The Management Fee Problem and The Investment Company Act of 1940

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THE PURPOSE OF this paper is to examine one aspect of the current controversy over regulated investment companies in general and mutual funds in particular. Three recent studies of the investment company industry have been conducted; first by the Securities Research Unit of the Wharton School of Finance and Commerce of the University of Pennsylvania;[1] a second, on mutual funds, was made by the SEC;[2] and a third report has been submitted by the SEC to Congress, which is now undergoing heated debate at this writing.[3] All three of these reports have vigorously attacked the investment company industry, and the *SEC's New Study* has advocated amendments to the Investment Company Act of 1940 which would drastically alter investment company operations. In response, the industry is vigorously defending

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[1] Wharton School of Finance and Commerce, *A Study of Mutual Funds*, H. Rept. No. 2274, 87th Congress, 2d Sess. 1 (1962) (hereinafter referred to as the "Wharton Report").

[2] U.S. Congress, House Document No. 95, 88th Congress, 1st Sess., *Report of Special Study of Securities Markets of the Securities and Exchange Commission*, Part 4, Chapter XI—Open-End Investment Companies (Mutual Funds) (hereinafter referred to as the "Special Study").

[3] U.S. Congress, House Report No. 2337, 89th Congress, 2d Sess. (1966) *Report of the Securities Exchange Commission on the Public Policy Implications of Investment Company Growth* (hereinafter referred to as the "SEC's New Study").

itself. This paper will examine the *Wharton School Report, The Special Study*, the *SEC's New Study*, and relevant case law as these apply to management fee problems under the Investment Company Act of 1940.

The SEC charges in effect amount to a statement that the investment company investor is not presently getting his money's worth. Because the investment company industry has grown to be a major factor in the securities markets of the United States, these charges convey great importance. The *SEC's New Study* highlights this growth with an impressive array of statistics. For example, investment company assets have grown from $2.1 billion in 1940 to $46.4 billion in 1966. The assets of mutual funds alone have grown from $450 million in 1940 to $38.2 billion in 1966. Most of the growth has taken place between 1952 and 1966.[4]

The number of shareholder accounts has increased from 300,000 in 1940 to over 6.7 million in 1965. The SEC notes, ". . . The present economic importance of the mutual fund industry can be gauged from the fact that in 1965 mutual funds raised about $5.2 billion through the issuance of new shares, more than double the $2.3 billion in new stock sold for cash in the United States during that year by all corporations other than investment companies."[5]

Thus, we have a major segment of the American securities market replete with the accusations of abuse, self-dealing, and conflicts of interest. In the end, Congress will decide whether public policy demands more stringent regulation of the industry. Their action, or lack of it, may have profound effects on a major source of equity capital for American business.

In order to understand the current controversy in the investment company field, it is necessary to examine the policies and shortcomings of the Investment Company Act of 1940. It should first be noted that the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Advisers Act of 1940 significantly affect the operation of the investment company industry. However, the Investment Company Act of 1940 is the only Federal Statute which is expressly concerned with investment company regulation. Due to the scope of this paper, it is the only Federal Statute which will be considered..

The Investment Company Act arose out of a study of the industry, ordered by Congress in the Public Utility Holding Company Act of 1935. In general, it can be said that the *Investment Trust Study* found gross abuses of fiduciary relationships, cheating, transactions in securities, property and loans to and with controlling persons, faulty capital structures, and the complete absence of shareholder control over management.[6] The abuses which the *Investment*

[4] *SEC's New Study*, p. 2.
[5] *Ibid.*, p. 2.
[6] *Ibid.*, p. 65.

Trust Study found were blatant and overt. It is generally conceded that the Investment Company Act was successful in curbing these serious abuses. On the other hand, the Act gives much discretion to management in the control of sales loads, managerial compensation, and brokerage commissions. Therefore, the argument is made that the Investment Company Act of 1940 is good as far as it goes in policing the infant industry of the '40s but that the burgeoning industry of the '60s requires further regulation.

There are three types of investment companies. The first is a face-amount certificate company which issues a certificate obligating the company to pay a fixed amount when the obligation matures. The purchaser usually receives a predetermined rate of return. The second type is a unit investment trust which sells redeemable interests in fixed portfolios of specified securities. It should be noted that the modern unit investment trust is simply a mechanism for selling the shares of a management investment company on an installment payment basis. Any company which is neither a unit investment trust nor a face amount certificate company is called a management company. The most important type of management company is the open-end company or mutual fund which sells redeemable shares, i.e., the purchaser has the right to redeem his shares for their net asset value.

It is important to note that most mutual funds are managed by external organizations, commonly referred to as investment advisers. They administer the mutual funds in almost every aspect from the management of office help to the selection of the portfolio. For their services, investment advisers receive a fee which is usually calculated as a percentage of the net assets of the fund. In many cases the investment adviser also acts as the principal underwriter of the fund's shares. Lastly, it should be noted that brokerage firms are often affiliated with an investment adviser and receive brokerage business through this connection.

The only provision of the Investment Company Act which deals directly with the problem of management fees is the following:

(a) After one year from the effective date of this subchapter it shall be unlawful for any person to serve or act as an investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, unless in effect prior to March 15, 1940, has been approved by the vote of a majority of the outstanding voting securities of such registered company and—

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

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

(3) provides, in substance, that it may be terminated at any time, without the

payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days written notice to the investment adviser; and

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

(c) In addition to the requirements of subsections (a) and (b) of this section it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral except a written agreement which was in effect prior to March 15, 1940, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved (1) by a majority of the directors who are not parties to such contract or agreement or affiliated persons of any such party, or (2) by the vote of a majority of the outstanding voting securities of such company.[7]

In sum, these provisions merely require the 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. Except for the requirement of full disclosure of the amount of compensation, there is no standard or limit set on management compensation.

The *Wharton School Report* conducted a fairly thorough study of the management fee problem. Its authors found that most investment advisers charge fees which tend to cluster around the traditional rate of one-half of 1 per cent per annum of the average net assets of the fund. Moreover, the study found that advisory fee rates are not related to the size of the fund, operating expenses of the adviser, or net income received by the fund. The Report stated:

> The concentration around the one-half of 1 percent level occurs more or less irrespective of the size of a fund's assets managed by an investment adviser, although operating expenses of the adviser were found to be generally lower per dollar of income received, and also lower per dollar of assets managed as the size of a fund's assets increased. When the advisory fees were measured against the investment income of the mutual funds, the median percent of such income paid out in advisory fees in fiscal 1960–61 by a representative group of mutual funds was 16.3 percent.[8]

In response, the funds have argued that it is to the benefit of the investor to have a large fund because expenses will thereby be spread over a larger group of investors and the fund will be better able to diversify. The above statistics refute this argument by showing that an increase in the size of the fund and the resultant economies of scale tend to benefit only the adviser because savings are not passed on to the investor.

The Report also argued that, for comparable asset levels, advisory rates

[7] Inv. Co. Act, Sec. 15(a) and (c).
[8] *Wharton School Report*, pp. XII-XIII.

charged mutual funds tend to be substantially higher than those charged by the same advisers to the aggregate of their clients other than investment companies. Moreover, this has taken place despite the fact that expenses involved in advising mutual funds were less than those incurred in advising other clients. Advisory fee rates have also tended to exceed the costs of internally managed mutual funds. Finally, the Report found a lack of flexibility in the advisory rates charged mutual funds when compared with size of assets managed in relation to rates charged other clients. The rates were also less flexible than the effective management costs of mutual funds without advisers.[9]

These facts tend to show that the provisions of the statute quoted above requiring both initial and continuing approval of management contracts have been spectacularly ineffective. The Report says:

> These findings suggest that the special structural characteristics of the mutual fund industry, with external adviser closely affiliated with the management of the mutual fund, tend to weaken the bargaining position of the fund in the establishment of advisory fee rates. Other clients have effective alternatives, and the rates charged them are more clearly influenced by the force of competition. Individual mutual fund shareholders do not pay higher management fee rates than they would incur through other institutional investment channels (which, however, normally do not involve substantial sales charges). Nevertheless, they do not generally benefit from the lower charges that the volume of their pooled resources might be expected to make possible. Mutual funds without advisers were found to have relatively lower and more flexible advisory costs—a situation which may be attributable at least in part, to conventional limitations on salary income (as opposed to payments to external organizations).[10]

Many law suits have been brought under the excessive management fee contention. These cases are very complex, and they are fought with difficulties for the shareholder-plaintiff. It would be helpful to examine a sampling of these cases in order to see how this type of litigation is handled in the courts.

In *Saminsky et al.* v. *Abbott et al.*,[11] plaintiff-investors sued Keystone Custodian Funds' trustee for excessive management and expense charges.[12] Using general equitable principles[13] (as you recall, the Investment Company Act does not regulate management fees), the court held that Keystone did not have an affirmative duty to disclose its actual expenses to prospective customers even though the ¼ of 1% per annum to cover these expenses[14] in addition to the ½ of 1% management fee was charged. The rationale used was that

[9] *Ibid.*, pp. XII-XIII.
[10] *Ibid.*, pp. XII-XIII.
[11] *Saminsky, et al.* v. *Abbot, et al.*, 40 Del. CH. 528, 185 A. 2d 765 (CH. 1961).
[12] *Ibid.*, pp. 522–33.
[13] *Ibid.*, p. 532.
[14] *Ibid.*, p. 531.

prior to the purchase of the shares, Keystone was at arm's length with prospective purchasers and that Keystone assumes the role of trustee only after the sale is completed. Under this theory, a prospective investor who wishes to investigate the management firm's operating expenses has only one recourse—ask for the information. If refused, the prospective investor must either forget his inquiry or purchase the shares of some other fund.[15]

However, this case exemplifies something more than the inherently weak position of a prospective fund investor, for the court recognized that under the right circumstances, the doctrine of equitable waste or spoilation could be applied to a common law business trust.[16] Two legal commentators say, "The importance of *Saminsky* lied in the recognition that advisory fees are subject to equitable revision where under a formula for payment which is originally reasonable the fees automatically grow with net asset value to a point where they no longer bear any reasonable relationship to the services rendered."[17]

Lastly, this case is important since the defendants urged the contention that the only necessary remedy for the mutual fund shareholder is the redemption of his shares. The judge in the *Saminsky* case answered this by saying:

> Turning to the question of the redemption privilege, I fail to see how a disgruntled investor here is in any better position than a dissatisfied corporate shareholder. Although the investor can redeem, he will suffer the loss of the amounts previously withdrawn from the Fund by the wrongdoers. He ought not be forced either to depart and submit to the loss, or remain and be deemed to have ratified. The investor may suffer adverse tax consequences in a forced withdrawal. At the very least he will incur a substantial loading charge if he invests in another Fund. Therefore I conclude for purposes of this motion that plaintiffs are not estopped from objecting to the alleged excessive compensation, nor can they be held to have continually ratified by refusing to redeem their shares.[18]

In *Meiselman* v. *Eberstadt*,[19] the basic issue was whether the affiliated directors through the management device, as fiduciaries, paid themselves excessive compensation.[20]

Plaintiffs maintained, using comparable statistics of executive compensation for other mutual funds, that the executives in the instant case were overpaid because they did not devote their full time to fund business. However, the

[15] *Ibid.*, p. 533.

[16] *Ibid.*, pp. 536–37.

[17] Meyer Eisenberg and Dennis J. Lehr, "An Aspect of the Emerging 'Federal Corporation Law': Directional Responsibility Under the Investment Company Act of 1940," *Rutgers Law Review*, 20 (Winter, 1966), 181 at 211.

[18] *Saminsky* case, p. 538.

[19] *Meiselman* v. *Eberstadt*, 170 A.2d 720 (Ct. of Chan. of Del., 1961).

[20] Ibid., p. 721.

court held that it had no real way of judging whether the management fee was excessive or not because the prime commodity sold to the fund was very much intangible—good investment advice.[21] As to the contention that as fiduciaries, the managers of the fund could not pay themselves more than the average compensation in the industry for similar services, the court argued ratification of such an arrangement by both unaffiliated majority directors and shareholders. Finally, the judge noted that the basic charges in the management contracts are lower than the average in the mutual fund field.[22]

This case is important for it shows the role of judicial discretion in an excessive fee action. The judge refused to decide whether the money paid by the fund to the managers was reasonable or not in view of the intangible nature of investment advice.

Saxe v. *Brady*[23] is another fully litigated excessive fee case. Plaintiffs launched a two-pronged attack: (1) that the management fee rate was excessive when compared to fees charged by other large fund managers and (2) that if the rate was not excessive, the dollar amounts paid under the arrangement were, in fact, excessive.[24]

The court was not impressed by the first argument and said that all the plaintiffs tended to show was that there is a tendency for the rate among the larger funds to be less than a flat .5%. Moreover, among these funds the rate seemed to the court to be neither extraordinary nor uncommon.[25] Again, the court used the argument of ratification in favor of the defendants. The court said that this seemed to indicate that the rate paid to the management company was a "commercially realistic one."[26]

As to the dollar amount argument, the court held that (1) the fees paid to the two large funds in comparison with the instant case did not automatically establish the legitimate outer limit of payments for advisory services and (2) there was no indication that the services rendered to the funds in comparison are the same in quantity or quality as those furnished in the instant case.[27] Thus, the court here re-emphasizes the difficulty brought out in *Meiselman, supra,* of placing an economic value on an intangible such as investment advice.

Moreover, the court held that under the present state of the law, the management company is entitled to make a profit apart from the salaries paid its executive personnel. Then, the court emphasized that the very nature of the

[21] *Ibid.*, p. 723.
[22] *Ibid.*, p. 723.
[23] *Saxe* v. *Brady*, 184 A.2d 602 (Ct. of Chan. of Del., 1962).
[24] *Ibid.*, p. 611 and p. 615.
[25] *Ibid.*, p. 611.
[26] *Ibid.*, p. 612.
[27] *Ibid.*, p. 615.

compensation arrangement (a percentage of net assets) lends itself to the payment of sums having no necessary relationship to the value of such services if tested by compensation standards usually applied to the business community.[28]

However, the court recognized the formalism it was adhering to in rendering a decision for the defendants. In other words, the plaintiffs have the facts but not the law—because of the void in the Investment Company Act. The court said:

> Based on the 1959 and 1960 figures the profits are certainly approaching the point where they are outstripping any reasonable relationship to expenses and effort even in a legal sense. And this is so even after making due allowance for incentive and benefit presumably conferred. This is not to say that no payment is justified after a fund reaches a particular size. It is only to say that the business community might reasonably expect that at some point those representing the fund would see that the management fee was adjusted to reflect the diminution in the cost factor.[29]

Thus, I would say that the court wanted to help the plaintiffs but realized that the facts were just not blatant enough for a common law remedy.

A third fully litigated case is *Acampora* v. *Birkland*,[30] a derivative action brought on behalf of a mutual fund company against its management corporation, another corporation, and the fund's officers and directors.

This case is interesting in that the plaintiffs attempted to get part of what in effect was the management fee back by contending not only that the fee was inequitably excessive, as in the other cases, but also that the contracts were illegal under various provisions of the Act.[31] The defendants were successful in warding off all these attacks except that the management company was held liable for officers' salaries which it had sluffed off on the fund through the use of a "reasonable amount" clause in its contract. In other words, the fund was not only paying a typical percentage of assets as a management fee but was also paying the salaries of officers of the management group. Furthermore, the court held that management should pay the cost of the installment investment plan under general equitable principles since the management company would benefit as the adviser and the larger net asset base would benefit management. Moreover, management received commissions on sales under this plan.[32]

As in other cases, the judge in this case realized that he was hamstrung by the Investment Company Act. He said:

> Certainly, the one-half of one percent approach leaves a great deal to be desired

[28] *Ibid.*, p. 615.
[29] *Ibid.*, pp. 616–17.
[30] *Acampora* v. *Birkland*, 220 F. Supp. 527 (D. Colo., 1963).
[31] *Ibid.*, pp. 531–32.
[32] *Ibid.*, pp. 545–47.

(even though counsel does not now question the propriety of this). Such a guaranteed fee fails to take into account success or failure of the advisory effort. Still another bad feature is that its probable increase is disproportionate to the value of the services rendered. It must, however, be pointed out that this matter is not here in issue. Indeed, the fact that a more equitable scheme could be worked out, or that this writer sees potential abuses in the method, does not furnish a basis for an adjudication of excessiveness.[33]

The basic point in all these cases is that the fund holder has no substantial legal remedy to combat excessive fees due to the lack of a standard in the Investment Company Act. The courts recognized a wrong but, in effect, are saying it is up to the legislature to solve this problem—not the judiciary.

Meiselman, Saxe, and *Acampora* are all interesting because they were fully litigated, i.e., they went all the way through the trial process. It is obvious that the strategy of the defense law firm in these actions is to tenaciously fight the case in the pretrial process. For example, the *Saminsky* case opinion was written to dispose of a motion for summary judgment under the Federal Rules of Civil Procedure. The defendants do this probably to avoid the adverse publicity which an extended trial may bring to a fund. Moreover, the expenses involved in these cases are fantastic, and a protracted trial and appeal will even increase them. If the management company loses the case at the pre-trial phase, it most often will seek a settlement.

However, even the settlement of such a lawsuit has its complications as compared to the settlement of an ordinary lawsuit. Therefore, I think it would be worthwhile to look at two settlements and see how they were handled.

Glicken v. *Bradford,*[34] was a proceeding on order to show cause why a proposed stipulation of settlement in a stockholders' derivative action over alleged excessive management fees filed in behalf of a mutual fund should not be approved by the court.[35]

This type of case is unusual in that since it was a derivative suit, the shareholders of the fund had to be notified of the proposed settlement and given an opportunity to object to it. Out of 270,000 shareholders, only two opposed settlement and the judge held that these objections were frivolous. The judge calculated the savings to the fund for past years to be $699,000 since the defendants agreed to a scale down in fees, a flat reduction in past fees, and to assume certain expenses of the fund which were previously borne by the fund.[36]

In deciding to approve the settlement, the judge was forced to consider the merits of the lawsuit since the settlement to be approved must be found to be

[33] *Ibid.,* pp. 548–49.
[34] *Glicken* v. *Bradford,* 35 F.R.D. 144 (1964).
[35] *Ibid.,* p. 146.
[36] *Ibid.,* pp. 147–49.

fair. This is because the plaintiff is, in effect, binding the other stockholders of the fund to this decision—even though they are not in court. Thus, the judge considered evidence brought forth by both sides through means of depositions and exhibits. The judge concluded that Investors Diversified Services, Inc. charged about the same fees as do other management corporations, and that it in fact performed more services for the fund than do many other management companies. Therefore, the judge concluded that the attack by the plaintiffs was not so much against this particular management company but against the mutual fund industry as a whole.[37]

Rome v. *Archer*[38] was a very similar case involving Wellington Fund, Inc. Again because of the derivative nature of the suit, the court was forced to consider all the contentions of the plaintiff and decide that the chancellor below did not abuse his discretion in approving the settlement. It is interesting to note that the court stressed evidence presented by the defendants that the Fund compares favorably to other similar funds in performance, that the expense ratio of the Fund was shown to be low in comparison to other similar funds, and that fees charged compared favorably with others.[39]

The point is that these settlements absolved the management group without a trial on the merits but bind the stockholders—many of whom do not understand what is taking place and many of whom, if they did understand, could not afford to object to the settlement.

The *SEC's New Study* downgraded the utility of the current fee litigation and concluded that it has done little to reduce or to stimulate the reduction of advisory fees. The Study contended that the greatest barrier to reduction is that the courts have held that management fee contracts were ratified by shareholders and by unaffiliated directors. Thus, the plaintiffs had to bear the burden of proving affirmatively that the fees were so grossly excessive that their payment constituted a waste of corporate assets.[40]

The *SEC's New Study* also emphasizes that the cases such as *Acampora, Saxe,* and *Meiselman, supra,* show, namely that shareholder protections created by the Act have been so construed under state law as to preclude judicial inquiry into the reasonableness of advisory fees.[41]

The Commission in its *New Study* updated the information gathered in the *Wharton School Report,* finding that the .5% rate was still prevalent in the industry in 1965. In a study of 57 externally managed funds with assets

[37] *Ibid.*, pp. 152–59.
[38] *Rome* v. *Archer,* 197 A.2d 49 (Sup. Ct. of Del., 1964).
[39] *Ibid.*, p. 55.
[40] *SEC's New Study,* p. 12.
[41] *Ibid.*, p. 13.

of more than $100,000,000 on June 30, 1965, the median fee rate equaled 0.48 per cent of average assets and the mean fee rate was 0.45.[42]

Expenses were found to be almost twice as high for the larger externally managed funds as compared to the internally managed funds. The expenses were also substantially higher than the fees which banks charge for managing investment portfolios of pension and profit sharing plans. The Commission conceded that the services required are different but that this did not adequately explain the variance. Moreover, the open-end funds pay substantially higher fee rates than those registered investment companies which are used as equity investment vehicles for banks and other institutions. Again, the Commission found that mutual fund advisory fee rates are substantially higher for comparable asset levels than the rates that private individuals pay for investment advice.[43]

The SEC also gave its own explanation of why the common-law cases reviewed above have failed to bring adequate relief to plaintiffs. First, the Commission asserted that the state law applicable to mutual funds was established mainly for the regulation of business associations and not for the unusual problems which arise between mutual funds, their stockholders, and advisers, and second, that the Act was enacted with the small funds of the 1940's in mind and not the huge complexes of the 1960's.[44] The Commission agreed that the absence of standards in the Investment Company Act leaves the stockholder with a legal right without a remedy. The Commission stated:

> Because the Act fails to articulate clearly the standard by which the propriety of managerial compensation should be measured, it makes for uncertainty and impairs rather than strengthens the fiduciary obligation of investment company managers to refrain from compensating themselves unfairly. If the Act is to be an effective force for fairness and equity in this area, the "few elementary safeguards" deemed adequate for the industry of 1940 must now be supplemented.[45]

Thus, the Commission took a kind of public utility approach to the problem, i.e., a standard of reasonableness is the best approach. The Commission recommended the Act be amended to provide as follows:

(1) All compensation received by any person affiliated with a registered investment company (including investment advisers, officers, directors, and trustees, any person serving as its principal underwriter and any affiliated person) for services furnished to the investment company be reasonable;

(2) The standard of reasonableness be applied in the light of all relevant factors,

[42] *Ibid.*, pp. 11–12.
[43] *Ibid.*, pp. 11–12.
[44] *Ibid.*, pp. 141–43.
[45] *Ibid.*, p. 43.

including the fees paid for comparable services by other financial institutions engaged in administering pools of investment capital of like size and purpose such as pension and profit sharing plans, insurance companies, trust accounts, and other investment companies; the nature and quality of the services provided; all benefits directly or indirectly received by persons affiliated with an investment company and the affiliated persons of such persons by virtue of their relationship with the investment company; and such competitive or other factors as the Commission may by rule or regulation or, after notice and opportunity for hearing, by order, determine are appropriate and material in the public interest;

(3) The application of this standard be unaffected by either shareholder or directorial approval of advisory contracts or other arrangements for management compensation;

(4) Recoveries in actions to enforce the statutory standard of reasonableness be limited to that portion of the compensation deemed excessive which has been paid or accrued within two years of the date of which the action is instituted; and

(5) The Commission be empowered to institute actions to enforce the statutory standard of reasonableness and to intervene as a party in any private action brought to enforce that standard.[46]

The Commission report states that this standard would not prevent fund managers from making a profit on the various services which they sell to a fund. However, the standard would mean that a fund manager could charge the fund no more than if he had arrived at the price in an arm's length bargain.[47]

This writer examines the Commission's solution to the management fee problem with great trepidation. The Commission may be attempting to replace one monster with another. First, there is the distinct possibility of even more litigation under this standard than under the present one. The Commission obviously assumed such litigation since it has provided for a statute of limitations in (4) above and also for its own participation in litigation in (5) above. Moreover, there is a myriad of factors which need to be considered in determining whether or not the fee is reasonable. The consideration of these factors may lead to prolonged and costly litigation.

Another problem arises from one of the measures of reasonableness recommended by the Commission: "the nature and quality of the services provided." An adjudicatory body may have difficulty judging the nature and quality of the services provided without measuring the performance of the fund in relation to other funds. Such measurement could have two deleterious effects. First, the measurements would possibly affect the future sale of shares. In effect, the fund will be rated and the receipt of a bad rating will adversely affect fund sales and thus injure the present shareholders. Second, the whole concept of measuring the performance of a fund goes against current policy of

[46] *Ibid.*, p. 13.
[47] *Ibid.*, p. 13.

securities regulation by the federal government. That policy is that the investor should be as free as possible to choose his own investments aided by disclosure and registration requirements. Third, as indicated above, the investment adviser has nothing to sell but advice and wisdom. It would seem very difficult for a court to place a value on a particular set of investment decisions.

Does the Commission's solution really go to the heart of the mutual fund problem? This writer thinks not. It is the structure of the mutual fund organization that is really causing all the difficulty. The truth of the matter is that Congress in 1940 enacted a monster into legislation—the external management entity. This is why there is so much danger as to possible conflicts of interest. It is why unaffiliated board members are so important and have become such a problem under the Act. One legal commentator noted this defect when he spoke of the impotency of the unaffiliated directors. If they rejected an advisory contract, the result would be a proxy fight and other intra-fund conflict. If a structural change is necessary, he noted that it will have to come from the legislature and not from the courts.[48] In Lobell's criticism of the *Wharton School Report,* he stated that the Report's attack is basically on the structure of the mutual fund, itself. He contended that the Report vindicates the industry as being a clean industry and that any change brought about will be not from bad to good but from good to different.[49]

The real solution to the mutual fund problem is the forced internalization of investment company management. The Commission in its New Study discussed this possibility, but rejected the notion. It felt that while much money could be saved with this procedure by the large companies, small companies would be penalized since their costs are often more than .5% of net asset value and thus small companies would be discouraged from forming. I believe the Commission's argument to be unrealistic since other ways can be found to compensate the promoters of investment companies such as officers' salaries and the future increased value of their shares in the fund, itself. Moreover, nothing in the Act would prohibit the creation of a "phantom stock" plan under which a fund manager would be compensated with a number of pseudo-shares of the fund which would receive dividends and appreciate just as actual shares of the fund. Here, the fund manager would be properly compensated for risk-taking.

It seems to me that the real reason that the Commission did not suggest the internalization of management is a political one. The mutual fund lobby and the political power of the management companies are just too much for the SEC to take on at this time. Thus, they decided to outflank the funds by establishing a standard of reasonableness. For the reasons stated above, I be-

[48] Nathan D. Lobell, "The Mutual Fund: A Structural Analysis," *Virginia Law Review,* 47 (March, 1961), 181 at 206.

[49] Nathan D. Lobell, "A Critique of the Wharton School Report on Mutual Funds," *Virginia Law Review,* 49 (January, 1963), 1 at 55.

lieve that this standard of reasonableness will cause more problems than it will solve.

It is, therefore, suggested that the SEC conduct a further study and arrive at a schedule of acceptable maximum fee rates. For example, the management organization might be allowed to charge .5% of the first $100,000,000 of net assets, .45% of the next $100,000,000, .4% on the third $100,000,000 and so on. This standard, enacted into law, would give the funds definite standards to meet, would allow the smaller funds enough to cover their costs, would allow all management organizations to make adequate profits, and would negate the necessity of fruitless and bitter litigation which would cost the taxpayers, fundholders, and management companies countless millions in legal fees.

In conclusion, it can be said that the whole investment company problem is quite complex and that there are no easy answers. The Investment Company Act was meant to solve the more overt problems highlighted by the 1935 study of investment companies. That it fails to solve more sophisticated problems is highly evident.

Much of anyone's solution to these problems will depend on his policy as to investment companies and securities regulation in general. Thus, this writer admits that the position taken in this paper is highly colored by the belief that disclosure is only a beginning in the securities regulation field and that without high standards it will prove useless. The position is also influenced by the notion (at least partially proved by the *SEC's New Study*) that those who invest in investment companies are financially less sophisticated than those who use other investment media. This disability was recognized by the Investment Company Act, and this recognition justifies changes in the Act.

In addition, those in fund management will hopefully be prudent enough to realize that action on their part now to establish a reasonable schedule of management fees may save them immeasurable grief—should their faliure to do so be answered by a burgeoning consumer-investor lobby.