continue to serve nonfund clients [158] or brokerage firms for whom the management of the fund is but one of a variety of activities.[159]

No-load shares are sold by the fund itself with the aid of its investment adviser. The absence of a sales load precludes the development of the complex distribution systems and the exertion of the vigorous direct selling efforts characteristic of the load funds. No-load funds employ no salesmen. However, they and their advisers stimulate share sales[160] by advertisements in newspapers and periodicals, stating that the fund is a no-load fund and inviting requests for copies of its prospectus.[161] And some no-load funds encourage brokers to recommend their shares to prospective investors by directing their portfolio brokerage business to those brokers who promote the sale of their shares.[162] Other significant sources of business are the adviser's general nonfund advisory clientele,[163] recommendations by lawyers, bankers, and others on whom people rely for investment advice; articles in the financial press; [164] the reputation of a particular fund for investment expertise; and new investment by existing shareholders.[165]

These methods of obtaining business have been considerably less effective than the load funds' far more vigorous, personalized selling drives. Hence the no-load funds have only a small share of total mutual fund assets and shareholder accounts.[166]

E. THE PATTERN OF FEDERAL REGULATION

Although the Investment Company Act is the only Federal statute expressly concerned with investment company regulation, three other Federal securities statutes—the Securities Act of **1933** ("Securities Act"), the Securities Exchange Act of **1934** ("Exchange Act") and the Investment Advisers Act of **1940** ("Advisers Act")—also establish significant regulatory controls over the investment company industry.

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[158] For example, T. Rowe Price Associates, Inc., which acts as investment adviser to T. Rowe Price Growth Stock Fund, Inc. (June **30, 1966, assets approximately $224.1** million), the largest fund that has consistently operated on the no-load principle, was a well-established private investment counselor long before it entered the mutual fund business. The aggregate assets that it manages **for** its nonfund advisory clients are still far in excess of the assets of its fund clients.

[159] These include such New York Stock Exchange firms as Ralph E. Samuel & Co., which acts as investment adviser to Energy Fund, Inc. (June **30, 1966,** wets **$49** million), Wood, Struthers & Winthrop, the investment adviser to Pine Street Fund, Inc. (June **30, 1966,** assets **$43** million) and to DeVegh Mutual Fund, Inc. (June 30, **1986,** assets **$22.1** million), and Lehman Bros., the investment adviser to the One William Street Fund, Inc. (June *30,* 1966, assets $231.6 million), the largest of all no-load funds on that date and currently the second largest no-load fund.

[160] Like the load fund advisers, the advisers to the no-load funds benefit from the augmented advisory income—and in some cases brokerage commissions—made possible by the growth **of** the funds through sales of new fund shares.

[161] Advertisements relating to securities are regulated by the Securities Act of **1933.** To prevent the avoidance of the prospectus requirements **of** the Securities Act, the content of such advertisements is limited in certain respects. Securities Act sec. 2(10)(b) and rule **134** thereunder (17 C.F.R. sec. 230.134). Because of these legal limitations on what can and cannot be said, securities advertisements are usually called "tombstone ads." Since mutual fund shares are securities, advertisements with respect to them must comply with these general rules. Because of the nature of mutual funds, advertisaments for their shares are somewhat less restricted than the advertisements **for** other types of securities. See Securities Act Release No. **4709** (July **14,1964).** Of course, the fund or its adviser could reproduce the entire prospectus **as** a newspaper or magazine advertisement. (Principal underwriters of load funds have done ***so.)*** But this entails considerable cost, and no-load funds have not utilized this means of advertising.

[162] This method of stimulating sales is also available to the load funds (see pp. 50-51, supra), who use it to a greater extent than the no-load funds.

[163] Many investment advisers either refuse or are reluctant to accept clients with assets below a certain stipulated level. Prospective clients whose means are below that level are often advised to buy shares in the no-load fund that the adviser manages. On occasion, nonfund clients recommend the fund's shares to their friends and acquaintances. And some advisers encourage their employees to sell shares **of** no-load funds under their management; at least one no-load fund adviser reinforces such encouragement by certain monetary inducements.

[164] Some financial writers ha e directed their readers' attention to the no-load funds.

[165] Like the load funds, most no-load funds seek to induce existing sh [illegible] t pur has ne sha re with the income dividends and the capital gain distributions that th [illegible] pp 202–204, [illegible] infra. Many no-load funds also offer voluntary accumulation [illegible]

[166] See p. 52, supra

To help clarify the full scope of the regulatory pattern governing the investment company industry and the special needs that the Act was designed to meet, the discussion of the Act is prefaced by a brief consideration of those other statutes.

1. The Securities Act

The Securities Act, the first of the Federal securities statutes, is essentially a disclosure statute.[167] Its primary effect is on the initial distribution of securities. Its purpose is to provide purchasers of securities being offered by issuers, their controlling persons, and underwriters with information material to informed investment decisions.

To achieve that objective, it imposes the following requirements with respect to most such offerings: (1) The securities cannot be offered to the public until a registration statement has been filed with the Commission setting forth the information with respect to the issuer, the nature of the security offered, and the terms of the offering called for by the Securities Act[168] and by the forms that the Commission has promulgated pursuant to its authority under that statute; (2) the securities cannot be sold to the public until the registration statement has become effective; and (3) a prospectus containing the basic information in the registration statement must be delivered to each purchaser.

The antifraud provisions of the Securities Act prohibit fraudulent or deceptive statements in the offer or in the sale of securities even if the offering is exempt from registration. Violations of the Securities Act may give rise to civil, and if willful, to criminal liabilities. The Commission may also take administrative action by suspending the effectiveness of materially deficient registration statements ("stop orders").[169] A stop order brings offers and sales of the registered security to a halt until the filing has been amended so as to conform with the Securities Act's disclosure requirements. At that time the stop order must be lifted and the registration statement declared effective.[170] The Commission has no power to approve or disapprove any security or to pass on its merits.

The impact of the Securities Act on most issuers of securities, including closed-end investment companies, is irregular. They do not come into contact with the Securities Act unless they wish to raise additional capital by selling new securities to the public or unless their controlling persons wish to distribute some or all of their holdings of outstanding securities to the public. Registration statements under the Securities Act relate to specific offerings. Thus, after the offering

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[167] Before 1933 the regulation of the securities markets was left almost entirely to the States. The speculative excesses of the 1920's and the ensuing great depression led to the enactment of a body of Federal law which has supplemented but not displaced State law controls over securities distribution and trading. In general, Federal-State relationships in this field can be summarized as follows: Federal law establishes nationwide minimum standards. State law may and often does impose additional and more stringent requirements. In some States the law empowers the administering official to pass upon the merits of securities. Pursuant to this authority, several States have prohibited the sale of contractual plans (see pp. 57–58, supra, and pp. 223-247, infra) as well as the sale of shares of funds whose operating expenses exceed specified limits.

[168] See schedules A and B annexed to that statute.

[169] Stop orders may be entered either before or after the distribution has been completed. In the latter circumstance, a stop order is an effective way of bringing the misleading character of the statement to the attention of the investing public. See *Oklahoma-Texas Trust* v. *S.E.C.*, 100 F. 2d 888, 891 (C.A. 10, 1939).

[170] Stop orders apply only to the specific securities covered by the registration statement whose effectiveness has been suspended. If a company whose registration statement has been suspended also has securities outstanding other than those covered by the suspended statement, the stop order will not affect trading in such other securities.

is over, the Securities Act makes no provision for keeping the statement up to date.[171]

Most mutual funds, on the other hand, are constantly making public offerings of their own shares and are therefore in continuous contact with the Securities Act. They revise their registration statements at regular (usually annual) intervals.[172] Just as with other types of public offerings, if the Commission after appropriate notice and a hearing (or an opportunity for a hearing) finds a mutual fund's registration statement to be inaccurate or inadequate, it can terminate the offer and sale of the fund's shares by suspending the effectiveness of its Securities Act registration statement.[173]

2. *The Exchange Act*

(*a*) *Commission regulation*

The Exchange Act, enacted one year after the passage of the Securities Act, supplemented the earlier statute by establishing a system of controls over both the exchange and the over-the-counter trading markets for securities. Among the provisions of the Exchange Act that bear most directly on the investment company industry are those which establish administrative mechanisms to protect the public from dishonest or irresponsible brokers and dealers.[174] The Exchange Act requires most securities brokers and dealers to register with the Commission and empowers the Commission to exclude persons and firms subject to specified disqualifications from most segments of the securities business [175] and to take other remedial action against them. Among the malpractices that have led to Commission action against brokers and dealers are certain types of misconduct incident to the distribution of mutual fund shares. They include switching investors from fund to fund and charging them a sales load on each purchase, timing and allocating purchases so as to deny customers the benefit of breakpoints for quantity purchases [176] and advising the purchase of fund shares on the ground that a dividend is about to be distributed without disclosing the fact that the amount of such dividend is re-

[171] Under the Exchange Act, however, a company filing a Securities Act registration statement must comply with the Commission's periodic reporting requirements for the fiscal year in which the registration statement became effective and thereafter if and as long as any class of securities to which the registration statement relates is held of record by at least 300 persons and the company's total assets exceed $1 million.

[172] These revisions are necessary in order to increase the quantity of shares registered and to update the financial and other information in the registration statement.

[173] For example, in *Managed Funds, Incorporated*, 39 S.E.C. 3W (1959) the Commission suspended the effectiveness of a mutual fund's Securities Act registration statement because the prospectus misrepresented the fund's investment policy and failed to disclose that its investment adviser was not performing the services required of it under its contract, that actual managerial authority over the fund had been delegated to a person who was not named in the prospectus, and that the board of directors gave scant attention to the fund's affairs.

[174] The Exchange Act is a comprehensive statute with numerous other provisions. Notable among these other provisions are those applicable to issuers of securities in which there is a substantial public investor interest. As a result of the 1964 amendments to the Exchange Act, most such issuers are now subject to continuing disclosure requirements on a regular basis and to controls over proxy solicitation and insider trading. The direct impact of these requirements on investment companies is quite limited because they are governed by a comparable, and in some significant respects, a more extensive group of disclosure requirements and regulatory controls applicable only to them. However, the continuous stream of factual information that the Exchange Act elicits from issuers is as great a benefit to investment companies and their shareholders as it is to other investors. Similarly, the provisions of the Exchange Act primarily concerned with market mechanisms are significant to investment companies as investors by protecting them from sharp and unfair practices in the securities markets.

[175] Such action must be supported by a finding that the party or parties against which it is directed either willfully violated some provision of the Securities Act, the Exchange Act, or the Commission's rules under those statutes, or has been convicted of or enjoined from certain specified types of misconduct, and by a further finding that disciplinary action is in the public interest. The Commission has a wide range of discretion with respect to the imposition of sanctions. It may deny applications for registration as a broker and dealer, revoke the registrations of registered brokers and dealers, suspend such registrations for appropriate periods (not exceeding 12 months), bar individuals from associating themselves with registered brokers and dealers, or suspend their right to such associations for a period not in excess of 12 months. If appropriate under the circumstances of a specific case, the Commission can censure a respondent.

[176] See p. 52, supra.

flected in the shares' net asset value so that the dividend will be simply a return of the investor's own money with the disadvantage, however, that it is taxable to him as ordinary income.[177]

(b) Cooperative regulation

The organized securities exchanges have for many years exercised a measure of control over the qualifications and business practices of their members and their members' employees. These activities are a significant protection for investors, including investment companies, who buy and sell securities through exchange members.[178] With respect to brokers and dealers who do an over-the-counter business, Congress amended the Exchange Act in 1938 to authorize registration with the Commission of associations of securities dealers the rules of which must be designed to promote just and equitable principles of trade.[179] The National Association of Securities Dealers, Inc. ("NASD") is the only such association that has ever registered with the Commission.

NASD membership is an economic necessity for most broker-dealers who participate in the underwriting phase of the securities business. This is so because the Exchange Act authorizes rules which prohibit members from giving discounts or concessions to nonmembers and because most securities dealers are NASD members. Virtually all mutual fund underwriters which distribute shares through independent broker-dealers are NASD members. Therefore, such broker-dealers must, as a practical matter, belong to the NASD.[180]

The NASD administers examinations to and passes on the qualifications of persons who seek to become members or to associate themselves with members. It assists in enforcing the statutes and rules administered by the Commission and promulgates and enforces rules of its own embodying a code of business ethics. The Association performs its disciplinary functions by denying applications for membership and affiliation with members and by imposing sanctions, which may range from censure to expulsion.[181] It assisted in the formulation of the Commission's Statement of Policy Relating to Investment Company Sales Literature [182] and maintains an Investment Company Department which helps to enforce that policy and to guide association members with respect to problems arising thereunder.[183]

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177 See, e.g., *Russell L. Irish,* Securities Exchange Act Release No. 7687, pp. 3–6 (August 27, 1965), *affirmed sub nom. Irish* v. *S.E.C.*, C.C.H. Fed. Sec. L. Rep. ¶ 91,830, — F. 2d— (C.A. 9, October 19, 1966); *Mason, Moran & Co.,* 35 S.E.C. 84, 90 (1953); *Thomas Arthur Stewart,* 20 S.E.C. 196, 201–202 (1945). See also Special Study pt. 4, 163–166.

Under the Exchange Act the Commission can take disciplinary action against principal underwriters who sell fund shares by means of prospectuses that they know or should know to be false or inadequate. See *Imperial Financial Services,* Inc., Securities Exchange Act Release No. 7684 (Aug. 26, 1965). While such action, i.e., a proceeding against the broker under the Exchange Act, does not preclude a stop order proceeding against the registration statement under the Securities Act, there are situations in which the Exchange Act proceeding may be more appropriate. A factor to be considered is the effect that a stop order proceeding may have on the fund's ability to redeem its shares if the proceeding gives rise to a wave of redemptions at a time when the fund is precluded from selling new shares.

178 The Commission has broad supervisory power over the rules, and the practice of the exchanges. Exchange Act sec. 19(b).

179 The statute by which this was done is commonly known by the name of its sponsor as the Maloney Act, which became section 15A of the Exchange Act. An attempt at self-regulation under the aegis of the National Industrial Recovery Act of 1933 (48 Stat. 195) came to an end when that statute was held invalid in *Schechter* v. *United States,* 295 U.S. 495 (1935).

180 Membership in the NASD is open to everyone who passes the Association's qualifying examinations and is not barred by reason of his prior misconduct.,

181 Such disciplinary action is subject to Commission, and ultimately to judicial, review.

182 Securities Act Release No. 3586, Investment Company Act Release No. 2821 (Oct. 31, 1957).

183 The NASD's activities in this area are described and evaluated in Special Study, pt. 4, 162–168.

(c) The 1964 amendments

A significant number of persons connected with the distribution of mutual fund shares are not subject to the NASD's self-regulatory jurisdiction. They are associated with principal underwriters which maintain their own captive sales forces.[184] Thus, they have no need for discounts or concessions from other securities dealers. Until recently the lack of controls (comparable to those of the NASD) over the qualifications and the selling practices of persons in this segment of the mutual fund business was a substantial gap in the overall regulatory pattern. This gap was closed by the 1964 amendments to the Exchange Act, which authorized the Commission to establish controls of its own over the qualifications and the business practices of brokers and dealers that do not belong to a registered securities dealers' association such as the NASD and of persons associated with such brokers and dealers.[185]

3. The Investment Advisers Act of 1940

The Advisers Act, enacted as a companion to the Act,[186] regulates the activities of those who receive compensation for advising others with respect to investments in securities or are in the business of issuing analyses or reports concerning securities. Like the Exchange Act, the Advisers Act requires those subject to its provisions to register with the Commission, prohibits fraudulent practices, and empowers the Commission to discipline violators of the statute and of its rules thereunder.

The Advisers Act, however, exempts from the requirements of registration and thus from the reach of the Commission's administrative sanctions under that statute "investment advisers whose only clients are investment companies * * *." [187] Many mutual fund advisers, particularly those which serve the larger funds and fund complexes, are within this exemption. Although the exemption does not run to the antifraud provisions of the Advisers Act [188] or to Commission rules thereunder, the Commission is limited in the enforcement of these provisions against unregistered investment advisers to injunctive suits in the courts and to transmitting evidence to the Attorney General for purposes of criminal prosecution. However, mutual fund advisers who also advise other persons must register with the Commission under the Advisers Act and are subject to administrative sanctions for willful violations of that statute incident to their mutual fund activities.

4. The Investment Company Act

The Securities Act, the Exchange Act, and the Advisers Act supply significant protections to investment company shareholders as well as other investors. Primarily, however, those statutes are concerned with disclosure and with the prevention of fraud. The Investment Company Act takes a different approach. It reflects a belief that investment companies present special problems which require that disclosure and controls aimed at the prevention of fraud be supplemented by further regulation.

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[184] See p. 56, supra.
[185] Exchange Act, secs. 15(b)(8)-15(b)(10).
[186] The Act is title I and the Advisers Act is title II of Public Law No. 768, 76th Gong., 3d Sess., 54 Stat. 789 (1940) entitled "An Act To provide for the registration and regulation of investment companies and investment advisers, and for other purposes."
[187] Sec. 203(b)(2).
[188] Sec. 206.

(a) The Investment Trust Study

The Act had its genesis in the Public Utility Holding Company Act of 1935 (Holding Company Act). The Holding Company Act was aimed at abuses resulting from the use of the holding company device in the electric power and retail gas industries, abuses that had led to enormous investor losses and to the neglect of consumer interests.[189] Consideration of financial malpractices in this specialized field led to concern over the broader but related problems presented by arrangements for pooling the resources of public investors with a view to security investments: Accordingly, the Holding Company Act directed the Commission:

> * * * to make a study of the functions and activities of investment trusts and investment companies, the corporate structures and investment policies of such trusts and companies, the influence exerted by such trusts and companies upon companies in which they are interested, and the influence exerted by interests affiliated with the management of such trusts and companies upon their investment policies, and to report the results of its study and its recommendations to the Congress * * *.[190]

Complying with that direction, the Commission made an exhaustive study of the then infant investment company industry. Its report, referred to herein as the "Investment Trust Study,)'[191] found that to an alarming extent investment companies had been operated in the interests of their managers and to the detriment of investors. A high incidence of recklessness and improvidence was also noted. Insiders often viewed investment companies as sources of capital for business ventures of their own[192] and as captive markets for unsalable securities that they, the insiders, wished to convert into cash.[193] Controlling persons frequently took unfair advantage of the companies in other ways,[194] often using broad exculpatory clauses to insulate them from liability for their wrongdoing.[195] Outright larceny and embezzlement were not uncommon.[196] Managers were able to buy inrestment company shares for less than net asset value, thus enriching themselves at the shareholders' expense.[197]

In addition, reports to shareholders were often misleading and deceptive.[198] Controlling positions in investment companies—represented by special classes of stock or by advisory contracts—were bought and sold without the consent, or even the knowledge, of public shareholders.[199] Basic investment policies were changed without shareholder approval.[200] The advisory contracts themselves were often long term and either noncancellable or cancellable only upon the payment of a substantial penalty by the company.[201] Sales loads

[189] See *Report of National Power Policy Committee,* H.R. *Doc. No. 137,* 74th Cong., 1st sess. (1935); F.T.C., *Utility Corporations, S. Doc.* No. 92, 70th Cong., 1st sess. 4 (1928-1935).
[190] Holding Company Act, sec. 30.
[191] See note 6 on p. 3 supra.
[192] Investment Trust Study pt. 3, 2640–2720.
[193] Investment Trust Study: pt. 3, 2541. See also Senate Hearings 74.
[194] See e.g., Senate Hearings, 102–103.
[195] See: e.g., Investment Trust Study, pt. 3, 1914, 1924.
[196] Senate Hearings, *58-62.*
[197] See Investment Trust Study, pt. 3, 1922–1924.
[198] See, e.g., Senate Hearings 154–155.
[199] See e.g., Senate Hearings 122–131.
[200] See, e.g., Senate Hearings 156–157.
[201] Investment Trust Study, pt. 3, 1920–22.

were as high as 20 percent.[202] Management fees charged in connection with contractual plans sometimes bore no relationship to any actual managerial services.[203]

Often only a small portion of the first year's payments in contractual plans were invested in underlying securities for the investor's account.[204] Because of extensive debt financing, fluctuations in the value of portfolio securities had a disproportionately severe effect on the value of investment company shares; highly leveraged capital structures made investment company shares extremely speculative and exposed those who purchased them to extraordinarily high degrees of risk.[205]

*(b) Fundamental policies of the **Act***

The Investment Trust Study led Congress to conclude that the "completely liquid, mobile and readily negotiable" assets of investment companies offered unusual opportunities to the unscrupulous,[206] that disclosure alone was an inadequate safeguard for investment company shareholders,[207] and that "the national public interest and the interest of investors are adversely affected * * * when investment companies are organized, operated, managed, or their portfolio securities are selected in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof in the interest of underwriters, brokers or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of security holders." [208]

Although the Investment Trust Study examined every aspect of the pre-1939 investment company industry, it focused primarily on the dangers arising from: (1) Outright dishonesty; (2) transactions in securities and other types of property with, and loans to, controlling persons; (3) unsound capital structures; and (4) the virtually complete immunity of many well entrenched, self-perpetuating managements from liability to the companies and from any semblance of shareholder control as well as the ease with which such controlling positions could be transferred.

These were the areas in which abuses were then most acute and the need for corrective action most pressing. Although attention was given to managerial compensation, underwriting charges, and brokerage commissions, they seemed on the whole of secondary importance in the late 1930's while the study was in progress. Since the Act was

[202] Senate Hearings 289.

[203] Investment Trust Study, Supplemental Report *on Companies Sponsoring Installment Investment Plans*, H.R. Doc. 482, 76th Cong., 1st sess. 38–40 (1939).

[204] Investment Trust Study, pt. 2, 223.

[205] See, e.g., Senate Hearings 240–243.

[206] In its report on the bill which later became the Act, the Senate Committee on Banking and Currency stated:

"Basically the problems flow from the very nature of the assets of the investment companies. The assets of such companies invariably consist of cash and securities, assets which are completely liquid, mobile, and readily negotiable. Because of these characteristics, control of such funds offers manifold opportunities for exploitation by the unscrupulous managements of some companies. These assets can and have been easily misappropriated and diverted by such types of managements, and have been employed to foster their personal interests rather than the interests of public security holders." Senate Report No. 1775, 76th Cong., 3d sess. (1940) (hereinafter cited as "Senate Report") 6.

[207] Although the Securities Act and the Exchange Act had been in effect for a number of years, the Senate committee concluded that:

"It is obvious that in the absence of regulatory legislation, individuals who lack integrity will continue to be attracted by the opportunities for personal profit available in the control of the liquid assets of investment Companies and that deficiencies which have occurred in the past will continue to occur in the future." Senate Report 6.

[208] Act, sec. 1(b)(2). This was one of a number of policy declarations and findings based on the Investment Trust Study and on other materials, and set forth in sec. 1 of the Act.

in very large measure a product of the Investment Trust Study, its substantive provisions reflect the study's emphases.[209] For the most part, the Act provided specific controls to eliminate or mitigate inequitable capital structures and dishonesty, loans to, and unfair property and securities transactions with insiders. It did not impose analogous controls on compensation for services—sales loads, managerial compensation, and brokerage commissions. In this area fund managers retained a very large measure of discretion. Their discretion was subjected to review, however, by the inclusion of certain provisions as to shareholder approval and as to the composition of investment companies' boards of directors, which would, it was thought, operate as effective checks on abuses in these areas.

(c) Substantive provisions

(i) Registration.—The act adopts the registration approach employed in the other Federal securities statutes. Companies that are investment companies in the statutory sense of that term [210] (and in some situations their promoters and underwriters) are prohibited from engaging in interstate commerce and from using the mails unless the company is registered with the Commission.[211] Willful violation of the registration provisions is a Federal crime.[212] Registered investment companies are required to make periodic reports to the Commission and to their stockholders.[213]

(ii) Protecting investment company assets.—Much of the act is designed to protect investment companies and their shareholders from outright dishonesty on the part of the companies' managers. It bars from the investment company industry persons convicted of, or enjoined from committing, certain types of misconduct involving security transactions,[214] makes larceny, conversion or embezzlement of investment company assets a Federal crime;[215] and authorizes the Commission to obtain injunctions against "gross misconduct or gross abuse of trust" by persons associated with registered investment companies.[216] The Commission is authorized to prescribe accounting policies and practices to which registered investment companies must adhere.[217] Financial statements must be certified by independent public accountants, whose selection must be ratified by the stockholders.[218] The Commission is authorized to establish bonding requirements applicable to those having access to the moneys and securities of investment companies,[219] and to prescribe rules for the protection of investment company portfolio securities.[220] Exculpatory provisions are prohibited to the extent that they purport to relieve any officer or director of an investment company from "liability to the company or its security holders to which he would otherwise be subject by reason

[209] In its final form, the Act was a compromise between the Commission's viewpoint, reflected in the original bill (S. 3580, 76th Cong., 3d sess.), and that of the industry. See Senate Report 1-2.
[210] The Act's definitional framework is described at pp. 1–13, supra.
[211] Secs. 7, 8.
[212] Willful violations of the Act's other provisions are also criminal offenses. Sec. 49.
[213] Sec. 30.
[214] Sec. 9.
[215] Sec. 37.
[216] Sec. 36.
[217] Sec. 31(c). In addition, subsections (a) and (b) of sec. 31 require that records be preserved and made available for Commission examination.
[218] See. 32.
[219] Sec. 17(g).
[220] Sec. 17(f) permits investment company securities to be kept in the custody of banks, of brokers, or of the company itself. However, if the securities are in the custody of a broker or of the compan itself, the Commission is auth ized t lopt rules with respect to such matters as earmarking, segregati n, and hypothecation.

of willful misfeasance, bad faith, gross negligence, or reckless disregard of the duties involved in the conduct of his office." [221]

(iii) *Capital structures.*—Complex, multi-tiered capital structures characterized by thin substrata of equity beneath towers of indebtedness, which were much more common than outright dishonesty, had proven damaging to investment company shareholders.[222] To these problems the Act provides effective solutions. Closed-end companies are generally precluded from issuing debt securities unless they have an asset coverage of 300 percent and cannot issue preferred stock unless such stock has an asset coverage of at least 200 percent.[223] Nor can they issue more than one class of debt security or more than one class of preferred stock.[224] Open-end companies cannot issue any debt securities at all.[225]

The Commission was given rulemaking power to prevent investment companies from buying securities on margin [226] or selling them short.[227] All stock issued by a management investment company, whether open-end or closed-end, must be voting stock;[228] and no voting trust can be created with respect to any such stock.[229] The extent to which registered investment companies can invest in the securities of other registered investment companies, insurance companies, brokers and dealers in securities, underwriters and distributors of securities and investment advisers is restricted.[230] If any investment company is reorganized, the Commission must be apprised of the proceedings, and if the company or the holders of 25 percent or more of any class of security affected by a proposed plan of reorganization request it, they may have the benefit of an advisory report by the Commission with respect to the fairness of the plan.[231]

(iv) *Checks on management domination of investment companies—Requirements with respect to the composition of boards of directors.*—The Act sought to check the theretofore virtually unrestricted power of management groups by imposing specific requirements with respect to the composition of the boards of directors of investment companies.[232]

At least 40 percent of the board must consist of persons who are neither officers nor employees of the investment company and who are unaffiliated with its investment adviser.[233] In the statutory sense,

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[221] Sec. 17(h).

[222] Sec. 1(b)(7) of the Act expresses concern about the harm done the public interest "when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities," and sec. 1(b)(4) states that the national public interest and the interest of investors are adversely affected "when the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed, or when investment companies are managed by irresponsible persons."

[223] Sec. 18(a).

[224] Sec. 18(c).

[225] Sec. 18 (f). They can, however, borrow money from banks but only if such bank borrowings have an asset coverage of at least 300 percent.

[226] Sec. 12(a)(1).

[227] Sec. 12(a)(3).

[228] Sec. 18(i). There is an exception to this rule for common law trusts organized prior to the Act's effective date. See p. 4, supra.

[229] Sec. 20(b).

[230] Sec. 12(d).

[231] Sec. 25(b).

[232] Sec. 10.

[233] Sec. 10(a). "Affiliation" is one of the Act's central concepts. Sec. 2(a)(3) defines an "affiliated person" of another person as:

"(A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person, (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof."

however, unaffiliated does not mean completely unrelated. Directors unaffiliated with the investment adviser may be—and sometimes are—relatives or close friends of their affiliated collegues.[234] And, as the definition shows, a director may own as much as 4.9 percent of the outstanding voting securities of an investment adviser without becoming an affiliated person of such adviser.

If any director, officer, or employee of the investment company acts as, or is affiliated with, its principal underwriter, a majority of the board must consist of persons other than and unaffiliated with the principal underwriter.[235] Similarly, if any director, officer, or employee of the investment company serves as, or is affiliated with, a regular broker to the company, a majority of the board must consist of persons other than, and unaffiliated with, such regular broker.[236]

The Act also provides that if any of the investment company's officers, directors, or employees are investment bankers or affiliated with investment bankers, a majority of the board must consist of persons who are neither investment bankers nor affiliated with an investment banker.[237]

(v) *Transactions with affiliated persons*—The general *rules*.—Additional provisions of the Act apply to transactions in which investment companies lend money to, sell property to, or buy property from, investment advisers, principal underwriters, and other affiliated persons.[238] These transactions are prohibited unless Commission approval has first been obtained.[239] Such approval can be granted only if the Commission finds "that the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned."[240] The Commission must further find that "the proposed transaction is consistent with the policy of each registered investment company concerned * * *" and "* * * with the general purposes of the [Act]".[241]

The Act also guards against the purchase of investment company shares by insiders on terms more favorable than those available to the general public. Options and warrants for investment company shares are permissible only when issued exclusively and ratably to all members of a class of security holders or in connection with a plan of reorganization.[242] Subject to certain exceptions established by Commission rule, mutual fund shares can be sold only at a public offering

[234] See *Acampora* v. *Birkland,* 220 F. Supp. 527, 535–536, 542–543 (D. Colo. 1963).
[235] Sec. 10(b)(2).
[236] Sec. 10(b)(1).
[237] The provision with respect to investment bankers (sec. 10(b)(3)) differs from those relating to principal underwriters and regular brokers in that it requires a majority of the board to be unaffiliated not merely with the particular investment banker with which the investment company is affiliated, but with any investment banker. This provision reflects concern over the dominant role of investment bankers and investment banking groups in many closed-end companies during the pre-1940 era.
[238] See secs. 17(a) to 17(d) which apply to transactions between investment companies and their affiliated persons, promoters, principal underwriters and persons affiliated with such affiliated persons, promoters, and principal underwriters.
[239] Sec. 17(c) provides two relatively minor exceptions to the general rules—for merchandise transactions in the ordinary course of business and for lessor-lessee relationships.
[240] Sec. 17(b)(1).
[241] Secs. 17(b)(2) and 17(b)(3). Controls were also imposed on the knowing acquisition by investment companies of underwritten securities "a principal underwriter of which is an officer, director, member of an advisory board, investment adviser, or employee of" the acquiring investment company "or is a person * * * of which any such officer, director, member of an advisory board, investment adviser, or employee is an affiliated [illegible]." Sec. 10(f) and Rules 10f-1, 10f-2, and 10f-3 thereunder (17 C.F.R., sec. 270. 10f-1, 10f-2, and 10f-3).
[242] Sec. 18(d). These provisions do not affect warrants issued prior to the enactment of the Act. One known pre-1940 issue of investment company warrants—the perpetual warrants for shares of the common stock of Tri-Continental Corp., the largest diversified closed-end company—is still outstanding

price described in the prospectus.[243] Insider profits from short-term trading in the securities of a closed-end investment company are recoverable by or on behalf of the company.[244]

(vi) *Transactions with affiliated persons: Specialized treatment of advisory contracts, underwriting agreements, and brokerage relationships.*—Advisory contracts, underwriting agreements, and brokerage relationships are areas in which the interests of those who perform the services differ to some extent from the interests of the fund's shareholders. In the first instance, this divergence relates to the amount of the advisory fee and the services to be obtained in return for it. Second, the adviser-underwriter may wish to set the sales load at a level high enough to maximize aggregate sales by giving generous incentives to sellers of the fund's shares. Existing shareholders who wish to invest new money in the fund and who have to pay a sales load on such purchases have an interest, however, in the load being as low as possible.[245] Third, the adviser's desire to have the size of the fund increased and thus to increase its advisory fee—which is almost invariably based on a percentage of the fund's assets—may not necessarily coincide with the interests of the fund's present shareholders. For example, in promoting increased fund size, the adviser may wish to use the brokerage commissions generated by the fund's portfolio transactions for the purpose of channeling additional sales compensation to retail dealers who recommend and sell the fund's shares. In that event the adviser may not be inclined to minimize brokerage costs.

The Act's controls over these relationships are, as indicated, less direct than those over other economic relationships between investment companies and their affiliated persons. In 1940, the Congress accepted the view that "a few elementary safeguards" were all that the public interest required in the areas of advisory fees, underwriting compensation and brokerage commissions.[246] The principal "elementary safeguards" that the Act imposed in these areas were prescriptions as to the form and content of advisory and underwriting contracts and requirements with respect to their approval by unaffiliated directors and by shareholders.[247]

The Act requires that the investment company's contract with its adviser be in writing and that the adviser's compensation thereunder

[243] Sec. 22(d). The Commission has exercised its rulemaking authority under sec. 22(d) so as to permit the rqduction or elimination of the usual sales load when a load fund sells its shares to persons affiliate with it. Such preferential terms can be offered only when the purchaser gives written assurance that he is purchasing for investment and when the transaction is pursuant to a uniform offer described in the prospectus. Rule 17 C.F.R. sec. 250.22d-1(h). The sales load can also be reduced or eliminated when sales made through private offerings are for the purpose of providing an investment company with its mitial capital. Rule 17 C.F.R. sec. 250.22d-1(g).

[244] Sec. 30(f) subjects closed-end investment companies' insiders to sec. 16 of the Exchange Act, which requires that they report their holdings of and transactions in the equity securities of the company to the commission, makes their profits from any combination of purchases and sales of such securities within any 6-month period recoverable by or on behalf of the company, and prohibits them from selling short or engaging in a related practice known as "selling against the box."

[245] Shareholders also reinvest dividends in the purchase of new fund shares. It is in the interest of the shareholders to be able to make such purchases free from any sales load. The adviser-underwriter, on the other hand, may wish to charge a sales load on such purchases so as to supply his retail dealers with a source of additional selling compensation, See ch. V, sec. E.

[246] The phrase "a few elementary safeguards" was used by the chief counsel to the Investment Trust Study. Senate Hearings 252.

There were many who favored the more drastic approach of requiring investment companies to be managed either by their own staffs or by affiliated external advisers furnishing their services at cost. A comparable approach had been adopted in the Holding Company Act with respect to service companies in holding company systems which frequently furnish services and sell goods to the operating members of the system. The Holding Company Act requires that intra-system contracts of this sort be "performed economically and efficiently for the benefit of * * * associate companies at cost fairly and equitably allocated among such companies." Holding Company Act, sec. 13(b). This approach was rejected, in part at least, out of considemtion for the needs of small investment companies that could not afford managerial staffs of their own. See Senate Hearings 251-252.

[247] Sec. 15.

be described with precision. Before an advisory contract can become effective, it must be approved by the holders of a majority of the fund's outstanding voting securities.[248] If the contract is to continue in effect for a period of more than two **years** after the date of its execution, such continuance must be specifically approved at least annually by either (a) the board .of directors as a whole, including a majority of the unaffiliated directors, or (b) the vote of the holders of a majority of the Outstanding voting securities.[249] An investment company has the right to terminate an advlsory contract at any time without penalty.[250] An advisory contract is automatically terminated in the event of an "assignment,"[251] and this necessitates a new contract which must be approved by the shareholders.[252] When shareholders' approval is solicited, the solicitation must be made in accordance with the Commission's proxy rules designed to promote full and fair disclosure and informed use of the shareholder franchise.?@

The Act sets no express limits on the compensation paid to affiliated persons[2*] nor does it expressly require that such compensation be reasonable.[255] **Only** when managerial emoluments are such as to make the affiliated person "guilty" of "*gross* misconduct or gross abuse of trust" and to make it necessary and desirable that he be suspended or barred from being employed by investment companies in the future can the Commission take remedial action under the Act.[256]

Comparable—but somewhat different—provisions govern agreements between the funds and their principal underwriters. Underwriting agreements, require the initial approval of *either* (a) the board of directors, including a majority of the unaffiliated directors, or (b) the holders **of** a majority of the outstanding voting securities.[257] Advisory contracts, on the other hand, can be approved initially *only* by the holders of a majority of the outstanding voting securities.[258] And although a fund can terminate an advisory contract unilaterally at any time,[259] it has no such unqualified right to terminate an underwriting agreement.

Explicit provision is made. as to sales loads in contractual plans. The aggregate sales load charged in the sale of such plans cannot exceed 9 percent of the total payments to be made,[260] and no more than one-half of the first year's payments or their equivalent can be de-

[248] Sec. 15(a).
[249] Sec. 15(a)(4).
[250] The terms of the contract may entitle the adviser to a notice period, but the duration of such notice period is limited to a maximum of 60 days. Sec. 15(a)(3).
[251] Under sec. 2(a)(4) **of** the Act the term "assignment" includes "any direct or indirect transfer or hypothecation of a contract or chose in action **by** the assignor, *or* of a controlling block **of** the assignor's outstanding voting securities by a security holder **of** the assignor; but does not include an assignment of partnership interests incidental to the death or withdrawal **of** a minority of the members of the partnership havmg only a minority interest in the partnership business or to the admission to the partnership *of* one **or** more memhers who, after such admission, shall be only a minority **of** the members and shall have only a minority interest in the business."
[252] Sec. 15(a).
[253] Sec. 20.
[254] Sec 10(d) can **be** viewed as an exception to this general rule. **As** noted in note 118 at p. **51**, supra, that section permits a no-load fund to have only one director unaffiliated with its investment adviser if it meets certain specified conditions. One such condition relates to the size **of** the management fee. Sees. 10(d)(6) and 10(d)(7).
[255] Sees. **27** (a)(5) and (a)(6) authorize the Commission to prescribe reasonable management fees and certain charges other than sales loads paid by contractual planholders. These provisions **do** not apply to the advisory fees paid by the mutual **funds** whose shares are held by the contractual plan companies.
[256] **In** such situations, the Commission is authorized to apply to the Federal **courts for** injunctive relief. Sec. 36.
[257] See. 15(b) **(2).**
[258] Sec. 15(a).
[259] Sec. 15(a)(3).
[260] Sec. 27(a)(1) is, as previously not:d, the only provision in the Federal securities statutes imposing an express limit on sales compensation.

ducted for sales load.[261] With respect to sales loads generally, there are no such explicit provisions. But the Act expresses a policy against "unconscionable or grossly excessive" sales loads and authorizes the Commission and the NASD to implement that policy by appropriate rules.[262]

The Act also imposes the following limitations on the commissions that affiliated persons (and affiliates of such persons) acting as brokers can receive from investment companies:

(1) in transactions effected on securities exchanges the commission cannot exceed the usual and customary commission;[263] and

(2) in transactions other than those on exchanges the commission cannot exceed 1 percent of the price.[264]

But the Act contains no express provisions regulating the manner in which investment companies may distribute the brokerage business generated by their portfolio activities nor does it expressly require that ancillary services supplied by brokerage firms in return for such brokerage business inure to the benefit of the investment companies who pay the commissions rather than to the benefit of the companies' external advisers.

(d) Appraisal of the Act

The provisions of the Act designed to protect investment companies and their shareholders from exploitation by irresponsible persons and to prevent inequitable or discriminatory capital structures as well as the safeguards against more subtle forms of overreaching through self-dealing transactions between investment companies and their affiliated persons have worked well on the whole. However, many of the Act's provisions were specifically tailored to meet conditions and practices prevalent in the investment company industry of a generation ago. And, some of these provisions are not suited to contemporary needs. Experience has shown that there are ambiguities and anomolies in the Act that should be corrected. Accordingly, chapter IX of this report recommends a number of changes in the existing statutory pattern.

The investment company industry has attracted many men of high professional competence and integrity because of their efforts and because of the salutary provisions of the Act serious abuses in transactions between investment companies and their affiliated persons have been reduced to a minimum.[265] While persons affiliated with investment companies may still obtain substantial benefits by virtue of their relationships to the companies, those benefits come not from the exploitation of investment company assets, but mainly from compensation for furnishing managerial, brokerage, and, in the case of mutual fiinds, underwriting services to the companies. Hence the Act has

[261] Sec. 27(a)(3).
[262] Secs. 22(b) and 22(c).
[263] See. 17(e)(2)(A).
Clause (B) of sec. 17(e)(2) permits affiliated brokers to charge commissions as high as 2 percent of the sales price for brokerage services in connection with "secondary distributions" of listed securities. A "secondary distribution" is the sale of a large block of listed securities off the exchange floor in which the seller pays a commission higher than the normal exchange commission.
[264] See. 17(e)(2)(C).
[265] Attempts to avoid the Act's requirements have been made by a small marginal element. These attempts—often inadvertent but sometimes deliberate—show that here as elsewhere in the law there is a need for vigilant enforcement.