



OFFICE OF THE DEPUTY ATTORNEY GENERAL
WASHINGTON, D.C.

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Honorable Harley O. Stagers
Chairman, Committee on Interstate
and Foreign Commerce
House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

This is in response to your request for the views of the Department of Justice on H.R. 9510, the "Investment Company Amendments Act of 1967." The stated purpose of the bill is to amend the Investment Company Act of 1940, and the Investment Advisers Act of 1940 to define the equitable standards governing relationships between investment companies, their investment advisers and principal underwriters.

This legislation is designed to implement recommendations contained in the President's Consumer Message of February 16, 1967 (H. Doc. No. 57, 90th Cong.).

H.R. 9510 was originally drafted by the Securities and Exchange Commission and is the result of an extensive study of the industry by the Commission which culminated in a 346 page report to Congress on December 2, 1966 entitled Public Policy Implications of Investment Company Growth (H. Rept. No. 1046, 89th Cong., 2d Sess.). The general conclusion of the report was that while mutual funds and other investment companies do offer a sound and useful investment media for the public, their dramatic growth in recent years has created problems requiring legislative attention.

Much of H.R. 9510 provides for technical changes in the existing Investment Company Act of 1940 and the Investment Advisers Act of 1940. The more important provisions are concerned with the following:

- a. Providing for a 5 per cent limitation on the basic sales charge.
- b. Limitations on the management fees that the investment adviser organizations may take for their management and investment advisory services to mutual funds and investment companies.
- c. Limitations on the "front-end load" imposed on investors who purchase mutual fund shares on an installment basis through what is known in the trade as the "contractual plan."
- d. Limitations on the sales of mutual fund management organizations which impose burdens on the fund or its shareholders or limit the funds' future freedom of action.
- e. Prohibition against the creation and enlargement of mutual fund holding companies.

This Department favors the enactment of H.R. 9510. However, we offer the following comments on three aspects of the bill:

1. The proposed limitation on the sales charge, set forth in section 12 of the bill, provides for a 5% limitation on the basic sales charge for mutual fund shares. Since Congress has deemed the industry a partially regulated one, the proposal for this limitation on the basic sales load, under the supervision of the Securities and Exchange Commission, is not inconsistent with the basic concept of the Act.

We note that the desire to place a limitation on the sales charge is based upon the judgment that the present charges are unduly high. In this connection it should be noted that section 22(d) of the existing Act, by authorizing what is essentially price maintenance, may contribute to this situation.

Section 22(d) of the existing Act provides in pertinent part as follows:

(d) No registered investment company shall sell any redeemable security issued by it to any person except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus, and, if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter or the issuer, except at a current public offering price described in the prospectus: ...

This provision presumably prohibits sales to the investor at prices lower, as well as higher, than those designated in the prospectus. It appears to us that in conjunction with the proposed limitation on sales charges contained in section 12 it may be desirable to effectuate a change in the fixed price policy embodied in section 22(d), and we recommend that further consideration be given to this subject. It is true that Congress, in originally enacting the "fixed price" provisions of section 22(d) in 1940, provided for the mutual fund industry an exception to the basic competitive requirements of the antitrust laws. In view of changed conditions, however,

and the fact that the mutual funds are so important an outlet for the small investor, it would seem that he should not perhaps be deprived of the opportunity of purchasing his investment at a price arrived at through the free operation of competitive forces. This could be accomplished by repealing section 22(d) altogether or by amending it to provide that no sales could be made "at a price higher than the current public offering price." This would make competitive price reductions possible.

It is our understanding that some consideration has heretofore been given to the possibilities of eliminating the price maintenance features of section 22(d) from the statute. Because of the nature of the security business, however, it has apparently been the view that to leave the matter to the free play of competitive forces would make for disorder in the industry. One reason advanced is that completely free competition would permit the shrewd and knowledgeable investor to bid for and receive the lowest price, while leaving the small and unsophisticated investor--the one most in need of protection--paying the higher price, reflecting a higher sales load. We believe, however, that this possibility, if real, is not appropriately solved by eliminating price competition. Further consideration of alternative safeguards for the smaller investor is recommended if, because of imperfect knowledge, he may be led to make economically irrational choices.

Another reason advanced against repeal of the price maintenance features of section 22(d) is that sales competition would provide an undue advantage to the larger mutual funds with their own sales forces. The argument is that the funds which have internal sales forces can set a larger sales fee and thereby secure and encourage better sales efforts than can funds which rely on the efforts of independent dealers, whose sales load margins

may be diminished by competition. In our judgment, it would not seem likely that the marketplace would thus reward the more expensive product and we doubt that competition would work to the advantage of the high sales cost firm. Should this prove a problem, other legal or regulatory remedies could perhaps be fashioned; for example, consideration could be given to a requirement that all mutual funds make their shares available to all broker-dealers.

2. Section 8 of the proposed legislation will provide that management and advisory fees be "reasonable." It would also authorize suits by the SEC and private investors challenging the reasonableness of such fees; such suits might be brought in either federal or state court in accordance with section 43 of the existing Act.

It is our understanding that under present practice the management fee contract is the result of negotiation between the management organization and the duly elected directors and officers of the mutual fund, and that the contract so negotiated is subsequently ratified by the mutual fund shareholders. Some courts have dismissed litigation over the "reasonableness" of management fee contracts on these grounds, and it is our understanding that the particular amendment has been drafted because of these decisions.

We note that the proposed amendment would place the courts in the position of making the kind of judgments as to reasonableness of rates often entrusted to regulatory agencies in the first instance. On the other hand, it may be argued that each fund's arrangement may be sui generis, and that the courts are not unaccustomed to suits requiring determination of the reasonableness of compensation (such as attorneys' and trustees' fees). In

our judgment, a proper balance may be struck between the desire, on the one hand, to assure consistency of regulation and to avoid proliferation of court action, and, on the other, to afford a ready remedy for unreasonable charges, if the SEC were assured an important role in this area. Hence, we believe that consideration should be given to the following alternative solutions: (i) requiring all complaints as to the unreasonableness of fees to be presented to the SEC for determination subject to the usual judicial review; or (ii) if the proposed court action provision is to be adopted in those instances in which the SEC has not brought the suit, a report to the court by the SEC as to the merits of each private suit instituted should be made mandatory (rather than permissive as provided by the bill's proposed amendment to section 44 of the Act).

3. Section 7 of the bill prohibits the creation and enlargement of mutual fund holding companies. We do not suggest that the holding company device is necessarily noncompetitive in nature. However, the proposed provision does eliminate the possibility that the holding company device might be used to create anticompetitive combinations among substantial competitors in this rapidly growing and already concentrated industry so important to the small investor. We favor the provision.

The Bureau of the Budget has advised that the enactment of legislation along the lines of H.R. 9510 would be in accord with the Program of the President.

Sincerely,



Warren Christopher
Deputy Attorney General