[illegible]	[illegible]	[illegible]	3(a)(12), Securities Exchange Act	63-65.........	13 (p. 63), 2 (p. 65)	28(a)...........	Deletes S. 2224 Amendment. (S. 2224 adds to definition of “excepted securities” those securities issued by certain bank common and collective trust funds and insurance company separate accounts.)
55..................	8.........................	26(a)..............	3(a)(19), Securities Exchange Act	65...........	3.............................	28(b)...........	Identical, renumbering change.
55..................	14......................	26(b)...............	12(a)(2), Securities Exchange Act	65...........	8.............................	28(c)...........	Do.
56....................	4........................	27.....................	Securities Act and Investment Company Act.	65.............	23...........................	29.................	Identical—renumbering change.
56-57..............	20 (p. 56) 5(p. 57).	28.....................	Sec. 19, Securities Exchange Act.	[illegible]	[illegible]	[illegible]	Provides statutory exemption from antitrust laws for minimum commission rates of national securities exchanges provided that the sale is reasonable and that the exchanges provide reasonable access and commission rate differentials for bona fide nonmembers.
57...................	6, 8, 11, 19, 23...	29......................	Effective date of amendments.	66-67......	14, 16, 19(p66) 3, 7, (p67)..	30...............	Renumbering changes to conform to variations in substance and renumbering of bills and acts noted above.

[1] Section numbers of Investment Company Act of 1940, unless otherwise noted.
[2] Bill sections of both H.R. 14737 and S. 2224 amend same section of act, unless otherwise noted.
[3] No corresponding provision in sec. 2 of this bill.
[4] P. 6, between lines 3 and 4, the words “Sec. 3 (a) The second sentence of par. (2) of” have apparently been omitted.
[5] No corresponding provision in sec. 3 of this bill.
[6] No corresponding provision in sec. 5 of this bill.
[7] No corresponding provision in sec. 8 of this bill.
[8] No corresponding provision in sec. 9 of this bill.
[9] No corresponding provision in sec. 12 of this bill.
[10] No corresponding provision in sec. 16 of this bill.
[11] No corresponding provision in sec. 27 of this bill.
[12] No corresponding section in this bill.
[13] No corresponding provision in sec. 20 of this bill.
[14] No corresponding provision in sec. 23 of this bill.
[15] P. 52, line 21 through p. 54, line 20 appears garbled. Cl. S. 2224, p. 60, line 15 though p. 62, line 25.
[16] No corresponding provision in sec. 26 of this bill.
[17] No corresponding provision in this bill.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., May 21, 1970.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce, House of Representatives, 2125 Rayburn House Office Building, Washington, D.C.

Re: H.R. 17333, 91st Congress.

DEAR MR. CHAIRMAN: In the absence of Chairman Budge, it is my pleasure to transmit herewith 30 copies of the memorandum, with appendix attached thereto, setting forth the Commission's views on H.R. 17333, in request to your response of May 5, 1970.

Our views on the bill are being transmitted at this time at the specific request of members of your staff, without prior clearance with the Bureau of the Budget, since time has not permitted clearance under the Bureau's Circular A-19. Upon receipt of the Bureau's clearance, we will transmit promptly the Bureau's advice to you.

Sincerely yours,

JAMES J. NEEDHAM, *Commissioner.*

Enclosure.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., June 18, 1970.

Re H.R. 17333, 91st Congress.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: In our letter of May 21, 1970, transmitting copies of the Commission's report on H.R. 17333, we indicated that time had not permitted advance clearance of such report with the Bureau of the Budget under the Bureau's Circular A-19 (Revised), and we promised to transmit to you promptly the Bureau's advice when received.

We were informed last evening by the Bureau of the Budget that there is no objection to the Commission's report of May 21, 1970, on H.R. 17333 from the Administration's viewpoint.

Sincerely,

HAMER H. BUDGE,
Chairman.

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION ON H.R. 17333 TO THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, HOUSE OF REPRESENTATIVES

This memorandum, prepared in response to a request by Chairman Staggers, sets forth the Commission's views on H.R. 17333, a bill reported to the Interstate and Foreign Commerce Committee from its Subcommittee on Commerce and Finance, which would amend the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933 and the Securities Exchange Act of 1934.

INTRODUCTION

In many respects H.R. 17333 is identical to H.R. 14737, a bill which was introduced by Congressman W.S. Stuckey in the House of Representatives on November 6, 1969.

The Commission submitted its views on H.R. 14737 to the Committee on December 10, 1969 and also submitted its views on a similar predecessor bill H.R. 12867, likewise introduced by Congressman Stuckey, by memorandum dated November 5, 1969 to the Committee. References are made to the views expressed in these memoranda to which the Commission adheres.

Many of the provisions of H.R. 17333 are the same as those found in H.R. 11995 and S. 2224. Chairman Budge testified in support of these two bills on November 12, 1969 and on December 11, 1969 before the Subcommittee on Commerce and Finance and the Commission has submitted extensive material for the record and has responded to questions from members of the Subcommittee. We will endeavor to avoid duplicating that material in this memorandum.

In major areas of particular importance to mutual fund shareholders, however, H.R. 17333 would eliminate or make largely illusory the protections for investors provided in H.R. 11995 and S. 2224 and would indeed give investors less protection in these areas than they now have either under the existing provision of the Investment Company Act or even under the corporation and common law of the various states. For these reasons, which will be discussed in more detail below, the Commission urges that the Committee revise H.R. 17333 so as to conform substantially to H.R. 11995 and S. 2224, in order that an adequate degree of investor protection may be obtained.

INVESTMENT ADVISORY CONTRACTS

H.R. 17333 like H.R. 11995 and S. 2224 contains, in Section 20 of the bill, a provision declaring that the investment adviser of a registered investment company has a fiduciary duty with respect to the receipt of compensation and authorizing the Commission, or a security holder of the investment company, to bring an action in court for breach of this fiduciary duty. The provisions in all three bills on this subject are much the same although H.R. 17333 requires a security holder to be “acting in good faith and with justifiable cause” while the other two bills contain no such restriction. H.R. 17333, however, makes this important safeguard largely illusory due to the provisions of Section 8(b) of that bill which exempts from Section 36(b) any investment advisory contract which has been approved by all of the unaffiliated directors and by vote of the holders of two-thirds of the voting securities of such company and goes on to provide that a contract so approved shall be presumed to be both fair and equitable and not in any breach of any fiduciary duty. Several points should be noted with respect to this provision of H.R. 17333.

1. As the Commission has repeatedly pointed out in its testimony with respect to mutual fund legislation over a period of nearly three years, and as the Senate Committee on Banking and Currency pointed out in its report on S. 2224, the structure of the mutual fund industry is such that unaffiliated directors or shareholders are not in a position to exert any control over investment advisory fees and in fact have never done so during the thirty years since the Investment Company

Act of 1940 was passed. In brief, this situation results from the fact that mutual funds, unlike other corporations, are not managed by their own officers and directors but by an outside management company which is compensated by an investment advisory fee. The management company effectively controls the fund which it has usually created. Approval of the investment advisory contract by the directors and shareholders is required by the existing provisions of the Investment Company Act. If such approval were withheld by either, this would have the disastrous consequences of leaving the company without management. Thus, the shareholders have no real choice. They must either keep the present management or have none. For the same reason the so-called independent directors cannot bargain with respect to the size of the fee even if they desire to do so. The record shows that almost invariably they do not desire to do so. This is understandable since it would disrupt relations among the board members and be unpleasant for the independent directors, who are chosen by the management company. Insofar as the shareholders are concerned the management company has control of the proxy machinery and there is never any contest over the management fee, with the result that the shareholders have no realistic choice except to send their proxies to representatives of the management company or else to not vote at all. Like shareholders generally, they will, as a matter of routine, return their proxies if requested to do so by management. The uniform experience of investment companies over the years demonstrates that the foregoing is precisely what occurs.

2. It would be anomalous indeed for Congress to declare that the investment adviser has a fiduciary duty with respect to his fee and then to turn around and say that he can breach that duty with impunity, no matter how outrageous the breach, if directors and shareholders who have no other choice, approve the contract. This is contrary to the basic law of fiduciary duty. The advisor is a fiduciary for all of his beneficiaries, in this case all of the shareholders. He should not be permitted to breach his duty to the minority simply because the majority has no objections.

3. As mentioned, the existing provisions of Section 15(a) and (c) require that investment advisory contracts be approved by the unaffiliated directors, shareholders, or both. This approval, however, requires only a majority vote. If this approval is not obtained there is no effective contract. The existence of these requirements underlines the extremely narrow scope which Section 36(b) would have under H.R. 17333. Unless a majority approves, there will be no contract at all. If somewhat more than this majority is obtained, Section 36(b) is inapplicable and breach of fiduciary duty is automatically sanctioned.

4. Section 36(b), as contained in S. 2224 and H.R. 11995, without the crippling effect of new Section 15(b) found in H.R. 17333, was jointly drafted by representatives of the Commission and the Investment Company Institute and jointly submitted by them to the Senate. The Institute is on record before the full Committee and before the Subcommittee on Foreign Commerce and Finance as supporting this reform. There is no need to largely nullify it in order to accommodate the legitimate needs of the industry.

Two other matters should be noted. First, new Section 15(b) contained in Section 8(b) of H.R. 17333 is the only provision either in

that bill or in H.R. 11995 and S. 2224, calling for approval of a contract or arrangement by the so-called independent directors, which utilizes the broader term "unaffiliated" directors rather than the specifically defined term "directors who are not interested persons." The term "unaffiliated" directors may include persons who have a significant interest in the management company. For this reason the requirement of approval by directors who are not interested persons was substituted throughout this legislation in an effort to eliminate such conflicts of interest. No one has ever, at any time, objected to this change. The use of the term "unaffiliated" in Section 8(b) of H.R. 17333 is inexplicable unless t is inadvertent.

The requirement of new Section 36(b) in H.R. 17333 that the security holder must be "acting in good faith with justifiable cause" is both unnecessary and confusing. If the shareholder has no cause of action the court will so determine. If he has cause of action he should prevail. No doubt such actions, which are quite expensive, would not be brought by a security holder unless he saw a reasonable chance of success. Litigation, however, is rather uncertain and anyone may lose a suit which he thought he would win. Is the unsuccessful security holder to be disciplined in some way or is there to be a preliminary trial on his good faith and justifiable cause which will, in effect, duplicate to a considerable degree, the trail [sic] on merits? Subparagraph (1) of Section 36(b) in H.R. 17333 provides that the plaintiff shall have the burden of proving a breach of fiduciary duty by "clear and convincing evidence." H.R. 11995 and S. 2224 contain no such restriction and merely require that the plaintiff have the burden of proof. The insertion of "clear and convincing evidence" is entirely inappropriate in a civil action. Some state courts have utilized this test in quasi-criminal actions such as a proceeding to disbar a lawyer. Even there many states do not utilize this test. Both the Commission and the Investment Company Institute intended, as did the Senate, that an action under Section 36(b) should not be quasi-criminal. Consequently, this element should not be introduced into Section 36(b).

SALES CHARGES

The provisions of H.R. 17333 with respect to sales charges diverge from those of H.R. 11995 and S. 2224 in exactly the same way as in the case of management fees. Both bills provide for regulation of sales charges by the National Association of Securities Dealers (NASD) subject to Commission oversight but the protection afforded in this area in H.R. 17333 is likewise nullified by an exclusion for contracts approved by the unaffiliated directors and shareholders. This provision is subject to many of the same objections as those relating to management charges and referred to above. Thee are, however, special considerations in this area which are not present in the case of management fees. In the first place shareholder approval of underwriting contract is not required by the existing provisions of Section 15(b0 of the Act. This recognizes the basic fact that existing shareholders have little interest in the sales charge, except to the extent that they might buy additional shares. They have already paid whatever sales load is charged and they do not particularly care what

charge is made to new shareholders. Under these circumstances to allow a vote of the existing shareholders to deprive an entirely different group of persons, perspective shareholders, of the protections afforded by NASD regulation is particularly unjustified. In the second place, no one has object to NASD regulation of sales loads. The NASD is an organization composed of persons engaged in the business of selling securities and its membership comprises the great bulk of those who sell mutual funds. There is no basis whatsoever to assume that this organization would act unfairly to those who sell mutual fund shares including its own members.

Nor can it be assumed that the Commission will act arbitrarily or be unreasonable in exercising its oversight of NASD rules in this area. It has never been suggested that the Commission has acted arbitrarily and unreasonably in exercising its oversight of NASD rules. On the contrary what criticism there has been of the Commission's activities in this field, in Congress and elsewhere, has been that the Commission's oversight of NASD's rules sometimes has tended, if anything, to be too lenient rather than too strict. The Commission may act "only as may be necessary for purposes of this subsection" and it is quite clear from the language of new Section 22(b)(1) as added by Section 12 of H.R. 17333, that if it is the intention of Congress that the regulation of sales loads be fair to sales personnel, broker-dealers, underwriters and to investors. If the NASD believes that the Commission has acted unreasonably or in a manner not authorized by Congress in exercising its oversight of NASD rules on sales loads, it would appear that the Association could obtain judicial review under the provisions of Section 25 of the Securities Exchange Act of 1934.

FRONT-END LOADS

The provisions of H.R. 17333 dealing with the so-called front end load on periodic payment plans authorize deduction of up to fifty percent of the first year's payments for sales charges in a manner generally similar [to] corresponding provisions in H.R. 11995 and S. 2224. There is, however, an important difference. Section 27(c) of the Act, as proposed to be added by H.R. 11995 and S. 2224 would require periodic payment plans to provide for a refund to any investor surrendering his certificate within the first three years of that portion of the sales charge which exceeds fifteen percent of the gross payments made. The corresponding provisions of H.R. 17333 contained in Section 16(a) of the bill would permit a refund only within the first year and then only of the excess sales charge over twenty percent.

We believe that this one-year period is too short. An investor may not realize until after the expiration of one year the extent to which his investment has been diluted by the fifty percent sales charge. We also believe that the twenty percent effective sales load charged to an investor who redeems within one year is too high.

The Commission supports the provisions on this subject contained in H.R. 11995 and S. 2224. If, however, the Committee should determine that the refund period should be somewhere between the one-year period in H.R. 17333 and the three-year period found in the other bills, the Commission would not object provided that the refund period significantly exceeded one year.

BANK ADMINISTERED INVESTMENT COMPANIES

H.R. 11995 and S. 2224 would have expressly permitted the operation by banks of so-called commingled agency managed accounts, subject to specified restrictions of which the most important is that no sales load in connection with the sale or interests in such accounts would be permitted. H.R. 14737 contains no provision with respect to such accounts and would not change the law with respect to them. H.R. 17333 would make the operation of investment companies by banks, and savings and loan associations, subject to the provisions and restrictions required by any law of any state or of the United States. We interpret this as leaving the right of banks, and savings and loan associations to operate registered investment companies to be determined either by subsequent legislation or by the interpretation of existing legislation. The question of whether banks may operate such funds consistently with the national banking laws is now pending in the Supreme Court of the United States in the case of Investment Company Institute v. Camp (No. 843, October Term 1969).

The Commission expresses no opinion on the national policy question of whether banks should be permitted to operate such funds and likewise expresses no opinion as to whether savings and loan associations should be permitted to do so. Otherwise the provisions of H.R. 17333 with respect to bank-operated investment companies are substantially the same as in H.R. 11995 and S. 2224.

FUND HOLDING COMPANIES

H.R. 11995, S. 2224 and H.R. 14737 would all permit the operation of fund holding companies subject to specified restrictions of which the most significant are the requirement that not more than three percent of the stock of any individual investment company may be owned by such a holding company, that only one percent of the securities of any portfolio fund may be redeemed in any period of less than thirty days, and that the sales load of the holding company cannot exceed one and one-half percent. H.R. 17333 diverges from these requirements by permitting any sales load which, when added to the sales load for acquisition of stock in any portfolio fund, is not excessive as defined in Section 22(b) of the Act.

The Commission adheres to its original recommendation that fund holding companies be prohibited (Public Policy Implications of Investment Company Growth, pages 311-324). This would be effectively accomplished by Section 12(d)(1)(A) proposed to be added to the Investment Company Act in all of the bills, were it not for the proviso contained in subparagraph (F).

The Commission believes that fund holding companies are an investment vehicle of doubtful utility and that their operation may be unnecessarily costly to investors and may have a disruptive effect on the portfolio funds. This would be particularly true if such holding companies were to proliferate so that they held, in the aggregate, a large part of the outstanding stock in some portfolio funds.

In any event, the Commission prefers the limitations on sales charges by such companies contained in H.R. 11995 and S. 2224. It is not clear whether or not a fund holding company could avoid the operation of proposed Section 22(b) of the Act as referred to in

subparagraph (F) by obtaining ratification of its underwriting agreement by unaffiliated directors and shareholders as provided in paragraph 8(b) of H.R. 17333 which was discussed above under the heading of "Sales Charges." If this could be done the result would be that there would be no limitation on the sales charges levied by the fund holding companies and their portfolio funds. This result would certainly be contrary to the public interest and the interest of investors.

EXCHANGE COMMISSION RATES

Section 30 of H.R. 17333 would replace existing subsection (c) of Section 19 of the Exchange Act of 1934 with a new provision exempting flat rate minimum commission charged by members of a stock exchange from the antitrust laws provided the commissions are adopted in accordance with the procedures of this Act and further provided that the commission rate is reasonable and that the exchange provide reasonable access and commission rate differentials for bona fide non-members.

We believe this prosivision [sic] is unnecessary and undesirable. The courts have indicated that exchanges enjoy a certain degree of latitude under the antitrust laws for their self-regulatory activities and that they may have a minimum commission rate without it being a "per se" violation of the antitrust laws. Exchange commission rates, of course, are, and would continue to be, subject to our jurisdiction and the Act presently provides that they be reasonable. A blanket immunity from the antitrust laws for all aspects of commission rate fixing would appear to be undesirable. In any event, the Antitrust Division of the Department of Justice should be consulted.

The wording of the amendment also creates problems. In the first place, the exchanges do not have a flat rate fixed minimum commission. Rather, the rate is scaled downward on larger transactions. Also, the exchanges do not charge commissions as the amendment would indicate. Rather, they fix the minimum commissions to be charged y their members. The exchange commission rate rules are not adopted pursuant to any procedure in the Securities Exchange Act. They are adopted pursuant to the rules of the exchange although they are subject to review by the Commission in accordance with Section 19(b) of the Act and Rule 17a-8 adopted pursuant to that Act.

The provisions conditioning the exemption on the rates being reasonable is somewhat troublesome. The Commission is required to attempt to see to it that the rates are reasonable and we are studying this subject extensively at the present time. The amendment could be construed as permitting an antitrust court to hold that commission rates violate the antitrust laws if the rates are not, in the opinion of the court, reasonable. Such an interpretation would mean that both the Commission and the antitrust courts would determine whether rates were "reasonable" by different procedures and with different consequences. This would disrupt the regulatory scheme. Finally, conditioning the exemption upon access for "bona fide no-members" raises a difficult question of policy under the Securities Exchange Act which is being considered by the Commission at the present time. It, and other provisions, are inter-related with the question of reciprocal business, the question of customer directed give-ups, the question of the competitive relationship between the New York and

American exchanges and other market places such as the regional stock exchanges, and the question of institutional membership on exchanges. WE do not think it desirable to resolve all of these questions in one clause dealing with antitrust immunity. Incidentally, we assume that the reference to "non-members" is intended to refer to non-member broker-dealers not all non-members of the exchange, which would defeat the purpose of a minimum or other fixed commission rate.

We note that in preliminary discussions with our staff certain representatives of the exchanges have indicated that they may oppose this provision because of the difficulties referred to above.

OTHER MATTERS

There is attached hereto an appendix containing our comments with respect to other aspects of H.R. 17333.

Attachment.

SECURITIES AND EXCHANGE COMMISSION APPENDIX CONTAINING ADDITIONAL COMMENTS ON H.R. 17333

1. SECTION 25, PAGE 59, LINES 15-23—PERFORMANCE FEES

This section makes the prohibition of performance fees in Section 205 of the Investment Adviser's Act of 1940 inapplicable to contracts made by registered investment advisers with "offshore" funds. We oppose this change because we believe that the provisions in the Investment Adviser's act concerning investment advisory contracts and fees between registered investment advisers and their clients should not be altered so that any group of clients would be adversely affected and lose the protection of that Act.

Investor confidence in the activities of registered investment advisers is enhanced by the belief among investors that these advisers are prohibited from engaging in activities harmful to the interest of their clients and from overreaching in setting their advisory fees. If foreign investors are to be encouraged to seek the advice of United States registered investment advisers, the confidence which is engendered by the present regulatory system should be retained. However, we would not oppose a modification of the bill to allow registered investment advisers to charge foreign unregistered investment companies a performance fee subject to the same limitations as those imposed on fees charged registered investment companies.

Section 25 of H.R. 17333 allows a registered investment adviser to charge a registered investment company a limited type of performance based fee. Although, as we noted during the Subcommittee hearings on this legislation, the Commission would still have preferred a flat prohibition, after discussion with the industry, such prohibition was changed to permit a fee which must increase and decrease proportionately on the basis of the investment performance measures against an appropriate index of securities prices or other appropriate measure of performance. As we stated during the house Subcommittee hearings in November 1969.

> Under this provision, no "base" or "standard" fee could be set arbitrarily in relation to the index; that is, the "base" or "standard" fee would be permitted only at the point that

> the fund's performance equaled the index. In every case, the point from which the increases and decreases must be measured to determine whether they meet the statutory requirement that they be proportionate is the point or fee level which is paid or earned when the fund's performance is equivalent to that of the index.
>
> Of course, the fee would still be subject to the fiduciary standards of section 36(b). (Hearings Before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737, 91st Cong. 1st Sess. (1969), p. 178. See also pp. 868-872.)

We understand that a question has been raised as to whether the language of Section 25 would prohibit a fee schedule whose base or standard amount is paid where the fund's performance exceeds the index. We believe that the language of Section 25 of the bill does this and that a simple explanation in the Committee Report similar to that quoted above would suffice.

However, if it is thought that the language is ambiguous, all possible further controversy could be avoided if there were inserted in H.R. 17333 at page 59, line 5 after the word "sentence":

"the point from which increases and decreases in compensation are measured shall be the fee which is paid or earned when the performance of the company or fund is equivalent to that of the index or other measure of performance, and"

2. SECTION 2(3), PAGE 2, LINE 18 AND PAGE 4, LINE 3 – INTERESTED PERSONS

This section omits legal counsel of investment company, principal underwriter and investment adviser and employees of such counsel from definition of "interested person." We oppose this deletion because a lawyer who counsels a fund, its adviser or underwriter is so closely related to management that he clearly should be considered to be the non-independent type of person the definition of "interested person" contemplates. In this connection, the Commission's General Counsel very early in the administration of the Act took the position that an attorney on a general retainer from an investment company is an "employee" of the company and is counted with other affiliated persons for purposes of Section 10(a) of the Act. (Investment Company Act Release 214 (1941)). Thus, using the approach of S. 2224 in including lawyers as "interested" persons would in a sense merely codify the longstanding interpretation since *employees* would be interested persons.

3. SECTION 8(b), PAGE 21, LINES 1-21 – MANAGEMENT FEES

This section removes the applicability of fiduciary duty standard imposed by new Section 36(b) where the advisory contract has been approved by all of the unaffiliated directors and the vote of two thirds of outstanding voting securities within one year. As noted above, the term "unaffiliated directors" may include persons who have a significant interest in the management company. However, this section omits the requirement of H.R. 14737 that in order for Section 36(b)

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not to apply, *interested* persons comprise not more than 50 percent of the board of directors of the investment company. Thus, an undesirable effect of H.R. 17333 would be that up to 60 percent of the board could be interested persons and if all the unaffiliated directors approve the contract, the fiduciary duty of Section 36(b) would not apply.

4. SECTION 12(a), PAGE 27, LINES 19-25; PAGE 28, LINES 1-5—SALES LOADS

This section adds to the factors to be considered by the NASD and the Commission in making rules to limit excessive sales loads "reasonable opportunity for profit for brokers and dealers and underwriters."

We are not in favor of this language, since we believe that investor protection should be the primary consideration in making such rules. Moreover, the last sentence of the section, which gives the Commission authority to allow higher sales loads for small companies "if it appears that such companies are subjected to relatively higher operating costs", should be deleted as contrary to the requirement for uniform sales loads in Section 22(d) of the Act, or in any event as superfluous, in view of the Commission's authority under Section 6(c) of the present law. At the very least, since this sentence appears to be modeled upon Section 27(b) of the present Act, the sentence should be modified to conform it to that Section to add a standard for the Commission to follow, such as "necessary or appropriate in the public interest and consistent with the protection of investors."

5. PAGE 6, LINE 24—OIL AND GAS FUNDS

this section deletes the amendment in S. 2224 and H.R. 11995 of Section 3(c)(11) and preserves the present complete exemption for oil and gas funds. We have no objection to this deletion, subject to the comments made in Chairman Budge's testimony of December 11, 1969. (Hearings Before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737, 91st Cong., 1st Sess. (1969) pp. 872-873.)

6. SECTION 29, PAGE 66, LINE 19 THROUGH PAGE 67, LINE 18—FINGERPRINTING

This section would amend the Securities Exchange Act of 1934 to require fingerprinting of (a) partners, officers, directors, and employees of a national securities exchange registered under that Act; (b) partners, officers, directors, and employees of a clearing corporation affiliated with such registered national securities exchange; and (c) partners, officers, directors and employees of a broker-dealer registered under that Act.

The section also provides that the fingerprints shall be promptly submitted to the Commission and that the Commission shall make rules and regulations to provide for the appropriating processing and use of such fingerprints.

While we feel that this section would generally provide a very worthwhile additional safeguard for public investors, we would nevertheless suggest the following changes:

1. That the fingerprint information required not be limited to persons employed by or associated with a national securities exchange

or broker-dealer registered with the Commission. In addition, persons employed by or associated with an investment adviser, a registered national securities association as defined in Section 15A of he Securities Exchange Act of 1934 (the National Association of Securities Dealers, Inc.), or a clearing corporation which may be affiliated with such an association, should also be included.

2. That the fingerprint information be submitted to the Department of Justice instead of the Commission. This agency is now experiencing its heaviest workload in its history at a time when it is not fully staffed. On the other hand, the fingerprint cards that would be submitted if this Bill were enacted would not be burdensome to the Department which already has on file over 184 million fingerprints and also receives nearly 7 million new ones annually Moreover, Section 0.85 of Title 28 of the Code of Federal Regulations (which is authorized by 28 USC 534) provides that the F.B.I. shall:

"(b) Conduct the acquisition, collection, exchange, classification, and preservation of identification records, including personal fingerprints voluntarily submitted, on a mutually beneficial basis, from law enforcement and other governmental agencies, railroad police, national banks, member banks of the Federal Reserve System, FDIC-Reserve-insured Banks, and banking institutions insured by the Federal Savings and Loan Insurance Corporation; . . . ."

3. We note that fingerprinting is not required for members, partners, officers, directors, and employees of member firms of exchanges as distinct from officers and employees of an exchange itself This would mean that a member firm's personnel would not be fingerprinted under this bill unless the firm was also a registered broker-dealer. Those exchange members, primarily specialists and floor brokers, who confine their securities activities to exchange transactions and do not do an over-the-counter business are not required to be registered as broker-dealers and a number of them are not. We are aware that personnel of member firms of the New York Stock Exchange are fingerprinted under the rules of the Exchange and New York law but this would not be true of personnel of members of other exchanges who are not members of the New York Stock Exchange. In any event if this national system is established it might be preferable to coordinate it with the New York system by the transmittal of fingerprint information concerning New York members to the Department of Justice along with those of other personnel n the securities and the investment advisory community.

Accordingly, we think that fingerprint information should be obtained for personnel of member firms as well as personnel of the exchange itself. If it is desired to exempt members of the New York Stock Exchange from this provision of the bill in view of the New York law, there could be an exemption for personnel of a member firm if fingerprint information concerning them is collected pursuant to state law. Incidentally, exchanges, as such, do not have partners so the reference to partners of an exchange in Section 29 of the bill is inappropriate. Accordantly, it is suggested that the bill be amended to provide that the fingerprints of the persons designated therein, as well as personnel of member firms of an exchange, with or without, as the Committee

[1] Attorney General's Report to Congress, page 399, June 30, 1967.

may prefer, an exemption for persons subject to state fingerprinting laws, and investment advisers and their employees, employees of any registered national securities association or of a clearing corporation which is affiliated with such an association, shall be promptly sent to an exchange or association with which the subject of the fingerprints or his employer is affiliated, or to the Commission if there is no such affiliation, and that the exchange, association or Commission shall promptly submit the fingerprints to the Attorney General who shall acquire, collect, classify and preserve fingerprint information (including fingerprints) relating to such persons and disseminate reports concerning such fingerprint information to the self-regulatory or regulatory organization which supplies the fingerprints. The bill also would authorize the Commission to make rules and regulations to provide for the appropriate collection and use of such fingerprint information by self-regulatory organizations and the Commission.