The advisory fee rates for portfolios larger than $100 million in most cases would not be significantly lower under the published bank fee schedules, since only two of them provided further scale downs from the basic rate for assets in excess of $25 million. In view of the significant scale downs contained in these schedules for assets up to that amount, it is not unlikely that a lower fee rate than reflected in the schedules could be negotiated for portfolios the size of some of the large mutual funds.

While there are differences in the factors affecting the cost of providing investment advice to mutual funds and pension and profit-sharing plans that may explain in part the higher fees paid by mutual funds, not all of these factors point in this direction. For example, bank fees for advising pension and profit-sharing plans must cover the cost of obtaining new accounts. Mutual fund investors, except those in no-load funds, bear these expenses through the sales load.[91] Moreover, many of the nonadvisory services typically provided by mutual fund advisers in consideration of the advisory fee correspond closely to the bookkeeping and other administrative services provided by banks in return for their advisory fees from pension and profit-sharing plans. In addition, bank fees for pension and profit-sharing plans usually cover custodial services. Most mutual funds pay their custodians directly for these services, since the basic advisory fee seldom covers them.[92]

Of course, apart from advisory fees, banks may receive other business benefits from the management of pension and profit-sharing plan assets which do not inure to mutual fund advisers.[93] Moreover, the investment adviser to a mutual fund may incur significant expenses and expend considerable effort in organizing the fund and subsidizing its operations before advisory fees generate sufficient revenue to cover management costs.[94] In view of the vigorous sales competition in the mutual fund industry, the organization of a new fund involves entrepreneurial risk. The adviser at least in part looks to the advisory fee for compensation for this risk.

Moreover, the responsibility of mutual fund advisers for the operation of the funds is more comprehensive than that normally assumed by advisers to pension or profit-sharing plans. In addition to investment advice and most of the administrative services provided by banks to pension and profit-sharing plans under their management, the mutual fund adviser is usually concerned with administering the fund as a corporate or trust entity. This involves the adviser in various aspects of shareholder relations, including the preparation of proxy material and arrangements for annual meetings, and it must assume the responsibility for compliance with recordkeeping and reporting requirements and other aspects of Federal and State regulation. As previously noted, these services are usually provided by the mutual fund investment adviser and paid for by the advisory fee.

These functions, however, account for only a portion of the differences between the advisory fees charged mutual funds and those charged pension and profit-sharing plans. Differences in the investment portfolios of mutual fund and pension plans also do not adequately explain the extent of the disparity in the advisory fee rates

91 See pp. 214-215.
92 See pp. 91-92, supra.
93 For example, banks may obtain substantial deposits from the plans' cash assets.
94 The extent of these expenses varies considerably. Where the fund has been organized by the adviser-underwriter to an established complex, these expenses may be minimal.

charged the two investment media. Mutual fund portfolios tend to be more heavily invested in common stock than pension and profit-sharing plan portfolios. Since common stock investments generally require more intensive analysis and surveillance than investments in bonds and preferred stocks, the management of mutual fund portfolios may be somewhat costlier than the management of pension or profit-sharing plans.

In recent years, however, pension and profit-sharing plans have placed increasing emphasis on common stock investments. At year end 1965, 55.6 percent of the market value of noninsured private pension plan assets consisted of common stock holdings, as compared to 33.7 percent at year end 1955.[95] Moreover, although the composition of a particular pension or profit-sharing plan portfolio may affect the possibility of negotiating fee rates lower than those set forth in the published schedules, the published bank rates do not vary with the invstment objectives of the plans. Similarly, although some mutuale fund investment advisers charge lower rates for the management of funds investing primarily in bonds,[96] they do not do so for balanced funds, which have a substantial portion of their assets invested in bonds and preferred stock. For example, the advisory fees for Investors Mutual, Inc., a balanced fund, and Investors Stock Fund, Inc., a common stock fund, both managed by IDS, are computed under identical fee schedules. As of September 30, 1965, 33.9 percent of Investors Mutual's portfolio was invested in bonds and preferred stock, as compared with only 0.6 percent for Investors Stock Fund on October 31, 1965.

The absence of any apparent rate differential based on mutual fund portfolio composition may be due to the nature of the investment advisory function. As long as a substantial portion of the assets of a large mutual fund or pension or profit-sharing plan is to be invested in a diversified portfolio of common stocks, the management cost may not be substantially affected by the ratio of common stocks, bonds, and preferred stock investments in the total portfolio. This is so because the same general economic forecasting, analyses of various industry groups and evaluations of particular companies within each industry group may be required for a common stock portfolio of $100 million as for one of $50 million.

Mutual funds as a group also tend to trade portfolio securities more actively than pension funds even with respect to common stock holdings. The Commission's staff estimates that during 1965 the portfolio turnover rate for mutual fund common stock holdings was 18.7 percent, as compared to 7.1 percent for all private noninsured pension plans.[97] Within both groups, however, turnover rates vary widely. Extreme differences in portfolio turnover rates may reflect diverse approaches to investment management, but a high portfolio turnover rate does not in itself justify higher advisory management fees. Decisions to hold securities may require as much research and analysis as do decisions to buy and sell.

Recently, one bank has started offering and a number of other banks have expressed interest in offering participations in commingled

[95] See table VII-1 at p. 276.
[96] For example, Keystone Custodian Funds, Inc. charges advisory fees to Keystone Custodian Fund B-1, which invests in investment grade bonds, at one-half the rates charged 8 other Keystone funds, including 2 funds which invest in more speculative quality bonds.
[97] See table VII-5 at p. 285.

investment accounts to the general public. Such accounts have essentially the same characteristics as mutual funds and are required to be registered under the Investment Company Act. Since bank-sponsored commingled accounts will be offered in competition with mutual funds, the competitive pressures on advisory fees for these accounts may not be the same as those that have operated on the fees charged by banks for pension and profit-sharing plans.[98]

2. Advisory fee rates charged mutual funds operated for banks

To a significant extent the relatively low advisory fees charged to pension and profit-sharing plans also are reflected in the charges paid by various registered investment companies which are organized exclusively as equity investment vehicles for banks and other institutional investors. As of June 30, 1966, there were five such funds with assets of over $1 million registered with the Commission. All of them pay advisory fees to and receive investment advisory and other services from external advisers. In all but one case the advisers are established trust departments of commercial banks.

The oldest such company registered with the Commission is Institutional Investors Mutual Fund, Inc. (IIMF), which was established in 1953 by the Savings Banks Association of New York State for its member banks. As of June 30, 1966, IIMF had net assets of $128.8 million, virtually all invested in common stock issues.

Savings Banks Trust Co., which is wholly owned by the member banks of the association, acts as the fund's investment adviser. In addition to providing investment management and the nonadvisory services typically provided by mutual fund advisers,[99] IIMF's adviser also serves as its custodian, transfer agent, and registrar. For these services the trust company receives a fee at the annual rate of 0.30 percent on the first $20 million of average quarterly asset value, 0.20 percent on the next $20 million and 0.10 percent on the balance. This fee schedule is designed to produce a profit on the investment advice given the fund equivalent to the trust company's profit on other services it renders to member banks. In 1965 the advisory fee amounted to 0.15 percent of average net assets.[100]

While Savings Banks Trust Co. performs various other services for its member banks, IIMF represents the only large portfolio of equity securities under its management.[101] Although compared to other mutual fund advisory fee rates, the rate charged IIMF is low, it is not lower than the fee rates paid by the other five institutional mutual funds. These funds are relatively small and are managed by the trust departments of commercial banking institutions which provide investment advice to substantial amounts of other assets. For example, the Mutual Investment Fund of Connecticut, Inc. (June 30, 1966 net assets $23.8 million) gets investment advice, custodial, stock transfer, and various other administrative services from the Morgan Guaranty Trust Co. of New York. The fund pays advisory

[98] First National City Bank of New York is the only bank which as yet has registered a commingled account under the Act. Although participation in National City's commingled account is being offered without sales charges, it charges an advisory fee of 0.50 percent on the average net assets in the account.

[99] Includes office rental and occupancy, clerical, bookkeeping, accounting and auditing services, stationery, supplies, and printing and determination of offering and redemption prices. See p. 104, supra.

[100] IIMF shareholders do not pay a sales load for the purchase of their shares. The fund does charge, however, a fee of 0.50 percent on all purchases and redemptions of fund shares. This fee is designed to offset brokerage commissions and other costs, such as transfer taxes, caused by the flow of capital in or out of the fund.

[101] Savings Banks Trust Co. also serves as investment adviser to M.S.B. Fund, a mutual fund organized for employees of member banks. On June 30, 1966, this fund had net assets of $2.8 million. On occasion, the trust company also performs analyses of individual portfolios for its member banks.

fees at the annual rate of **0.25** percent on the first $10 million of gross asset value and **0.125** percent on the balance. In **1965** its advisory fee amounted to **0.18** percent of average net assets.

Advisory fees at even lower rates were paid by the two other institutional mutual funds. The **1965** advisory fee rates charged these funds were as follows:

Name of fund	Net assets, June 30, 1966 (millions)	Investment adviser	1965 advisory fee rate (percent)
Savings Bank Investment Fund	$44.8	State Street Bank & Trust Co	0.04
Bank Fiduciary Fund	21.0	Manufacturers Hanover Trust Co	.10

3. *Advisory fee rates charged other nonfund clients*

The advisory fee rates charged pension and profit-sharing plans and institutional mutual funds are substantially lower than those in the mutual fund industry. Another example of generally lower rates—and one pointed to by the Wharton Report—are the charges for portfolio advisory services made by investment advisers to individual and institutional clients other than pension and profit-sharing plans.

Advisory fee rates for individual accounts tend to be somewhat higher than the bank fee schedules for pension and profit-sharing plans and reflect the higher cost (per dollar of assets managed) of obtaining and servicing such accounts, which on the average are considerably smaller than pension or profit-sharing plan accounts. In addition, private portfolios must be tailored to individual needs and circumstances, including tax and estate considerations, and individual clients often request—and receive without extra charge—advice on financial matters unrelated to management of their security investments. Moreover, as some advisers have stressed, private clients tend to change advisers more often than pension and profit-sharing plans do. Since even the higher fee rate paid by the average private account amounts to a relatively small sum, and the account receives extensive services and is more liiely to be terminated than a pension or profit-sharing plan account, the fee levels for private accounts reflect to a signscant extent the relatively higher costs of obtaining, maintaining, and retaining, through time-consuming client contact, the nonfund investment advisory account.

These factors do not affect the cost of furnishing investment advice to mutual funds. The size of the average mutual fund is far more comparable to the size of the average pension or profit-sharing plan than to individual advisory accounts. Advisory relationships in the mutual fund industry are more stable than such relationships with private accounts and certainly as stable as advisory relationships with pension and profit-sharing plans. Moreover, in the mutual fund industry the cost of obtaining new shareholders is paid for, except in the case of no-load funds, by the sales load.

Nevertheless, the Wharton Report found that where investment advisers managed portfolios for mutual fund clients and €or nonfund clients, the rates charged the mutual funds were less flexible and substantially higher for comparable asset levels than the fee rates charged nonfund clients. The Report examined and rejected contentions that the lower fee rates charged other clients by advisers of mutual funds reflect the absence of many of the expenses resulting from services rendered to the funds but not to other clients. It pointed out that the shareholders of an investment company do not receive the individual attention given to private advisory clients.[102]

The Report concluded that serving as investment adviser to mutual funds was generally more profitable than providing such services to other clients. Its conclusion was supported by an analysis of income statements of investment advisers having both fund and nonfund clients. They tended to have "sharply higher" operating costs per dollar of assets managed than advisers managing only mutual fund assets. Among advisers managing portfolios of both fund and other clients, there was a systematic tendency for operating expense ratios to rise with increases in the relative importance of nonfund income.[103]

The lower fee rates which the Wharton Report found were charged to the nonfund clients of mutual fund advisers correspond to the rates reflected in the fee schedules of banks for individual accounts and those filed with the Commission by registered investment advisers. Although the basic annual fee rate usually is **0.50** percent or more, this rate is usually halved for portfolios ranging from **$1** million to **$2** million. Many of these schedules clearly indicate that even lower rates can be negotiated for portfolios in excess of **$2** million. And, as previously noted, investment advisers who are broker-dealers frequently reduce advisory fees for nonfund clients by **a** portion of the brokerage commissions earned from the client's account, a benefit which mutual funds affiliated with a broker-dealer seldom realize.[104]

The Wharton Report's conclusions correspond to those reached by the more intensive examination of selected mutual funds and mutual fund complexes made by the Commission's staff. One investment adviser whose operations were examined by the staff charged fees to a mutual fund under its management that were more than double the fees that would be charged under its advisory fee schedule for "full normal services" to nonfund clients. This adviser's schedule for nonfund clients states that fees in excess of **$10,000** are subject to modification, and the adviser indicated to the staff that fees on accounts **of** **$3** million or more might be reduced as much as **20** percent below the scheduled rates. The fee schedule for nonfund clients also covers the cost of custodial services that this adviser does not give to its fund clients. The adviser indicated that if a private client did not desire these services, the fee might be reduced as much as **20** percent.

Another investment adviser studied by the staff charged advisory fees for the mutual fund assets under its management that were more than triple the average rate for its other clients. The fund involved in this staff study was a no-load fund, and the adviser spent more than one-third of the advisory fees received from the fund on selling and promotional expenses. Nevertheless, the fund account was more profitable than the aggregate of the other accounts. This was so because the management of the numerous nonfund accounts.was more time consuming than the management of the fund's portfollo.

The fact that mutual funds tend to pay more for investment management than do other types of advisory clients does not mean that mutual fund shareholders are charged more for investment advice than they would be if they had individually sought *to* obtain professional management services for their investment capital, Most invest-

[102] Wharton Report 492–494.
[103] Wharton Report 495–496.
[104] Sea pp. 108–110, supra.

ment advisers do not accept accounts of less than $100,000. Those that do often set a minimum fee which would be prohibitive to the average mutual fund shareholder.

The status of the mutual fund investor, however, is not at all comparable to that of the private advisory client. The mutual fund shareholder does not obtain investment management tailored. to his individual needs and objectives or enjoy the face-to-face relationship that normally exists between a private client and his investment adviser. Unlike the private advisory client, the mutual fund investor in most cases pays, in addition to the advisory fee, an initial sales load in order to obtain professional investment advice. Those who invest through contractual plans incur additional charges. When a mutual fund investor seeks to change advisers by redeeming his shares, he must pay a capital gains tax on any appreciation of his initial investment which has not been previously distributed to him; and if he reinvests in another load fund, he must pay another sales load.

F. PROFIT MARGINS OF EXTERNAL ADVISORP ORGANIZATIONS

While portfolio management is by far the most substantial service paid for by the mutual fund advisory fee, for some funds the fee includes management services which are not provided by investment advisers to pension and profit-sharing plans and other nonfund clients. This factor, as well as certain differences between portfolio management for publicly held mutual funds and other types of investment advisory clients, may justify somewhat higher fee rates to them.

But examination of the management costs of the internally managed investment companies shows that such factors do not adequately explain the much higher advisory fees charged to the externally managed funds.[105] This conclusion is further supported by the Wharton Report's analysis of the **1960** operating expenses of mutual fund advisers which showed that their expenses per dollar of assets managed tended to be lower for fund clients than for nonfund clients.[106] **A** further indication that the operating expenses of mutual fund advisory organizations do not require the maintenance of the present level of advisory fee rates is found in the available income and expense data for these organizations for the period since 1960.[107]

1. Total operations

Table **111–8** shows, for their fiscal years ended in **1965,** the pre-Federal income tax profit margins of the **14** advisory organizations which managed mutual fund assets of at least **$250** million as **of** June **30, 1965,** for which public data are available. **Also** reflected in the table are the total income and total pretax profit figures from which the profit margins are derived and the two chief components of the advisory organizations' total income—advisory fees and the income from distribution **of** fund shares (net of compensation or

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[105] *See* pp. 110–114, supra.
[106] Wharton Report 507–508.
[107] Although such data arc not available on an industrywide basis, most of the publicly held mutual fund advisory organizations Ele with the Commission annual reports containing certified financial statements pursuant to Commission rules under secs. 13 and 15(d) of the Exchange Act. In addition, the Commission has occasionally required that allocated financial data concerning the investment adviser's mcome, expenses and net profit under the advisory eontract with the investment company (or with a complex of investment companies) be included in the investment company's proxy statement where *a* change in tho advisory contract was submitted to the shareholders for their approval.

allowances to salesmen, agents, and dealers). The income and profits for most of the advisory organizations in table III–8 are, unless noted, for their entire operations. In certain instances they may include advisory services to nonfund clients, insurance underwriting, and other nonfund business.

TABLE III–8.—*Income, expenses, and profits before Federal income tares of 14 mutual fund advisory organizations for their fiscal years ended 1956*

[Dollars in thousands]

Advisory organization	Fiscal year ended	Advisory fees received	Net distribution income [a]	Other income	Total income *	Before Federal income taxes: Profit (Loss)	Before Federal income taxes: Profit margin (percent)
1. Channing Financial Corp	Dec. 31	$4,161	$2,039	[b] $420	[b] $6,619	[c] ($949)	(14.3)
2. Distributors Group, Inc	do	1,419	557	[d] 53	[d] 2,030	595	29.3
3. The Dreyfus Corp	do	5,109	[e] 3,025	558	8,692	5,118	58.9
4. Hamilton Management Corp	Apr. 30	1,993	2,493	294	4,780	[f] 1,957	40.9
5. Insurance Securities Inc. [g]	June 30	5,369	11,540	1,939	18,848	12,903	68.5
6. Investors Diversified Services, Inc	Dec. 31	21,538	9,340	8,195	39,073	17,786	45.5
7. Investors Management Corp	Nov. 30	5,919	1,821	76	7,816	3,443	44.1
8. Keystone Custodian Funds, Inc	Dec. 31	6,706	2,606	142	9,454	[h] 3,890	41.1
9. National Securities and Research Corp	do	3,378	1,240	147	4,765	2,309	48.8
10. The Putnam Management Co., Inc	do	4,274	2,745	492	7,511	1,656	22.0
11. Supervised Investors Services, Inc	Oct. 31	1,807	157	46	2,010	771	38.4
12 Vanca, Sanders & Co., Inc	do	1,082	5,101	187	6,369	3,100	48.7
13: Waddell & Reed, Inc	Aug. 31	8,696	9,236	135	18,068	6,816	37.7
14. Wellington Management Co.	Oct. 31	5,260	1:380	138	6.778	4,232	62.4

[a] Distribution income is net of allowances to salesmen, agents, and dealers.
[b] Does not include equity in unconsolidated subsidiary net income and net realized investment gains of $4.6 million.
[c] Does not include $150 thousand litigation settlement writsoff.
[d] Includes $23 thousand profit on securities sold.
[e] Includes $2.1 million in contractual plan net sales commissions.
[f] Does not include $410 thousand operating loss of insurance subsidiary.
[g] Does not include operations of ISI's wholly owned subsidiary Life Insurance Co. of California
[h] Does not include $92 thousand allocated to provision for subsidiary losses.
* Totals may not add due to rounding.

The pretax profit margins for these advisory organizations ranged from **68.5** percent to a loss **of 14.3** percent and the median was **42.6** percent. The Channing Financial Corp. was the **only** organization **of** the **14** which suffered a loss on its combined advisory and sales operations in 1965.[108] The largest advisory organization, IDS, with total income **of** over **$39 million**, had a profit margin **of 45.5 percent.**[109]

2. Advisory and distribution operations performed for mutual funds

Table III–9 shows the income,[110] profits before Federal income taxes, and pretax profit margins for the mutual fund distribution and advisory operations **of 10** large adviser-underwriters for which

[108] The figures for the Channing Financial Corp. include certain consolidated insurance operations.
[109] Since IDS distributes shares of the funds under its management exclusively through its own retail selling organization it does not pay part of its total distribution income to broker-dealers as do underwriters which distribute shares through independent dealer systems. In computing operating expense ratios deduction of the commissions paid to the IDS salesmen serves to make such data for IDS more comparable(but not necessarily identical, to the data for adviser-underwriters which use dealer-distribution systems: If sales commissions were not deducted in calculating net distribution income, IDS would have a lower profit margin. This also applies to Insurance Securities Inc. Hamilton Management Corp. Channing Financial Corp., and Waddell & Reed, Inc., which retail shares kxclusively or primarily through their own selling organizations.
[110] Brokerage income from mutual funds, which in some instances is another major source of revenue for advisers or their affiliates, has not been included in the table.

allocated expense data are available.[111] The income and profits shown for each adviser-underwriter are the averages of the years from 1961 to 1965 for which such data are available. All 10 organizations showed a profit from their combined mutual fund distribution and advisory operations. Pretax profit margins ranged from about 4.3 percent for the Parker Corp. to over 71 percent for ISI. The median was 45.6 percent.

Although the combined mutual fund distribution and advisory operations of the 10 organizations were profitable, the difference in profitability between the advisory and distribution functions is striking. The Wharton Report found that 16 of the 37 advisers who also served as principal underwriters for the funds under their management had lost money on their underwriting operations in 1960.[112] For ensuing years, table III-9 also shows that the distribution of mutual fund shares was sometimes unprofitable and that, even where profitable, profit margins generally were much lower than those on fund advisory operations. Of the 10 adviser-underwriters, 4 had unprofitable fund distribution operations. Distribution pretax profit margins ranged from a loss of 117.8 percent for The Parker Corp. to an 88.4 percent profit for Insurance Securities Inc.[113] The median was a profit of 8.7 percent.

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[111] The source of nine of these companies' reports are proxy statements filed by mutual funds for which the company served as manager or distributor. Data on The Dreyfus Corp. come from the prospectus for its public offering and the data for Insurance Securities Inc., are from the annual reports to the Commission of the Insurance Securities Trust Fund.

[112] Wharton Report 514-517.

[113] ISI is the exclusive distributor of participating agreements in the Insurance Securities Trust Fund. These agreements automatically terminate at the end of 10 years and the purchaser must pay an additional 8.85 percent creation fee (salesload) on the net asset value as of the termination date to renew his agreement. In addition, ISI sells exclusively through its own sales representatives, and only in California.

TABLE III-9.—*Average [a] annual income, pre-tax profits and profit margins of investment advisers for their mutual fund advisory and distribution operations for fiscal years ended 1961–65*

[Dollars in thousands]

Investment adviser	For the fiscal years ended	Mutual fund distribution and advisory operations			Mutual fund distribution operations			Mutual fund advisory operations		
		Income	Before Federal income taxes		Income [b]	Before Federal income taxes		Income	Before Federal income taxes	
			Profit	Profit margin		Profit (Loss)	Profit margin		Profit	Profit margin
				Percent			Percent			Percent
1. E. W. Axe & Co., Inc.[c]	June 30, 1961, 1962	[d] $1,894	$164	8.7	$513			[d] $1,381	$181	13.1
2. The Dreyfus Corp.[e]	Dec. 31, 1961, 1962, 1963, 1964	4,476	2,087	46.6	2,376	($17)	(3.4)	2,100	1,442	68.7
3. Investors Management Co., Inc.[f]	Nov. 30, 1961, 1962	5,762	[illegible]		1,066	644 56	27.1	4,696	2,514	53.5
4. Insurance Securities Inc	June 30, 1961, 1962, 1963, 1964, 1965	11,017	[illegible]	[illegible]	7,620	6,739	88.4	3,397	1.104	32.5
5. Investors Diversified Services, Inc	Dec. 31, 1961, 1962, 1963	21,104	10,279	48.7	5,104	(418)	(8.2)	16,000	10.697	66.9
6. The Parker Corp.[g]	do	2,144	92	4.3	393	(463)	(117.8)	1,751	555	31.7
7. The Putman Management Co., Inc.[g]	do	5,350	1,384	25.9	3,295	400	12.1	2,055	984	47.9
8. Supervised Investors Services, Inc	Oct 31, 1961, 1962	2,654	1,864	51.3	623	27	4.3	2.031	1,337	65.8
9. Waddell & Reed, Inc	Aug. 31, 1961, 1962, 1963	10,270	2,972	28.9	5 214	1,073	20.6	5,056	1,899	37.6
10. Wellington Management Co.[h]	Oct. 31, 1961, 1962	5. 030	2,658	52.8	1:188	338	28.5	3,842	2,320	60.4

[a] Average is for those years from 1961 to 1965 for which data were available for each company.

[b] Distribution income is net of compensation or allowances to salesmen, agents, and dealers.

[c] The fiscal year of the distributor, Axe Securities Corp., ended Dec. 31.

[d] Includes $212 thousand in other income, principally advisory fees from iioninvestment company clients,

[e] Includes $1.8 million in sponsor fees $142 thousand of delegated service fees, and $56 thousand of related other income on the) Dreyfus Investment Program.

[f] Investors Management Co., Inc. was a subsidiary of the distributor, Hugh W. Long & Co., Inc., now known as the Anchor Corp.

[g] 1964 the Parker Corp was merged into the Putman Management Co., Inc.

[h] Includes the advisor; operations of the Wellington Co., Ltd., of Delaware and the distribution operations of the Wellington Co., Inc.

In contrast to the losses or low pretax profit margins on operations encountered in the distribution of mutual fund shares are the high profit margins resulting from advisory operations. The advisory pre-tax profit margins of the 10 firms in table III–9 ranged from about 13 percent to about 69 percent with a median of 50.7 percent. Results for E. W. Axe & Co., Inc., which had the lowest advisory profit margin by far, include the operations relating to its nonfund advisory operations. This is consistent with the Wharton Report's finding that operating ratios were sharply higher and profits lower for advisers with nonfund clients than ratios of advisers with only investment company clients.[114]

Table III–9 also supports the Wharton Report's findings that to a significant extent mutual fund advisers use the profits from advisory fees paid by the funds to subsidize underwriting activities in the hope of increasing the size of the funds under their management and generating greater advisory fees. This practice tends to give the larger investment advisers a substantial advantage over the smaller ones in the competition for sales of mutual fund shares.

3. The effect of reductions in advisory fee schedules

The impact that reductions in fee rate schedules would have had on advisory profit margins was available for six advisers. If the new schedules had been in effect for the fiscal year prior to their adoption, pretax profit margins for such fiscal year would have been as follows:

TABLE III–10.—The effect of advisory fee reductions on advisory profit margins

Investment adviser	Advisory profit margins (percent)		
	Actual	Pro forma	Reduction
E. W. Axe & Co., Inc.	18.6	6.7	64.0
Investors Diversified Services, Inc.[a]	69.8	66.9	4.2
Do.[b]	59.9	55.1	8.0
Investors Management Co., Inc.	53.9	52.6	2.4
Supervised Investors Services, Inc.	65.0	60.4	7.1
Waddell & Reed, Inc.	34.3	27.2	20.7
Wellington Management Co.[c]	61.0	59.8	2.0

[a] 1963 schedule change.
[b] 1964 schedule change.
[c] Includes the advisory operations of the Wellington Co., Ltd., of Delaware, adviser to Windsor Fund, Inc.

The changes in the profit margins for most of these advisers resulting from reductions in the advisory fee rates were not very Substantial. Moreover, by the end of 1965 the *gross* advisory fee income of these advisers was in almost every instance higher than it was prior to the rate reduction. Although no data are available on the profits presently derived from advisory fees, it is likely that in some cases profits are once again at pre-rate reduction levels or higher. In others, reductions in profits from advisory contract changes may be completely offset in the near future by the advisers' realization of economies of size resulting from further growth in the size of the funds.

G. EXISTING RESTRAINTS ON MANAGEMENT COMPENSATION

The historical pattern of substantial adherence by many funds to the 0.50 percent advisory fee rate in the mutual fund industry, despite economies of size realized from the growth of those funds

[114] Wharton Report 495.

71–588 O—66——10

and the complexes of which they are a part, suggests inadequacies in the economic, the regulatory, and the other legal restraints on mutual fund advisers' compensation. These restraints can be derived only from the competitive conditions under which the industry operates, the disclosure requirements of Federal securities laws, the "few elementary safeguards" provided by the Investment Company Act, including requirements for the approval of advisory contracts by shareholders and directors, and the standards governing management compensation under State law and the Act.

1. Advisory fees and competition

The disparity between the advisory fee rates charged externally managed funds and those charged pension and profit-sharing plans and other nonfund investment advisory clients in large measure reflects differing economic environments. Banks and other investment advisory organizations are in active competition with each other for the accounts of pension and profit-sharing plans and other nonfund advisory clients. However, investment advisers seldom, if ever, compete with each other for advisory contracts with mutual funds. While fund advisers do compete in offering their services to the public through the sale of fund shares, that competition is not price competition so far as the public is concerned. Cost reductions in the form of lower advisory fees or other cost considerations do not figure significantly in the battle for investor favor. Although advisory fees are continuing charges which must be paid without regard to the fund's investment success, to the average mutual fund investor an annual 0.50 percent advisory fee rate may not appear substantial in relation to the value of his investment. A 0.50 percent rate amounts to $25 per year on an investment valued at $5,000. Moreover, investor awareness of this charge has tended to be minimized by the profitability of mutual fund investments in the generally rising stock markets of recent years.

To the extent that mutual fund investors are aware of and concerned over advisory fees, their opportunities for obtaining mutual fund management services at significantly lower costs are limited. For most of the externally managed funds the reductions from the traditional 0.50 percent advisory fee rate are not substantial. Thus, only by investing either in the few internally managed mutual funds or the small number of externally managed funds which pay significantly lower fees can an investor realize appreciable savings in management costs. Even if an investor were aware of these funds, his evaluation of investment performance, individual investment objectives, possible savings in sales loads (a much more weighty consideration to a cost-conscious investor than the advisory fee),[115] the influence of personalized selling efforts and other considerations would probably be the most important factors affecting his investment decision. Should he already be a mutual fund investor, the prospect of paying another sales load and possibly a capital gains tax is likely to deter him from switching to another fund with a lower advisory fee.

Advisory fees, however, are the funds' principal operating expense and have become very substantial in amount. Mutual funds are unique among large purchasers of investment management services because neither cost considerations nor other competitive factors influence the funds' choice of their advisers. This is the consequence of the virtually complete merger of the funds' management

[115] See p. 53, supra.

with the advisory organizations. Mutual funds are formed by persons who hope to profit from providing management services to them. Realization of these expectations can best be assured if the funds remain under the effective control of their advisers.

The ability of advisers to retain this control is illustrated by the fact that when a change of advisers occurs, it almost always results from the sale of the fund's advisory organization or sale of a controlling interest in it. Although such an event terminates the existing advisory contract,[116] the pervasiveness of adviser control over the fund is evidenced by the fact that such a contract termination is invariably accompanied by a new contract between the fund and the successor adviser. The new contract seldom, if ever, provides for any reduction in advisory fee rates.

2. Advisory fees and the limitations of disclosure

Disclosure is often termed the "keystone" of the Federal securities laws. Disclosure requirements imposed upon issuers of securities help public investors to make informed investment decisions and provide them with necessary information to take legal and other action against corporate abuse. In addition, and in many respects just as important, disclosure develops and maintains conventional limitations over the relationships between corporate managements and public shareholders. It does so by making publicly available a body of information which guides investors and corporate managers themselves in appraising the propriety of particular actions, circumstances, and arrangements.

The disclosure requirements developed by the Commission in the administration of the Federal securities laws place considerable emphasis on the remuneration and other benefits received by officers, directors, controlling persons and other insiders of publicly held corporations.[117] Despite the fact that such requirements apply to investment companies to an even greater extent than to most other types of publicly held enterprises,[118] Congress determined at the time of the passage of the Investment Company Act that disclosure alone provides inadequate protection for investment company shareholders. The House report on the bill which became the Investment Company Act stated with respect to the investor protections afforded by the Securities Act and the Securities Exchange Act:

> Generally these acts provide only for publicity. The record is clear that publicity alone is insufficient to eliminate malpractices in investment companies.[119]

[116] The Act requires that advisory contracts entered into by registered investment companies provide for "automatic termination in th[illegible]t of it[illegible] sign[illegible]t [illegible] the i[illegible]v[illegible]st[illegible]ne[illegible]t [illegible]d[illegible]i[illegible]r." S[illegible]. 15(a) It defines an "assignment" to incl[illegible]e [illegible] direct or indirect transfer or hypothecation of a contract * * * by the assignor or of a controlling block of the assignor's outstanding voting [illegible] iti[illegible] b[illegible] a security holder of t[illegible] assignor * * *." Sec. 2(a)(4). For discussion of problems relating to [illegible] of [illegible]a[illegible]agement [illegible]rganizati[illegible]n see pp. 14[illegible] [illegible]3 i[illegible]fra.

[117] For ex[illegible]m[illegible]l[illegible], prospectuses for offerings registered under the Securities Act are required to disclose [illegible]he an[illegible]t of [illegible]irect and indirect remuneration paid or propose[illegible] t[illegible] be paid t[illegible] [illegible]nb[illegible] [illegible]f [illegible] [illegible]nt. These disclosures are required for all officers and directors as [illegible] group, for eac[illegible] [illegible]t[illegible]r an[illegible] for e[illegible]c[illegible] of the th[illegible]e highest paid officers whose aggregate remuneration exceeds $30,000. See, e.g., item 17 of the Registration For[illegible] S-1 under Schedule A to the Securities Act.

[118] [illegible] no[illegible] i[illegible] [illegible]r II, the disclosure requirements of the Securities Act apply only to public offe[illegible]ings of securities by [illegible], their controlling persons and underwriters Since virtually all mutual funds, unlike [illegible]st other typ[illegible] [illegible] publicly held enterprises, make *continuous public offerings of their securiti[illegible]*, the Securities Act's requirements furnish a continuous flow of current information concerning the funds and their se[illegible]i[illegible]i[illegible]. In addition the Investment Company Act subjects all investment companies registered with the Commission under that act to the proxy solicitation and periodic reporting rules adopted by th[illegible] C[illegible]i[illegible]i[illegible] under secs. 13 and 14 of the Securities Exchange Act.

[119] House Report 10.

Externally managed funds pay for most management services through gross fees to separate advisory organizations rather than through salaries and other remuneration to the individuals who manage their affairs. Although such fees pay for the services of those persons affiliated with investment advisers who perform the same functions as officers and employees of internally managed companies, they also pay for the services of other professional, administrative, and clerical personnel and for the office and research facilities incidental to these services. Appraisal of the fairness of the charges for the entire package of these services is far more complex than an appraisal of the reasonableness of individual executives' compensation. The Wharton Report suggested the lower management costs of the internally managed companies may reflect the restraining influence of conventional limitations on executive salaries.[120] But even here the restraints may have been weakened by the industry pattern of fees paid by the externally managed companies.

To the extent that disclosure has served to develop and maintain conventional limitations on the level of advisory fees charged to externally managed companies, these limitations have served mainly to keep advisory fee rates from rising above the 0.50 percent fee rate traditional in the industry. As noted, this traditional fee rate was developed at a time when mutual funds and fund complexes were only a fraction of their present size. It was itself derived from the advisory fee rates commonly charged for the more costly management services, per dollar of assets managed, provided to the much smaller portfolios of individual investment advisory clients.

3. *Shareholder voting rights*

The Act's safeguards with respect to advisory fees consist mainly of the provisions of the Act requiring initial approval of advisory contracts by the holders of a majority of the outstanding voting shares and annual renewal, by either the shareholders or the board of directors including a majority of the unaffiliated directors.[121]

The requirements for initial approval of advisory contracts by shareholders, together with the disclosure requirements for proxy material soliciting their approval, have had a prophylactic effect and may well have served to discourage advisers from charging fees at rates higher than the traditional 0.50 rate. However, requirements for shareholder approval of advisory contracts cannot realistically—as experience has demonstrated—be relied upon to achieve any material departures from the traditional 0.50 percent advisory fee rate that would reflect the economies of size available from the growth of the funds.

Shareholder voting in mutual funds, as in most publicly held enterprises, is conducted almost entirely by proxy. In most instances proxies are solicited only on behalf of management. The Commission's proxy rules require that the form of the management proxy afford shareholders an opportunity to signify either their acceptance or rejection of management proposals.[122] In addition, the rules require, under certain circumstances, that the proxies of management provide shareholders with an opportunity to vote on proposals initiated by shareholders.[123]

[120] Wharton Report 494.
[121] Secs. 15 (a) and (c).
[122] Rule 14a-4(b), Reg. 14 under the Exchange Act; Investment Company Act sec. 20a.
[123] Rule 14a-8.

The shareholders' opportunity to accept or reject management and shareholder proposals can provide them with meaningful alternatives in connection with most matters for which their approval is solicited. As a practical matter, however, these alternatives do not exist in connection with—shareholder approval of advisory contracts. Proxy contests initiated by competing investment advisers have taken place only in very rare instances where existing management relationships have completely broken down.[124] The shareholders themselves cannot select a new adviser, formulate a new advisory contract or set a new advisory fee; only the fund's board of directors and the shareholders acting together can do that. The shareholders alone can only ratify or refuse to ratify what management proposes. Shareholder refusal to adopt or renew the contract proposed by management, however, might leave the fund without an effective advisory contract, and the Act provides that no person or organization may serve as an investment adviser to a registered investment company except pursuant to a written contract.[125] Thus, exercise of the shareholders' right to refuse to ratify the adoption or the renewal of an advisory contract is fraught with uncertainty for—and possibly with harm to—the fund's operations. The drastic consequences that may attend the exercise of that right impair its effectiveness as a control over advisory fees.

Given sufficient shareholder understanding of and unrest over advisory fee rates, shareholders might attempt through the exercise of their voting rights to obtain a reduction in advisory fees by electing a board of directors or trustees independent of existing management and pledged to seek a reduction. The directors or trustees of most funds are elected annually by shareholders, and the Act contains provisions designed to safeguard this right.[126]

The election of directors independent of or opposed to the existing management in other types of publicly held corporations—while not common—does occur on some occasions. Often this occurs because a large stockholder or an organized group of stockholders has enough voting power to elect one or more directors themselves or hold a large enough interest in the company to be willing to expend the substantial resources necessary for conducting a proxy contest to achieve their objective.[127]

But there is little likelihood of shareholder-initiated opposition to the management of a mutual fund. Mutual fund managers through their relationships with the dealers and salesmen who sell the funds' shares have an advantage over outsiders in the solicitation of shareholder votes that managements of most other publicly held corpore tions do not have. Moreover, as the Wharton Report noted, mutual fund shareownership tends to be more highly dispersed than

[124] Such a proxy contest took place with respect to Managed Funds, Inc., after the Commission found that existing management had committed serious violations of the Federal securities laws in connection with their management of the funds. See *Managed Funds, Inc.*, 39 SEC 313 (1959); see also ch IV, p 192, supra.

[125] Act, sec. 15(a).

[126] Except for common law trusts organized prior to 1940, the Act requires that all stock issued by registered management investment companies to be voting stock with voting rights equal to those of every other outstanding stock. Act, sec. 18(i). Voting stock is defined as stock "presently entitling the owner or holder thereof to vote for the election of directors of a company." Act, sec. 2(a)(40). The term "directors" includes "any natural person who is a member of a board of trustees of a management company created as a common law trust." Act, sec. 2(a)(12).

[127] Under the law of most jurisdictions management may use corporate assets for reasonable expenses incurred in connection with a proxy fight, but opposing shareholders can obtain reimbursement from the corporation for their expenses only if they are successful. 5 Fletcher, Cyclopedia Corporations 228–229 (Perm. ed., 1952 Rev. Vol.). 1 Hornstein, Corporation Law and Practice 431. *Steinberg* v. *Adams*, 90 F. Supp. 604 (S.D. N.Y., 1950); *Campbell* v. *Loews, Inc.*, 134 A. 2d 852 (Del. Ch., 1957); *Rosenfeld* v. *Fairchild Engine & Airplane Corp.*, 309 N.Y. 168, 128 N.E. 2d 291 (1951).