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A STUDY OF MUTUAL FUND COMPLEXES*

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I. INTRODUCTION

A. *What Is a Mutual Fund Complex?*

The last decade has seen an increasing number of dollars entrusted to the care of professional money managers. Although most of these dollars continue to be invested in such time-honored vehicles as common law trusts and life insurance, a growing portion is being invested in new or newly popular vehicles such as variable annuities, commingled trust funds, and mutual funds.¹ The growth of mutual funds has been particularly striking.² From 1940 through 1969 the net assets of

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I prepared this Article while a Fellow at the University of Pennsylvania Law School Center for Study of Financial Institutions. Much of the information on specific mutual funds and fund complexes was gathered in field studies at a number of mutual fund complexes. In addition, many of the ideas in this paper were discussed at a round table at the University of Pennsylvania Law School on September 15, 1970. I am indebted to the Director of the Center, Professor Robert H. Mundheim, for his invaluable counsel and assistance. I would also like to thank participants in the round table discussion, members of the mutual fund industry, and especially William J. Nutt, a Fellow of the Center, for their contributions to this paper. The views expressed are my own.

¹ Foldessy, *Rush to Mutual Funds by Insurance Concerns Approaches Stampede*, Wall St. J., Feb. 25, 1970, at 1, col. 1. See also Mattlin, *New Policies for Insurance Companies*, INST. INV., Jan. 1970, at 53.

² "Mutual fund" denotes a company which offers or has offered securities to the public representing a proportionate share of an investment portfolio held by the fund. An investor may redeem his shares at any time for their net asset value—the fair market value of fund assets divided by the number of outstanding shares. Mutual fund is common parlance for an open-end investment company as defined by § 5(a)(1) of the Investment Company Act of 1940, 15 U.S.C. § 80a-5(a)(1) (1964). See

mutual funds increased from \$450 million³ to \$48.3 billion, and by the end of the next decade are expected to reach \$100 billion.⁴ Growth will accrue not only to existing funds but also to a large number of new entrants. One-third of the funds currently registered with the Securities and Exchange Commission (SEC) have been in existence for less than two years.⁵ In addition, the creation of new funds by insurance companies is accelerating so rapidly that one commentator has characterized the trend as approaching a "stampede."⁶

One striking characteristic of mutual funds is their propensity to cluster into groups—each group managed by a common adviser and sold by a common distributor. Mutual fund groups so dominate the industry that forty-nine major groups, each with \$100 million or more in net assets, are responsible for over ninety percent of the industry's net assets.⁷ The SEC has referred to "groups of funds under common management" as "fund complexes."⁸ So defined, the term "fund complex" suggests the common interests ordinarily shared by the funds in a group. With a common adviser, distributor, and frequently boards of directors and officers,⁹ with shareholders who can transfer among the funds in the group without payment of a sales charge,¹⁰ and with graduated load reductions based on cumulative purchases of all the funds,¹¹ each fund in a complex has an interest not only in its individual success but also in the success of the other funds in the group.¹²

1 L. LOSS, SECURITIES REGULATION 144-46 (2d ed. 1961). Open-end investment companies ordinarily sell their shares through distributors who charge the investor the net asset value of the shares plus a sales charge or "load," usually between 7.5% and 8.75% of the total purchase price. SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. 51-54 (1966) [hereinafter cited as SEC REPORT].

³ SEC REPORT 2.

⁴ Investment Company Institute, Annual Report 5 (1969).

⁵ Of the 1167 investment companies registered with the SEC at the close of fiscal 1969, 389 were created during fiscal years 1968 and 1969. See 35 SEC ANN. REP. 126 (1969). Although these figures include closed-end as well as open-end companies, the great majority of investment companies created in recent years have been open-ended.

⁶ Foldessy, *supra* note 1. See also 35 SEC ANN. REP. 128-29 (1969).

⁷ Marketing Mutual Funds in the 1970's: A Strategic Appraisal, Address by John C. Bogle, National Mutual Fund Conference sponsored by the *Institutional Investor*, in New York City, Mar. 31, 1970, on file in Biddle Law Library, University of Pennsylvania Law School [hereinafter cited as Bogle Address].

⁸ SEC REPORT 47.

⁹ See Bogle, *The Mutual Fund Complex*, 3 REV. OF SEC. REG. 911, 912 (1970).

¹⁰ SEC REPORT 47-48.

¹¹ *Id.* 48 n.98. See also note 50 *infra*.

¹² For a description of some mutual fund groups, see SEC REPORT 104-08; SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt. 4, 102-07 [hereinafter cited as SPECIAL STUDY]; WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 2274, 87th Cong., 2d Sess. 69-73 [hereinafter cited as WHARTON REPORT]; Fiske, *Fidelity: The Problems of Success*, INST. INV., Mar. 1969, at 29; Mattlin, *The Problems of Being the Enterprise Fund*, INST. INV., Mar. 1970, at 25; Welles, *Capital Research: Can a Fund be Run Like a Think-tank*, INST. INV., Dec. 1968, at 43; *The Whiz Kids Take Over at Wellington*, INST. INV., Jan. 1968, at 23.

John C. Bogle, Chairman of the Board of Governors of the Investment Company Institute, points out that the SEC definition of the term fund complex, although properly emphasizing the common interests of the funds in a group, is not sufficiently comprehensive.¹³ Because a community of interest exists not only between the funds in a complex but also between the funds and their adviser,¹⁴ any definition of the term is misleading unless it includes the adviser as well as the funds. The funds have an interest in providing the adviser with adequate compensation so that the adviser can in turn attract topflight analysts and portfolio managers. The adviser has an interest in providing superior performance, even without an incentive fee,¹⁵ because performance normally is important in attracting new investment.¹⁶ The funds and the adviser usually share an interest in increasing fund net assets through the sale of fund shares because the management fee usually increases with an increase in fund assets,¹⁷ while the expense ratio, the cost per invested dollar of operating the fund, usually decreases. Fixed expenses paid directly by the fund may be spread over a greater number of invested dollars, and, if the fund's management fee—usually a percentage of fund net assets—is scaled down as assets increase, the average percentage paid on each dollar of net assets may be reduced.¹⁸

Mr. Bogle is correct in pointing out that the interests of the funds and their adviser often converge. Yet identity of interests is not always the rule.¹⁹ Conflicts between these interests will be the subject of this study.

Many of the problems to be discussed are not restricted to fund complexes; they are present whenever a professional money manager is responsible for more than one account. Bank trust departments and investment advisers handling more than one counseling account have similar problems. In fact, many of these problems are compounded for investment advisers who manage both a large number of counseling accounts and a complex of mutual funds and for banks and insurance companies which have moved into the mutual fund industry with registered investment companies and with fund-like products such as

¹³ Interview in Philadelphia, Pa., Feb. 1970; see Bogle, *supra* note 9, at 911-12.

¹⁴ Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 U. PA. L. REV. 1058, 1059-60 (1967).

¹⁵ An incentive fee ties the adviser's compensation at least partially to the performance of the portfolio it is managing. See generally 35 SEC ANN. REP. 129-30 (1969).

¹⁶ See note 123 *infra*; cf. Mundheim, *supra* note 14, at 1060.

¹⁷ SEC REPORT 89.

¹⁸ See *id.* 96-101, 255.

¹⁹ See Mundheim, *supra* note 14, at 1060-62.

commingled trust funds and variable annuities.²⁰ Indeed, a broader definition of "fund complex"—perhaps a better term would be "investment complex"—might include a variety of investment media and their common adviser. A complex might consist of several mutual funds, a contractual plan, a closed-end investment company, a variable annuity, investment counseling accounts, a weekly investment publication, and the adviser's own portfolio. Although no complex currently embraces all of these variations, a surprisingly large number of combinations do exist.²¹ This study is relevant to the problems of investment complexes, but the focus of the discussion will be limited to mutual fund complexes.

B. *The Legal Context*

1. Organization

Mutual funds and their investment advisers depend for their legal existence upon state law. Funds take the form of corporations or trusts;²² advisers, usually organized separately from the funds, almost always take the form of public or private corporations or partnerships.²³ State law and federal statutes, including the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940, define the regulatory limits within which funds and their advisers operate.²⁴

With few exceptions each fund, whether organized as a corporation or as a trust, exists as a separate legal entity within the complex.²⁵ Each fund organized as a corporation has its own charter or certificate

²⁰ See generally SEC REPORT 35-37; MUTUAL FUNDS 1-59 (PLI 1970) (remarks of Reese H. Harris, Jr. & Lawrence J. Latta); Note, *Commingled Trust Funds and Variable Annuities: Uniform Federal Regulation of Investment Funds Operated by Banks and Insurance Companies*, 82 HARV. L. REV. 435 (1968).

²¹ Investors Diversified Services, for example, includes among its many products mutual funds, contractual plans, variable annuities, and the adviser's own personal portfolio. Investors Diversified Services, Inc., Growing Through Service 6-11 (Oct. 1969). The Wellington Management group includes mutual funds, a closed-end company, and investment counseling accounts. Wellington Management Co., Annual Report 8-11 (1968).

²² WHARTON REPORT 44. The trust form of organization is not as important today as it once was. For some of the reasons behind the decline, see *id.* 45.

Mutual funds organized as trusts should not be confused with unit investment trusts, sometimes called fixed trusts. Fixed trusts are used as the vehicle for contractual plans and as such their portfolios almost always consist solely of the shares of a specific mutual fund. SEC REPORT 226-27.

²³ SEC REPORT 46.

²⁴ For a general description of the federal regulation governing investment companies, see North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME LAW. 677 (1969).

²⁵ See SEC REPORT 47-49.

of incorporation, its own board of directors, and its own shares of stock; each fund organized as a trust has its own trust agreement defining the fund's purpose and powers.²⁶ Thus, funds within a complex ordinarily have the trappings of individually operated companies. As a matter of practice, however, most funds are little more than pools of dollars, skeletons with few if any employees other than officers and directors.²⁷ The real job of running most funds is done by the investment adviser hired by the fund or, in the case of trusts, named in the trust agreement as trustee or hired by the named trustee.²⁸ The adviser normally serves each fund pursuant to a separate advisory contract or trust agreement,²⁹ although frequently the contracts or agreements of the various funds are quite similar.

This barebones description of fund complexes does not do justice to the diversity within the mutual fund industry. A number of important complexes were organized before the industry had settled on a more or less standardized form of organization³⁰ and, for the most part, the Investment Company Act left such organizations undisturbed. For example, the funds in several complexes are not managed by an external adviser.³¹ Rather, the funds hire their own employees to provide investment advice and other services. These employees may work directly for the funds or for a corporation jointly owned by the funds.³² But even funds within an internally managed group are ordinarily organized as separate corporations or trusts, with managerial responsibility vested in separate boards of directors or trustees.³³

²⁶ Mutual fund trusts also issue shares of stock which cumulatively represent the entire beneficial interest in the fund assets. See, e.g., Keystone Custodian Fund Series S-4, Prospectus 1 (Sept. 29, 1969).

²⁷ CCH MUTUAL FUNDS GUIDE ¶1531 (1970); see SEC REPORT 46.

²⁸ SEC REPORT 46; WHARTON REPORT 49-51. Keystone Custodian Funds, Inc. serves as corporate trustee and investment adviser to the nine Keystone Custodian Series Funds. See, e.g., SEC REPORT 332 n.30. The Putnam Management Company, Inc. serves as investment adviser to The Putnam Growth Fund, which also has its own trustees. See The Putnam Growth Fund, Prospectus 3-4 (Mar. 2, 1970, revised May 1, 1970).

²⁹ See SEC REPORT 108.

³⁰ For a general description of the history of the mutual fund industry, see *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAW. 732, 767-812 (1969).

³¹ See SEC REPORT 49. See generally *id.* 102-11.

³² Until recently, when it changed over to an external management arrangement, the investment advisory and other management services of the Massachusetts Investors Trust-Massachusetts Investors Growth Stock Fund (MIT-MIGS) complex were performed "by a board of five trustees, an advisory board and a staff of employees, all of whom" were paid directly by the funds. *Id.* 104. In the Union Service group (formerly known as the Broad Street Group), investment research and administrative services are furnished by Union Service Corporation, which is jointly controlled by all the investment companies. Union Data Service Center, Inc., a wholly owned subsidiary of Union Service, performs transfer, redemption, and other shareholder services. Broad Street Investing Corporation, Annual Report 22 (1969). See also SEC REPORT 106-07.

³³ MIT, for example, is organized as a Massachusetts business trust. MIGS is organized as a corporation, as is each fund in the Union Service group. SEC REPORT 104, 106.

The difference between such funds and externally managed funds lies in the source of their investment advice, not in their legal organization.

In a few instances, the funds in a complex are not organized as separate legal entities. Instead, they jointly comprise a single investment company which issues several series of stock, each series representing a different portfolio with a different investment objective.³⁴ The funds share a single board of directors³⁵ and an adviser which manages each of their portfolios pursuant to a single investment advisory contract.³⁶ Nevertheless, the investors in any one series of stock, like the shareholders of more conventionally organized funds, participate only in the performance of the portfolio represented by that series.

Mutual funds generally hire a principal underwriter to sell fund shares, granting it an exclusive distributorship and the right to charge purchasers of the shares a sales commission, or "load."³⁷ The principal underwriter is almost always either the adviser itself or a corporation controlled by the adviser.³⁸ Each fund in a complex ordinarily has its own contract with the underwriter but, like the advisory contracts, the distribution contracts for the most part are identical.

This general pattern is subject to several exceptions. No-load funds traditionally have sold their shares directly to the public without an underwriter-intermediary,³⁹ but even no-loads sometimes sell their shares through a principal underwriter owned by the investment adviser.⁴⁰ Internally managed funds, lacking an external adviser, may

³⁴ United Funds, Inc. is an example of this type of investment company. Incorporated in 1940, the company issues four series of capital shares, each series representing ownership of a separate portfolio of securities. Though all four portfolios are managed by the same adviser, Waddell & Reed, Inc., each has its own investment objective. Thus, the company consists of a growth fund, an income fund, a science fund, and a bond fund. In 1968, a capital appreciation fund was added to the complex, but it was organized as a separate corporation. United Funds, Inc., Prospectus 2 (July 3, 1969); United Vanguard Fund, Inc., Prospectus 5 (Oct. 20, 1969). For a brief description of this complex, see SEC REPORT 47. Because the objectives of one series may conflict with those of another, but the approval of a majority of all shareholders may be required to effect major changes, the SEC has recommended to Congress that "existing series companies be prohibited from creating new series in the future and that no new series company be permitted to register under the Act." *Id.* 330-31.

³⁵ See United Funds, Inc., Prospectus 6-7 (July 3, 1969).

³⁶ *Id.* 10.

³⁷ SEC REPORT 54-56.

³⁸ *Id.* 54.

³⁹ *Id.* 59.

⁴⁰ For example, the no-load mutual funds advised by Scudder, Stevens & Clark, a partnership, are distributed by Scudder Funds Distributors, Inc., a wholly owned subsidiary of Scudder, Stevens & Clark. Scudder, Stevens & Clark Common Stock Fund, Inc., Prospectus 9 (Apr. 18, 1969). Because Distributors receives nothing from fund purchasers to compensate it for its function as distributor, it must be subsidized by Scudder, Stevens & Clark.

own the underwriter themselves⁴¹ or may contract for distribution.⁴² Finally, funds organized as a single corporation ordinarily do not negotiate separate underwriting contracts for each series of stock;⁴³ similarly, the trustee for a complex of funds organized as separate common law trusts may, depending upon the trust agreements, negotiate a single distribution contract on behalf of all the funds.⁴⁴

2. Judicial Review of Mutual Fund Directors and Advisers

The adviser initially determines how the various funds are treated. Its determination is subject to review by each fund's board of directors, and both the adviser and the fund boards are in turn subject to judicial review.

Judicial review of the actions of mutual fund directors is grounded in the state law duties of care⁴⁵ and loyalty,⁴⁶ duties the law has

⁴¹ The shares of the Union Service funds are distributed by Union Service Distributor, Inc., a wholly owned subsidiary of Union Service Corporation, the organization which performs investment research and administrative services for the funds and for Tri-Continental Corp., a closed-end investment company. Union Service Corporation, in turn, is controlled by the investment companies. Broad Street Investing Corp., Prospectus 3, 5 (May 1, 1970).

⁴² When they were internally managed, MIT and MIGS were distributed by Vance, Sanders & Co., Inc., a corporation not owned by the funds. See SEC REPORT 106; note 32 *supra*.

⁴³ See United Funds, Inc., Prospectus 13 (July 3, 1969).

⁴⁴ Shares of the nine Keystone Custodian Series Funds, each organized as a separate common law trust, are distributed by the Keystone Company of Boston and by Cornerstone Financial Services, Inc. pursuant to common underwriting contracts negotiated by the funds' common trustee, Keystone Custodian Funds, Inc. The two underwriters are wholly owned subsidiaries of Keystone Custodian Funds, Inc. See Keystone Custodian Fund Series S-4, Prospectus 8-9 (Sept. 29, 1969).

⁴⁵ The duty of care affords only cursory control of directors' activities. Cases in which directors have been found to have violated the standard are highly unusual. As one commentator has put it, "The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack." Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968). See generally *id.* 1094-1101; cases reprinted and abstracted in W. CARY, CASES AND MATERIALS ON CORPORATIONS 513-50 (4th ed. 1969).

There is some question whether mutual fund directors owe the same duty of care as that applicable to directors of ordinary industrial corporations or whether they owe the higher duty applicable to directors of financial corporations. Compare Jaretzki, *Duties and Responsibilities of Directors of Mutual Funds*, 29 LAW & CONTEMP. PROB. 777, 780 n.10 (1964), with Eisenberg & Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940*, 20 RUTGERS L. REV. 181, 189-92 (1966). See generally *Note on Liability of Directors of Banks and Other Financial Institutions*, in W. CARY, *supra* at 525; Wymeersch, *Some Aspects of Management Fees of Mutual Funds*, 17 BUFFALO L. REV. 747, 762 n.58 (1968).

For a case in which both the affiliated and nonaffiliated directors of a mutual fund were found negligent, see *Lutz v. Boas*, 39 Del. Ch. 585, 171 A.2d 381 (Del. Ch. 1961).

⁴⁶ The duty of loyalty prevents a director from preferring his own interests over those of the corporation on whose board he sits. In the words of one court, the duty of loyalty requires a director "not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it." *Guth v. Loft, Inc.*, 23 Del.

traditionally imposed on corporate directors. In addition, mutual fund directors and advisers owe the funds duties arising under the Investment Company Act.⁴⁷

Judicial review of the adviser, apart from federal law, derives from several different state-law theories.⁴⁸ Review may be based on the adviser's contractual obligation, express or implied, to treat each fund fairly. Courts generally have been disposed to imply covenants of good faith and fair dealing in contracts, especially if such covenants are indispensable to effectuate the intention of the parties.⁴⁹ When an adviser serves a group of funds, the intent of the parties is apparently that each fund participate in a fair share of the benefits deriving from its membership in the fund complex.⁵⁰ A covenant of good faith and fair dealing may also be implied from the adviser's position with respect to the funds. By hanging out its "shingle" as an investment adviser, the adviser impliedly represents that it will deal fairly with each of the funds it serves.⁵¹

Ch. 255, 270, 5 A.2d 503, 510 (Sup. Ct. 1939). When a question of loyalty is involved, the courts will scrutinize a director's actions closely, applying a fairness standard rather than the more permissive standard of care. See *Johnson v. American Gen. Ins. Co.*, 296 F. Supp. 802, 809 (D.D.C. 1969) (quoting *Meinhard v. Salmon*, 249 N.Y. 458, 459, 164 N.E. 545, 546 (1928)); *Levien v. Sinclair Oil Corp.*, — Del. Ch. —, 261 A.2d 911, 915 (Del. Ch. 1969); *DeGraaf v. Birkhead*, 103 N.Y.S.2d 942 (Sup. Ct. 1951) (defendant directors liable for preferring one subsidiary in an industrial complex over another). See generally W. CARY, *supra* note 45, at 550-698.

⁴⁷ See generally *Eisenberg & Lehr*, *supra* note 45.

⁴⁸ The state-law duties of advisers serving as trustees for funds organized as common law trusts or hired by fund trustees are at least as strict as those binding the directors of funds organized as corporations. See Note, *Rights and Obligations in the Mutual Fund: A Source of Law*, 20 VAND. L. REV. 1120, 1135-38 (1967). In many cases the trust agreement reinforces the duties arising under state law. See *Jaretski*, *supra* note 45, at 778 n.6.

⁴⁹ *Sacramento Navigation Co. v. Salz*, 273 U.S. 326, 329 (1927). See also *Kirke La Shelle Co. v. Paul Armstrong Co.*, 263 N.Y. 79, 87, 188 N.E. 163, 167 (1933).

⁵⁰ Mr. Bogle has summed up what he sees to be as some of the benefits of a fund complex:

[N]ew funds of all types will probably be necessary for a management organization that wishes to maintain its growth, to say nothing of its vitality.

With more funds will come more services, too. The multi-fund complex will aim at providing a variety of services that tend to unify and consolidate the offering of its various funds and build an identity of interest among the shareholders of all of the funds. Thus, we should see an expansion of combined fund purchase arrangements (owning a "package" of funds) and inter-fund exchange privileges (making it possible to modify the risk-reward character as the investor's goals change). And, if management company profit margins return to former levels, it may not be far-fetched to project substantial cost-saving benefits to the investors in the funds within the complex, in the form of management fee schedules that relate in part to the assets of the complex, rather than the assets of its individual fund components.

Bogle Address 8-9 (emphasis omitted).

⁵¹ The theory under which the covenant might be implied is appropriately known as the "shingle" or "implied representation" theory. See Cohen & Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development*, 29 LAW & CONTEMP. PROB. 691, 702-04 (1964), and references cited therein.

Judicial review of the adviser may also be based on obligations arising not from the contract but from the relationship between the adviser and the funds.⁵² Obligations of care arise when an adviser dominates the funds' boards of directors.⁵³ Domination is, of course, a factual question, but the fact that fund boards consist of affiliated directors and nonaffiliated directors who frequently are nominated by the adviser and are closely attuned to its interests suggests that a finding of domination and thus a duty of care for state-law purposes may be made in some instances.⁵⁴

If the investment adviser does not dominate its funds' boards of directors, a finding that it owes duties beyond those flowing from its advisory contracts is more difficult. On the one hand, an adviser is a separate legal entity selling its services pursuant to separately negotiated contracts. On the other, an adviser is closely identified with the funds⁵⁵ and often does not deal with them at arm's length. Recognizing the adviser's dual role, some lawyers have chosen to view advisers as fiduciaries in most of their dealings with the funds, but not with respect to the management fee, which, they argue, is set in arm's length

⁵² It may be unnecessary to use existing state-law principles to define an adviser's duties to its funds if, as some commentators have suggested, a common law of mutual funds is or should be evolving. See Note, *supra* note 48, at 1144. If a common law of mutual funds does evolve, however, it may result from interpretation of the Investment Company Act and not from development of new state-law doctrine. *Id.* 1148. See generally Eisenberg & Lehr, *supra* note 45. But see *Moses v. Burgin*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶92,747 (D. Mass. Aug. 18, 1970). *Moses* involved a shareholder's action against Fidelity Fund, Inc., one of the twelve funds in the Fidelity group, Fidelity Management & Research Co., investment adviser for the group, The Crosby Corporation, a wholly owned subsidiary of the adviser and exclusive distributor of Fidelity group funds, and Fidelity Fund's affiliated and nonaffiliated directors, alleging violations of defendants' statutory duties under §§ 1, 15, 35, and 36 of the Investment Company Act, 15 U.S.C. §§ 80a-1, 15, 35, and 36 (1964), and their common law fiduciary duties. Judge Wyzanski concluded that "the claimed federal common law does not exist." *Moses v. Burgin supra* at 92,267.

⁵³ See, e.g., *Levin v. Sinclair Oil Corp.*, — Del. Ch. —, 261 A.2d 911, 914 (Del. Ch. 1969). While the court might have relied on the generally accepted principle of *Pepper v. Litton*, 308 U.S. 295, 306 (1939), that a dominant or controlling shareholder—in this case *Sinclair Oil*—is a fiduciary, it instead emphasized the factual dominance *Sinclair* exercised through selection of the subsidiary's directors.

⁵⁴ [Y]ou know and I know that if you are choosing an unaffiliated director or an independent director you are not going to choose anybody who is going to be too hard on you. You are going to tend to pick a friend of yours; and may I say again, as a footnote, that in my litigation I have encountered two situations where a so-called unaffiliated or independent director happened to be the son of the leading stockholder of the adviser.

Now, how funny can you get? And yet with straight countenance under oath the testimony was that the son was going to "call them as he sees them," to coin a phrase, and he was not going to be partial to his father.

UNIVERSITY OF PENNSYLVANIA *Conference on Mutual Funds*, 115 U. PA. L. REV. 669, 739-40 (1967) (remarks of Abraham L. Pomerantz) [hereinafter cited as *Conference*].

Yet the independence of the nonaffiliated directors may be on the increase. See text accompanying notes 143-44 *infra*.

⁵⁵ For example, advisers and their funds frequently have similar names. Thus, Scudder, Stevens & Clark advises, among other funds, Scudder, Stevens & Clark Balanced Fund, Inc., Scudder, Stevens & Clark Common Stock Fund, Inc., and Scudder Special Fund, Inc. See, Scudder, Stevens & Clark Common Stock Fund, Inc., Prospectus 4 (Apr. 18, 1969).

negotiations with the nonaffiliated directors.⁵⁶ The SEC would extend the adviser's fiduciary status, even absent the new amendments⁵⁷ to the Investment Company Act, to the management fee.⁵⁸

Though no court decision is directly on point, the conclusion that advisers are fiduciaries, at least in most of their dealings with the funds, seems compelling. Like investment counselors, who have been held to be fiduciaries with respect to their counseling accounts,⁵⁹ advisers of mutual funds occupy a position of "trust and confidence" with respect to the investments they manage.⁶⁰ Indeed, in some complexes the adviser serves both funds and counseling accounts, according them the same treatment.⁶¹ Thus, it is untenable to say that advisers owe fiduciary duties to one and not to the other. Surely the legal organization of funds as corporations and trusts is not a meaningful difference: counseling accounts can also take these legal forms. Nor does the conclusion that advisers are fiduciaries depend on the generally discredited "shell theory," which would disregard the funds' status as separate legal entities.⁶² The fiduciary obligation need run only to the funds and not to the shareholders themselves.

To say that directors and advisers have duties subject to judicial review is not to say that the courts will carefully scrutinize the dis-

⁵⁶ Conference 745 (remarks of Alfred Jaretzki, Jr.); *id.* 758 (remarks of Robert M. Loeffler).

⁵⁷ S. 2224, 91st Cong., 2d Sess. (1969), the Senate's version of the "mutual fund bill," amending the Investment Company Act of 1940, was passed in May 1969 and referred to the House Committee on Interstate and Foreign Commerce. The House Committee reported its own bill (H.R. 17333) to the House on August 7, 1970. H.R. No. 1382, 91st Cong., 2d Sess. (1970). H.R. 17333 was vacated and S. 2224 as amended passed in lieu thereof on August 23, 1970. The bill is presently in conference.

⁵⁸ *Hearings on H.R. 11995, S. 2224, H.R. 13754, & H.R. 14737 Before the Subcomm. on Commerce & Finance of the House Comm. on Interstate & Foreign Commerce, 91st Cong., 1st Sess., pt. 1, at 189-90 (1969).* See also Consumer-Investor Planning Corp., SEC Securities Exchange Act Release No. 8542 (Feb. 20, 1969), in [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,677, at 83,528 n.7; note 268 *infra* & accompanying text.

⁵⁹ *E.g.*, Kidder, Peabody & Co., SEC Securities Exchange Act Release No. 8426 (Oct. 16, 1968), in [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,618; Haley & Co., 37 S.E.C. 100, 106 (1956); Arleen W. Hughes, 27 S.E.C. 629, 638 (1948).

⁶⁰ See Nielson, *Fiduciary Standards of Conduct Under the Investment Company Act*, in CONFERENCE ON MUTUAL FUNDS 153-54 (S. Hodes, P. Geerlings, M. Simpson eds. CCH 1966). The "trust and confidence" theory is different from but closely related to the "shingle" or "implied representation" theory. See generally Cohen & Rabin, *supra* note 51, at 702-04.

⁶¹ In Scudder, Stevens & Clark, for example, each fund (except for Scudder Special Fund) has a portfolio manager who is also responsible for a number of investment counseling accounts. The manager bases his portfolio decisions for both the fund and the accounts primarily on the investment recommendations of Scudder's collective research staff. His latitude to depart from these recommendations is the same in both instances.

⁶² The shell theory is propounded in Lobell, *The Mutual Fund: A Structural Analysis*, 47 VA. L. REV. 181 (1961). For the current attitude toward the shell theory, see Conference 748 (remarks of Alfred Jaretzki, Jr. & Professor Morgan A. Shipman).

charge of these duties. When an adviser has an equal self-interest in each of the funds it serves, the courts, in their traditional reluctance to become involved in questions requiring the substitution of their judgment for that of a disinterested decisionmaker, will defer to the adviser's and the fund directors' good faith business judgment on how to resolve conflicts between the funds. Even if the higher standard of care applicable to bank directors is also applicable to mutual fund directors, the courts will find illegality in only the most egregious cases.⁶³

The nature of a fund complex is such, however, that the adviser sometimes has a greater self-interest in some funds than in others.⁶⁴ For example, one fund may be paying an incentive fee which gives the adviser a special reward for good performance.⁶⁵ The adviser's self-interest may be served in such a case by giving the fund preference when executing transactions in companies which the fund and other funds in the group concurrently wish to buy or sell.⁶⁶ When the adviser has an especially strong self-interest in a particular fund, the courts have cause to scrutinize more carefully the adviser's treatment of the other funds in the complex,⁶⁷ unless the nonaffiliated directors have already discharged this responsibility.⁶⁸ The nonaffiliated directors are in a good position to protect the funds from self-dealing by the adviser. To the extent that they perform this function effectively,⁶⁹ their efforts need not be duplicated by the courts. In fact, in a number of states, statutes embody the principle that transactions between corporations with overlapping directors are not void or voidable for that reason alone if, after appropriate disclosures have been made, the transactions have been approved by a majority of disinterested di-

⁶³ See note 45 *supra*.

⁶⁴ For a discussion of factors which might lead an adviser to perceive a stronger self-interest in particular funds, see text accompanying notes 117-26 *infra*.

⁶⁵ In recent years incentive fees have become increasingly popular. 35 SEC ANN. REP. 129 (1969). See generally text accompanying note 122 *infra*.

⁶⁶ See text accompanying notes 150-65 *infra*.

⁶⁷ During the course of a discussion concerning proposed revisions to rule 17d-1, the SEC, almost as an aside, mentioned the danger that the adviser of a fund complex may be tempted to favor one fund at the expense of another: "Of course, if the investment adviser which controls such companies were to engage in certain activities that advantaged one company to the detriment of another, he might be engaged in a breach of his fiduciary obligations . . ." SEC Investment Company Act Release No. 5128 (Oct. 13, 1967), in [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,477.

⁶⁸ See SEC REPORT, *supra* note 2, at 148; Mundheim, *supra* note 14, at 1058-59.

In many complexes the same nonaffiliated directors serve on the boards of several funds. For a discussion of one of the advantages to the funds of overlapping directorships, see part VI *infra*.

⁶⁹ The problem has been that nonaffiliated directors have been generally ineffective in safeguarding the interests of mutual fund shareholders. SEC REPORT, *supra* note 2, at 12, 130-31, 148. But see Conference 741, 755 (remarks of Joseph E. Welch). See also note 54 *supra*.

rectors or shareholders.⁷⁰ In a fund complex such statutes might seem to insulate from judicial review transactions between the adviser and a fund even if the adviser has a strong self-interest in favoring another fund in the group. In practice, however, such statutes leave the courts an important role to play in protecting fund interests.

First, because the statutes are directed toward situations where directors or officers of a fund are closely associated with or sit on the board of the adviser, they would not seem to apply to complexes in which the funds are not organized as corporations and thus have no boards of directors. Second, even in complexes where the funds are organized as corporations, the nonaffiliated directors may not qualify as disinterested under state law and thus their approval may not satisfy the statutory requirement.⁷¹ The need for a provision broadly defining interested directors in the recently enacted amendments to the Investment Company Act suggests that some directors have been nonaffiliated under the Act while still maintaining a strong interest in the adviser.⁷² Third, the board of directors may not review many transactions between the adviser and the funds. For example, in some complexes the board does not review or reviews in a perfunctory manner the assignments of portfolio business to brokers who have provided the adviser with research or who have sold fund shares. Finally, statutes on interested directors are not commonly thought to validate basically unfair transactions, regardless of the literal meaning of the statutory language.⁷³ The approval of the disinterested directors is thought merely to shift to the plaintiff the burden of proving unfairness.⁷⁴

If the courts do, in some circumstances, scrutinize the fairness of the adviser's treatment of the various funds, they are most likely to

⁷⁰ *E.g.*, CAL. CORP. CODE § 820 (West 1955); DEL. CODE ANN. tit. 8, § 144 (Supp. 1968); NEW YORK BUS. CORP. LAW § 713(a) (McKinney 1963). Several of these statutes are reprinted in W. CARY, *supra* note 45, at 557-59. For a brief discussion of the law as it exists in states which have not enacted such statutes, see *Note on Transactions Between Corporations Having Common Directors; And Burden of Proof*, *id.* 571.

⁷¹ See WHARTON REPORT, *supra* note 12, at 465-66; note 54 *supra*.

⁷² S. 2224, 91st Cong., 1st Sess. § 2(3) (1969) (passed by Senate May 26, 1969, 115 CONG. REC. 13700-01 (1969)). The provisions apply not only to affiliated persons but also to members of their immediate family and persons who have certain business, professional, or personal relationships with the adviser. For the complete text of the House version of the Mutual Fund Bill, amending the Investment Company Act, and the House Committee Report, H.R. 17333, see CCH SPECIAL 2 (CCH Mutual Funds Guide, Special Report, Aug. 11, 1970).

⁷³ See *Remillard Brick Co. v. Remillard-Dondini Co.*, 109 Cal. App. 2d 405, 418, 241 P.2d 66, 73-74 (1952); C. ISRAELS, *CORPORATE PRACTICE* 195-97 (2d ed. 1968); Marsh, *Are Directors Trustees?*, 22 BUS. LAW. 35, 46-47 (1966); Wymeersch, *supra* note 45, at 778-80.

⁷⁴ C. ISRAELS, *supra* note 73, at 197. Such shifting of the burden of proof may well be unimportant. *Duties and Liabilities of Corporate Directors*, 22 BUS. LAW. 29, 129 (1966) (remarks of Harold Marsh, Jr.).

In Delaware and a few other jurisdictions shareholder ratification does change the standard from fairness to waste. See, e.g., *Saxe v. Brady*, 40 Del. Ch. 474, 486, 184 A.2d 602, 610 (Del. Ch. 1962). See generally Eisenberg & Lehr, *supra* note 45, at 224.

impose as a remedy an injunction against further unfairness. In some cases, however, they may also find dollar liability. Liability in the case of the adviser would be contractual or grounded in its fiduciary obligations.⁷⁵ Liability in the case of the affiliated directors would be grounded in their duty of loyalty.⁷⁶ By sitting on both sides of a transaction and favoring some funds over others, the affiliated directors have acted in their own self-interest rather than in the interest of the funds they serve.

It is harder to establish liability on the part of the nonaffiliated directors. If, despite their nonaffiliated status under federal law, they are found to be "interested" under state law, then their status is comparable to that of the affiliated directors.⁷⁷ But if they are not interested in the adviser, it is difficult to find that they have acted out of self-interest and thus breached their duty of loyalty. Nevertheless, such a finding might be made if a nonaffiliated director sits on the boards of several funds, as such directors frequently do, and owns materially different amounts of stock in each of the funds.⁷⁸

With this legal framework in mind, we can now turn to some of the specific problems which arise within the fund complex.

II. INVESTMENT MANAGEMENT

Before analyzing some of the problems posed by the adviser's role as investment manager to a fund complex, we will first examine the process by which mutual fund advisers manage fund portfolios. We will then focus on the problems by presenting them as they might arise in a typical complex.

A. *The Investment Management Process*

Investment management is usually a four-step process: basic research, dissemination of information, portfolio decisionmaking, and executions.

⁷⁵ See text accompanying notes 45-63 *supra*.

⁷⁶ See note 46 *supra*.

⁷⁷ See, e.g., *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921); *Shlensky v. South Parkway Bldg. Corp.*, 19 Ill. 2d 268, 166 N.E.2d 793 (1960).

⁷⁸ A footnote in the *Wharton Report* raises the question whether a nonaffiliated director might not be considered affiliated if he serves on the board of more than one fund in a complex. *WHARTON REPORT*, *supra* note 12, at 465 n.22. Service on more than one board similarly might lead a court to find that a nonaffiliated director was "interested" in the adviser for state law purposes. Such a finding, however, would be ill founded and have undesirable effects. Business practicality often dictates that the same directors serve on more than one board, and this practice may in fact be advantageous from the fund's viewpoint. The Senate committee report on the mutual fund bill currently in conference, *see* note 57 *supra*, includes an express statement that "a director of one investment company would not ordinarily be deemed an interested person of that company by reason of being a director of another investment company with the same adviser." S. REP. NO. 184, 91st Cong., 1st Sess. 34 (1969).

Advisers must do basic research on the general investment climate, on the investment outlook of particular industries, and on the investment prospects of individual companies.⁷⁹ Advisers can do such research internally⁸⁰ or can obtain it from outside researchers, usually brokerage houses.⁸¹ Ordinarily advisers utilize both types of research, differing primarily in the extent to which they rely upon each type.⁸²

Advisers may conduct and collect research once on behalf of all the funds in their group or separately for each fund. In some complexes the adviser employs a team of analysts to conduct research into whatever investment opportunities appear most promising. Although this research is done without reference to the needs of particular funds, the adviser assumes that enough opportunities will turn up to satisfy each fund's needs.⁸³ In other complexes, the adviser assigns analysts

⁷⁹ SEC REPORT, *supra* note 2, at 84-86.

⁸⁰ Though not an "adviser" within the terms of the Investment Company Act, Union Service Corporation, the organization which performs investment research and administrative services for the Union Service group of funds, relies almost entirely upon the research of its twenty-one analysts. See Hedges, . . . *And Three Big Ones Which Ran Well*, INST. INV., Mar. 1970, at 32, 36-37. This research includes "armchair" analysis of a company, its competitors, and the industry outlook, and personal interviews with company management, its customers, and its competitors, among others. Although Union Service receives outside research (most of it unsolicited), it places little reliance on much of it. It believes that outside research alone is insufficient to support an investment recommendation and that analysts should have latitude in pursuing their own original investment ideas. Other difficulties with outside research cited by advisers are the uncertainty as to their position on the information line and the danger that research organizations serving companies in other capacities (usually investment bankers) may find it difficult to prepare forthright reports. Many investment advisers today seem to be taking an increasingly critical view of outside research. See Mattlin, *Can Wall Street Research Shape Up?*, INST. INV., Apr. 1970, at 29.

⁸¹ Carlisle-Asher Management Co., adviser to Afuture Fund, Inc., a small no-load fund, and a number of discretionary investment accounts, has only a few investment management employees and consequently must rely almost entirely upon outside research. It maintains that good analysts are rare and high priced, and only infrequently come up with usable ideas. Rather than attempt to hire such analysts, Carlisle-Asher believes its time is better spent identifying the best analysts in the investment community and then "picking their brains" for investment ideas. The Carlisle-Asher employees devote their efforts to evaluating the opinions of others rather than researching companies themselves.

Shareholders Management Co., adviser to a number of different funds, has taken essentially the same position with respect to outside research. See Mattlin, *supra* note 12, at 25, 76; Welles, *Fred Carr: Tracker of Emerging Growth*, INST. INV., Dec. 1968, at 57, 60.

⁸² Advisers often use outside research as a source of new investment ideas, as a means of keeping in touch with what the investment community has been thinking, and as a check on their own ideas. Such research supplements the research done by the adviser's own analysts. Advisers usually require that in-house research be done on a company before purchasing its securities.

⁸³ Each analyst working for Union Service Corp., *see* note 80 *supra*, is assigned to a particular industry or group of industries. The analysts examine the general outlook of the industry but concentrate on those companies within it offering the best investment potential. When an analyst decides that a company is especially attractive, he studies it in depth. Thus, the Union Service analysts select companies for study on the basis of their investment potential and not on the basis of portfolio needs.

to do research tailored to the needs of specific funds.⁸⁴ But even these advisers usually do some collective research, at least on the general investment climate.⁸⁵ A number of advisers employ some analysts to conduct research for the funds generally and others to conduct research for specific funds.⁸⁶

The adviser must arrange for the basic research product to be distributed to those who are responsible for portfolio decisions.⁸⁷ Distribution poses no problem if the research is done for a specific fund or a small group of funds. If the adviser does not have a policy that such research must be shared among all the funds in the group, it can depend on informal memoranda or word-of-mouth to convey the information to those responsible for managing the funds' portfolios. But if research is done collectively or the adviser has a policy that research done for specific funds must be shared with the other funds in the group, a problem of equitable distribution arises. Here, the adviser must disseminate the information to a relatively large number of people, and informal methods may be unreliable and may pose a question of fairness, especially if a few analysts and decisionmakers have become particularly close. Thus, many advisers have adopted formal methods of distributing such information. Some advisers go to considerable lengths to insure that timely information about specific opportunities is delivered simultaneously to all decisionmakers. Others distribute regularly published lists containing ratings, earnings forecasts, and other

⁸⁴ The investment management division of Keystone Custodian Funds, Inc. at times has consisted of four essentially autonomous groups: an income group, a conservative growth group, an aggressive growth group, and a speculative growth group. Each group is responsible for specific funds, conducting its own research and collecting outside research on companies in which those funds might invest. Although two groups may do research on the same company, Keystone utilizes a number of formal and informal techniques to keep such inefficiencies to a minimum.

⁸⁵ In Keystone, for example, a committee meets regularly to discuss the general economic outlook and to formulate the general investment policy of the complex. A different committee discusses particular industries and develops a comparative rating of industries to guide the various groups in deciding which industries to emphasize in their funds' portfolios. Keystone also employs technical analysts who serve all the groups.

⁸⁶ Wellington Management Co. and its wholly owned subsidiary, Ivest, Inc., employ ten analysts whose full-time job is to research for the entire organization and about eleven analysts assigned to research for particular funds. Unlike many other complexes, all analysts and portfolio managers do a certain amount of research for the complex in addition to the work which they do for specific funds. Each individual in the investment management division is responsible for "primary coverage" of from one to ten companies and for monitoring another one to ten. Primary coverage involves intensive and continuing study of a company and requires personal contact with management and with customers of the company. Monitoring involves meeting with management and making earnings estimates but is less intensive than primary coverage. In all, about 200 companies are given primary coverage and another 200 are monitored. See generally *The Whiz Kids Take Over at Wellington*, *INST. INV.*, Jan. 1968, at 23, 62.

⁸⁷ In a number of mutual funds, outside research is channelled directly to the portfolio managers rather than passing first through the collective research staff. Ellis, *To Get Performance You Have to Be Organized For It*, *INST. INV.*, Jan. 1968, at 44, 70-71. If the adviser has a policy which requires portfolio managers to share information, the problem of fairly disseminating outside research still arises.

information on a large number of different companies.⁸⁸ Still others hold regular meetings during which members of the investment management division get together to exchange information and to discuss new developments.⁸⁹ Advisers often adopt more than one method of distributing the information.

The third step in the investment management process is portfolio decisionmaking. Although the board of directors of each fund has a statutory duty to manage the fund's affairs, specialists usually handle the day-to-day task of managing the fund's portfolio.⁹⁰ Traditionally, an investment committee—sometimes but not always including directors—has handled portfolio decisions for most if not all the funds in a complex.⁹¹ Recently, however, a single individual, commonly referred to as a "portfolio manager," has assumed this responsibility in many complexes.⁹² A portfolio manager usually manages the portfolio

⁸⁸ The work product of Scudder, Stevens & Clark's collective research staff is distilled into a list of about 800 stocks which is printed every two weeks and distributed simultaneously to all the portfolio managers (Scudder refers to them as "investment counselors") in the organization. The list contains the standard information available in a stock digest, an earnings estimate for the next twelve and twenty-four months, and a positive, neutral, or negative rating on the company. If this rating is changed or a rating is made on a company not previously included on the list, the new rating is immediately teletyped to all Scudder offices and simultaneously distributed throughout the office in which the rating change originated. The initial notice is followed by a short paragraph explaining why the rating was changed and a longer memo if the change was serious.

⁸⁹ Every Tuesday morning the New York office of Scudder, Stevens & Clark holds a meeting during which analysts discuss particular industries and specific companies. This meeting is video taped and a tape is distributed to each of the other offices. Every Friday morning a conference call is held during which subjects of importance are discussed and questions answered.

Wellington Management Co. has taken the meeting concept one step further. Every morning at 9:10 a.m. a meeting of all analysts and portfolio managers convenes. The analysts and portfolio managers in various cities are tied into the meeting by telephone. The meeting is conducted in three parts. (1) All transactions of the previous day are read and portfolio managers who made investment decisions stand ready to be quizzed. This takes roughly ten minutes. (2) Anyone who wishes to comment on a company or industry does so. (3) A portfolio manager, an analyst, or the management of a company makes a more formal presentation. If any time remains before the meeting's prompt adjournment at 9:50 a.m., the floor is thrown open for further comment. The minutes of each meeting are published and usually distributed on the same day. See *The Whiz Kids Take Over at Wellington*, *INV.*, Jan. 1968, at 23, 27, 62.

⁹⁰ See *WEARTON REPORT*, *supra* note 12, at 49-50.

⁹¹ The portfolio of each of the four Union Service funds is managed by an executive committee of each fund's board of directors. The same four men serve on the committee which manages Broad Street Investing, National Investors, and Whitehall; except for one member, an entirely different committee manages Union Capital. The executive committees meet daily. Each Union Service fund also is served by a portfolio supervisor. See note 95 *infra*; Hedges, *supra* note 80, at 37.

⁹² The current attitude of many advisers is summed up well in Windsor Fund, 1968 Annual Report 4 (1968):

During its first 5½ years, the investments of Windsor Fund, like those of most mutual funds at the time, were supervised by an Investment Committee. A group of money managers together decided which securities should be purchased, which sold. For the Fund, the period can best be described as humbling

In May of 1964, Wellington Management Company, the Fund's Investment Adviser, altered its method of supervising the Fund's investment program. The new—and present—style focused responsibility and authority on

of only one fund. But in some cases he may manage the portfolios of several funds⁹³ or, in a new development known as "satellite management," he may manage only a portion of a single fund's portfolio.⁹⁴

a Portfolio Manager heading a small team of skilled, experienced securities analysts and supported by the Investment Adviser's total research organization. The aim is to enhance flexibility and exploit fully the large and growing flow of financial information so that the Fund would be more responsive to the rapid changes which characterize the investment world today.

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A mutual fund's investment results are a reflection of its management's strategy. On page 7, Windsor Fund's Portfolio Manager outlines his strategy, relates it to 1968's progress, and looks into 1969.

Wellington's former method of portfolio decisionmaking is described in WHARTON REPORT, *supra* note 12, at 50-51. A new column in *Forbes* on "The Money Men" is one illustration of the public interest which has been directed towards portfolio managers in recent years. For an article on John Neff, Windsor Fund's portfolio manager, see FORBES, Apr. 1, 1970, at 72. For a discussion of the relative merits of the investment committee and the portfolio manager systems of portfolio management, see Ellis, *supra* note 87, at 46-47, 68.

Portfolio managers may vary in the freedom they have to manage fund portfolios. In Scudder, Stevens & Clark, for example, the portfolio managers of the Balanced and Common Stock Funds are expected to manage the funds in keeping with the general investment policy of Scudder, Stevens & Clark. They rely primarily upon the master list prepared by the collective research department, *see* note 88 *supra*, and have no staff of their own to do research specifically for the funds, although they do some research themselves. The portfolio manager of Scudder Special Fund, on the other hand, has more latitude in making investment decisions. He receives the master list but also has three or four analysts who work specifically for the fund. A partner of Scudder, Stevens & Clark explains that the nature of a more aggressive fund such as Special Fund requires that it be managed by a man with full responsibility to work with the collective research department in pursuance of the unique requirements of the fund. He also suggests that special research is needed for Special Fund because Scudder's research does not concentrate on some of the smaller and more volatile companies in which Special Fund is interested.

⁹³ For example, John Neff, portfolio manager of Windsor Fund, is also portfolio manager of Gemini Fund, a dual-purpose investment company. *See* FORBES, Feb. 1, 1970, at 68.

⁹⁴ In a *Forbes* article, Thomas R. Reeves, senior vice president of Investors Diversified Services, has explained why and how a satellite system was instituted at IDS:

"When you hire a good money manager what you are getting is a proven stock picker. But with \$6 billion to invest you don't need one proven stock picker; you need about 30, with another 30 in training. . . ."

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. . . "We had *two* men making all the equity decisions Two men could only follow so much, which led to investing solely in the largest companies. . . ."

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. . . "We set out to divide up the portfolios into as many 'satellites' as we could find competent people to manage the money. . . . Today, we have 27 people managing some amount of money. . . ."

Investors Mutual now is managed by six people, Stock Fund by nine, Variable Payment Fund by seven. . . . One type of portfolio manager gets some \$250 million to invest and considerable freedom to roam the investment world with it.

Others get \$25 million to \$100 million to invest in areas where they have research responsibilities.

FORBES, Mar. 1, 1970, at 85-86 (emphasis in original); *see* Fiske, *supra* note 12, at 111 (Fidelity Funds); Mattlin, *supra* note 12 (Enterprise Fund). The drawback of the satellite system, as expressed by one portfolio manager, "is that you lose a certain amount of continuity, objectivity or scheme in your portfolio." Hedges, *supra* note 80, at 50 (remarks of E. Kirkbride Miller, portfolio manager of T. Rowe Price Growth Fund). For a suggested restructuring of the satellite management system, *see* Mongello, *A New Way to Split Your Portfolio*, INST. INV., Aug. 1970, at 28.

A portfolio manager system may also operate below the level of final decisionmaking.⁹⁵

The final step in the investment management process is the execution of trades. A central trading department ordinarily handles transactions for all the funds.⁹⁶ The trader selects the market on which to execute each trade and the broker to handle the order.⁹⁷ He often furnishes information to portfolio managers on market conditions, on inquiries from other traders, and on the availability of and market for large blocks of stock.⁹⁸ He grants reciprocal business, when possible, to brokers who have furnished research, sold fund shares, or performed some other service for the funds or the adviser.⁹⁹ In addition, the trader often allocates executions between funds which have entered an order to buy or sell the same stock.¹⁰⁰

B. A "Typical" Complex

We shall deal with the investment management problems arising

⁹⁵ In the Union Service group, for example, a different portfolio supervisor follows the portfolio of each fund and makes investment recommendations to the director of research who considers them when making investment recommendations to the executive committee of the fund's board of directors.

⁹⁶ For a general description of the trader's role in the investment management process, see Geyer, *An Institution's Best Friend Can Be Its Trader*, INST. INV., Jan. 1969, at 35.

⁹⁷ The process by which the central trading department for the Keystone group handles fund portfolio transactions is fairly typical. A portfolio manager (the head of one of Keystone's four investment management groups) sends the trading department an order slip which stipulates the fund involved, the security, the number of units of such security to be bought or sold, and the appropriate price range. The slip may stipulate the sale or purchase price and/or the speed of execution, but generally the trader prefers to have full discretion as to price and speed because of the rapidly changing situations which often arise in the market. Once entered, an order is good from day to day until satisfied, and the trader regularly appraises the portfolio manager of the order's progress.

Upon receipt of the order, the trader determines whether the price (if stipulated) is realistic in terms of present market conditions. If it is not, the trader will not fill the order until the market price returns to the price range indicated. If the price is realistic, the trader refers to a long list of brokers (Keystone deals with 100 to 150 different brokers) and to the various compilations of blocks available in the third market. Autex and Instanet, electronic block trading devices, are helpful in this regard as are the sheets distributed by various block trading houses. In addition, the trader keeps a list of all the block buy and sell solicitations phoned in to his office.

On the basis of such information, the trader decides how and where to execute the trade. See text accompanying notes 166-78 *infra*. Price, the secrecy with which the trade will be made, and the market information which a broker will provide are all factors which enter into his judgment. The trader next considers whether the trade might be placed with a broker who has provided Keystone with research or sold fund shares. The central trading department at Keystone handles about 100 to 150 orders a day.

The trader for the Wellington Management group prefers to have the portfolio managers decide whether a stock should be purchased (or sold) immediately as a large block or whether it should be accumulated (or disposed of) slowly over a period of days or weeks. See SPECIAL STUDY, *supra* note 12, at pt. 2, at 856-57; Greene, *Execution of Portfolio Transactions*, in CONFERENCE ON MUTUAL FUNDS 49, 55-58 (P. Geerlings ed. CCH 1967).

⁹⁸ See Geyer, *supra* note 96.

⁹⁹ See text accompanying notes 209-18, 239-42 *infra*.

¹⁰⁰ See text accompanying notes 151-57 *infra*.

within a fund complex in the context of a hypothetical group of funds. The XYZ group consists of Funds A, B, and C, their adviser XYZ, and their distributor XYZ Distributors, a wholly owned subsidiary of XYZ. Fund A is what is commonly known as an income fund: its investment objective is "to produce favorable current income and long-term growth of income with due regard to preservation of capital value." Fund A is the smallest of the group, paying XYZ a fee of .5 of 1 percent of its net assets,¹⁰¹ and (to simplify this analysis) XYZ pays all the fund's expenses.¹⁰² Last year the fund paid an advisory fee of \$125,000 based upon average net assets of \$25 million. The fund has a board of five directors, two of whom are also officers and directors of XYZ. The other three directors are not affiliated with XYZ.¹⁰³

Fund B is a "growth" fund: its objective is "longer-term appreciation in capital value and an increase in future dividends from income." Fund B is the largest fund in the group and pays what is commonly known as a scaled-down fee: on its first \$100 million of net assets it pays a fee of .5 of 1 percent; on its second \$100 million, .4 of 1 percent; and on its third \$100 million, .3 of 1 percent.¹⁰⁴ Again XYZ pays all of the fund's expenses. Last year Fund B paid a total fee of \$1.2 million, .4 of 1 percent on average net assets of \$300 million. Fund B's board of directors is identical to that of Fund A.

Fund C is a capital appreciation fund: its objective is "to produce capital appreciation for investors in its shares." XYZ created the fund two years ago to reach the then-lucrative market for volatile funds which might achieve impressive short-term gains. During the last two years sales of Fund A and Fund B shares have just managed to offset redemptions, while sales of Fund C shares have been strong and have led to a rapid increase in the fund's total net assets. Fund C pays a basic fee of .75 of 1 percent of net assets, but the percentage increases to a maximum of 1.5 percent or decreases to zero depending on Fund C's performance relative to Standard and Poor's Index of 500 Common

¹⁰¹ A fixed .5 of 1% is the traditional formula for figuring the management fee. Since the publication of the WHARTON REPORT, *supra* note 12, however, a scaled down fee schedule has become popular, especially for larger funds. SEC REPORT, *supra* note 2, at 89.

¹⁰² Ordinarily, advisers do not absorb all of a fund's expenses, SEC REPORT, *supra* note 2, at 90-91, though a few advisers, such as IDS, do so for their larger funds. *Id.* 92.

¹⁰³ Section 10(a) of the Investment Company Act, 15 U.S.C. § 80a-10(a) (1964), requires that, ordinarily, at least 40% of the directors be nonaffiliated with the adviser, but when the principal underwriter is a subsidiary of the adviser, a majority of the fund's board must be nonaffiliated if the fund and the underwriter have even one overlapping director, officer, or employee. Typically, the adviser does control the principal underwriter. SEC REPORT, *supra* note 2, at 54.

¹⁰⁴ See note 101 *supra*.

Stocks.¹⁰⁵ In its first year, Fund C paid a fee of 1.25 percent of its average net assets, but last year its performance slumped and it paid only .4 of 1 percent on average net assets of \$75 million, or a total fee of \$300,000. The same five directors who sit on the boards of Funds A and B sit on the board of Fund C.

The XYZ investment management division consists of three analysts who do general research on industries and companies they think attractive; three portfolio managers, one assigned to each fund; and two analysts who work directly for Fund C, ferreting out new issues and small companies usually traded in the over-the-counter market. The manager of Fund A is Mr. Ames; the manager of Fund B is Mr. Bright; the manager of Fund C is Mr. Cap.

The cost to XYZ of the collective research staff and its supportive facilities, such as office space and library, is \$200,000 per year. Mr. Ames receives a salary of \$30,000 a year, Mr. Bright \$100,000, and Mr. Cap and the two Fund C analysts, a combined \$100,000. If the cost of investment services is apportioned among the funds in accordance with the formulas discussed below,¹⁰⁶ XYZ is spending \$42,500 on Fund A,¹⁰⁷ \$250,000 on Fund B,¹⁰⁸ and \$137,500 on Fund C.¹⁰⁹

C. The Duty of Care

The initial problem arising in the investment management area is whether the relative amount an adviser spends on each fund in its complex has any bearing on whether it is discharging its fiduciary obligations. Put more concretely, does the fact that XYZ is spending more on Fund B than on Funds A and C suggest in any way that it is breaching its fiduciary duty to A and C?

¹⁰⁵ Each percentage point that the fund's performance exceeds the performance of the Standard & Poor's Composite Stock Price Index of 500 Common Stocks (S & P Index) will increase the basic .75 of 1% fee by .05 of 1%; each percentage point below the S & P Index will reduce the fee by .05 of 1%.

Five types of performance fee are generally in use. Four of these five types relate the fee to the performance of some specified securities index. The fifth bases the adviser's compensation on a certain percentage of the fund's net realized capital gains and unrealized capital appreciation. P. Vanica, *Size, Growth, Performance, and Advisory Fee Arrangements of Registered "Speculative" Investment Companies: 1960-1969*, at 14-15, 56-60, June 4, 1970 (unpublished thesis submitted to the Alfred P. Sloan School of Management, MIT); see 35 SEC ANNUAL REPORT 129-30 (1969).

¹⁰⁶ See text accompanying notes 286-88 *infra*.

¹⁰⁷ $30,000 \text{ (direct cost)} + \frac{25 \text{ (Fund A net assets)}}{25 + 300 + 75 \text{ (total complex net assets)}}$
 $\times 200,000 \text{ (collective expenses)} = 42,500.$

¹⁰⁸ $100,000 \text{ (direct cost)} + \frac{300 \text{ (Fund B net assets)}}{25 + 300 + 75 \text{ (total complex net assets)}}$
 $\times 200,000 \text{ (collective expenses)} = 250,000.$

¹⁰⁹ $100,000 \text{ (direct cost)} + \frac{75 \text{ (Fund C net assets)}}{25 + 300 + 75 \text{ (total complex net assets)}}$
 $\times 200,000 \text{ (collective expenses)} = 137,500.$

The amount the adviser spends on each fund has no necessary bearing upon whether it is discharging its duty of care. An adviser owes each fund a minimum standard of professional care.¹¹⁰ Whether it meets this standard with respect to a fund depends solely upon its treatment of that fund and not upon the expenses it has incurred on the fund's behalf.¹¹¹ Similarly, the treatment it accords the other funds is irrelevant, except possibly as evidence of what the minimum standard should be. The minimum standard is determined according to industry practice and the special needs of each fund. If, for example, a fund has a large number of portfolio holdings, or if achievement of its investment objective involves a high portfolio turnover or investment in highly volatile companies requiring continual review, the adviser may have to do more to meet the standard of care than it would for a fund with only a few securities, a low turnover rate, or investments in stocks of relatively low volatility.¹¹²

Thus, the difference in XYZ's expenditures itself has no significance. Fund B, by virtue of its many holdings, or Fund C, by virtue of its volatility or high turnover rate, may require additional expenditures. But even if they do not, the issue is whether the treatment XYZ accords each of the funds meets the standard of care which that fund commands. Once XYZ has met that standard, it is free to devote additional attention and dollars wherever it chooses, and the funds have no legal grounds for complaint.¹¹³

¹¹⁰ See note 45 *supra*.

¹¹¹ See generally FIRST ANNUAL INSTITUTE ON SECURITIES REGULATION 330-31 (R. Mundheim, A. Fleischer, Jr., & D. Glazer eds. PLI 1970) (remarks of Leonard M. Leiman) [hereinafter cited as INSTITUTE ON SECURITIES REGULATION].

¹¹² A comparison of Ivest Fund and Wellington Fund, both in the Wellington Management group, illustrates the difference in the demand funds may make upon the adviser. An aggressive fund, Ivest on Aug. 31, 1969 held 63 different common stocks (plus unspecified miscellaneous stocks) worth about \$273 million, see Ivest Fund, Annual Report (1969), and had an average yearly portfolio turnover of over 100%, see Ivest Fund, Prospectus 1 (Jan. 2, 1969, revised Mar. 27, 1969). During this period Ivest had the services of two portfolio managers and two analysts in addition to the collective research available to all the funds in the group, see note 86 *supra*. At the same time Wellington Fund, a conservative fund, held 92 different common stocks worth over \$1 billion, see Wellington Fund, Quarterly Report (Aug. 31, 1969), and had an average yearly turnover of under 40%, see Wellington Fund, Prospectus 6 (Apr. 1, 1969, revised May 19, 1969). Wellington had for the common stock portion of its portfolio the services of one portfolio manager and three analysts in addition to the collective research. Thus, Ivest, with its more aggressive objective and higher turnover rate, required the same size staff as Wellington Fund, with its greater size and number of holdings but more conservative orientation. Of course, the size of the staff may also depend upon the abilities of each analyst and portfolio manager.

¹¹³ In some circumstances one fund may be able to contract with the adviser for services additional to those required by the duty of care. If, for example, the adviser should agree to assign additional analysts to a fund, no problem is posed because the other funds are not affected. Situations arise, however, in which such a contract may impinge upon the adviser's fiduciary obligations to the other funds. If the adviser contracts to allow one fund to execute all its trades in securities held in common, before the other funds, those other funds are placed in a disadvantageous position when executing their trades. If the adviser's fiduciary duty to treat each

If this conclusion is correct, it means not only that the comparative amounts which the adviser *spends* on each fund have no bearing on whether it has discharged its fiduciary obligation, but also that the comparative amounts which the adviser *collects* from each fund have no bearing. The standard of care is determined by fund needs and industry practice, not by the amount which a fund pays the adviser. That a fund has paid too little is no excuse for the adviser's inattention. That a fund has paid too much is no grounds for preferred treatment. The remedy in each case is to renegotiate the fee to reflect better the actual costs of meeting the appropriate standard of care.¹¹⁴

D. *The Duty of Fairness*

Although the standard of care ordinarily affords adequate control over the adviser's activities, it does not provide adequate protection in several situations. Inherent in such situations is the danger that the adviser will engage in self-dealing, not in the obvious sense of appropriating for its own a benefit belonging to a fund, but in the more subtle sense of preferring funds in which it has a strong self-interest over funds in which it does not. The law traditionally has applied a standard of fairness to situations posing a threat of self-dealing.¹¹⁵ This standard allows closer scrutiny of the adviser's activities than the standard of care, an essentially permissive standard that leaves the adviser considerable discretion in exercising its business judgment.¹¹⁶ In the fund complex, situations calling for the standard of fairness

fund evenhandedly arises under state law, the other funds can contractually agree to such an arrangement, provided that it is approved by a majority of their disinterested directors. See text accompanying note 70 *supra*. But if the adviser's fiduciary duty arises under the Investment Company Act, see note 52 *supra*, the funds cannot contract away their statutory rights. Investment Company Act § 47, 15 U.S.C. § 80a-47 (1964).

¹¹⁴ In practice, a fund's nonaffiliated directors may conclude that the benefits of being part of a complex justify subsidizing, at least to some degree, certain other funds in the group. See text accompanying notes 286-88 *infra*. An alternative to renegotiating the fee would be for the nonaffiliated directors to contract for a higher level of services than that required by the common law—thus bringing the value of the services received into accord with the fee paid.

¹¹⁵ See notes 46, 113 *supra*. Section 17(d) of the Investment Company Act, 15 U.S.C. § 80a-17(d) (1964), might also be applicable to many of the problems discussed in this study. Section 17(a) prohibits an affiliated person of an investment company and the investment company to effect any transaction as joint participants in violation of SEC rules. Rule 17d-1, the applicable rule, prohibits such transactions unless they are first approved by the SEC. In a fund complex, the adviser is an affiliated person of each fund within § 2(a)(3)(E) of the Act, 15 U.S.C. § 80a-2(a)(3)(E) (1964), but the funds themselves are not presumed to be affiliates of each other unless the SEC in an action under § 2(a)(9), 15 U.S.C. § 80a-2(a)(9) (1964) establishes that the funds are under common control. Such control might be premised on the fact that the funds have common boards of directors or that different boards are under the controlling influence of the adviser. A finding that the funds are under common control and thus affiliates of each other would be retroactive, see *Fundamental Investors, Inc.*, 41 S.E.C. 285 (1962), and would consequently have far-reaching effects. See generally *MUTUAL FUNDS* 357-96 (PLI 1970) (remarks of John A. Dudley & Robert J. Routier).

¹¹⁶ See note 45 *supra*.

exhibit four characteristics which distinguish them from the more common situations calling only for the standard of care. All four of these characteristics must be present if the standard of fairness is to apply.

The first is that the adviser stands to gain more from some of the funds which it manages than from others. In the case of the XYZ group, XYZ may profit most from promoting the performance of Fund C, even if this involves prejudicing Funds A and B. In contrast to the fees paid by Funds A and B, which are based solely on their respective net asset values,¹¹⁷ the fee paid by Fund C rewards or penalizes XYZ in accordance with the fund's performance.¹¹⁸ Some actual figures will highlight the difference.

An investment generating appreciation of \$1 million¹¹⁹ will increase by \$1 million the net asset base on which the fees payable by Funds A and B are figured. Thus, because the percentage used to compute each fund's fee—.5 of 1 percent for Fund A and .3 of 1 percent for Fund B—will not be changed by the increase in net assets, the appreciation will produce \$5000 in additional fees from Fund A¹²⁰ and \$3000 in additional fees from Fund B.¹²¹ In the case of Fund C, however, the additional appreciation will mean an increase not only in the asset base upon which the fund's fee is figured but also, and more importantly, in the percentage used to compute the fee. Consequently, if the \$1 million in appreciation improves Fund C's performance relative to Standard and Poor's Index by even 1 percent, it will increase the percentage payable on the fund's total assets by .05 of 1 percent which on total assets of \$76 million (\$75 million plus \$1 million in appreciation) will mean an increase in XYZ's fee of \$38,000.¹²²

¹¹⁷ See text accompanying notes 101-04 *supra*.

¹¹⁸ See note 105 *supra* & accompanying text.

¹¹⁹ The discussion is in dollars rather than percentages because situations calling for the fairness standard involve the distribution of benefits which are of insufficient quantity to satisfy all fund needs. See text accompanying note 132 *infra*. Consequently, they pose for the adviser the problem of allocating a benefit potentially worth a certain number of dollars among a number of interested funds. Such benefits may take the form of an especially good stock with only a small number of shares in the public float or an unusually inexpensive block of stock which is too small to fill all the funds' authorizations. Of course, there is no certainty in investment management. Advisers can never be sure that any particular investment will be profitable. Nevertheless, the funds are purchasing the adviser's best judgment as to which stocks represent the best investment opportunities. Even if the adviser's judgments prove wrong, a fund that has not been allowed to invest in what the adviser thought to be best has been treated unfairly because it did not get all that it bargained for. If investment management is really worth paying for, the funds investing in the opportunities the advisers consider best will, presumably, perform best in the long run on a risk-adjusted basis.

¹²⁰ The additional fee is figured by multiplying .5 of 1% times the \$1 million in additional assets which the appreciation has produced.

¹²¹ The additional fee is figured by multiplying .3 of 1%, the percentage Fund B pays on assets in excess of \$300 million, times the additional \$1 million in assets.

¹²² A concrete illustration may be helpful. Assuming that the S & P Index were unchanged for the year and that Fund C similarly had no capital gain or loss, the

Other, less quantifiable factors may also lead XYZ to conclude that it has a special interest in promoting Fund C's performance. It may believe that Fund C's sales depend more heavily on its short-term performance than do the sales of the other funds because Fund C has yet to establish a long track record and because investors are more concerned with the relative performance of aggressive funds.¹²³ In addition, XYZ may believe that by promoting the performance of the fund which is in the potentially "hottest" market¹²⁴ and which pays the highest basic percentage of net assets¹²⁵ it will maximize sales and hence its management fee. Finally, it may note that an investment generating a million dollars in capital appreciation will have a greater percentage effect on the portfolio performance of Fund C than on the portfolio performance of Fund B: \$1 million will increase Fund C's portfolio by 1.3 percent ($1,000,000 \div 75,000,000$), Fund B's by only .3 of 1 percent ($1,000,000 \div 300,000,000$). Of course, \$1 million will have an even greater percentage effect on the performance of Fund A ($1,000,000 \div 25,000,000 = 4$ percent), but the assumption has been that investor interest in income funds, as reflected in new sales, is comparatively low.

The factors contributing to XYZ's special interest in Fund C are typical of those which may operate in a complex.¹²⁶ Sometimes the

\$1 million in appreciation would mean an increase in the fund's net assets from \$75 million to \$76 million or 1.3%. The Fund thus would outperform the Index by 1.3% and the basic .75 of 1% fee would be increased by .065 of 1% ($1.3 \times .05\%$). See note 105 *supra*. By preferring Fund C over Funds A and B when it decides which fund is to be given the opportunity to reap such appreciation, XYZ stands to benefit by over \$30,000 in increased fees.

¹²³ The *Wharton Report* noted a weak positive relationship between the inflow of new money and past portfolio performance among the common stock funds studied, but not among the balanced funds. WHARTON REPORT, *supra* note 12, at 20. Investor awareness of fund performance, as reflected in a boost in sales, has increased since the time of the *Wharton Report*. I. FRIEND, M. BLUME, & J. CROCKETT, *MUTUAL FUNDS AND OTHER INSTITUTIONAL INVESTORS: A NEW PERSPECTIVE* 13 (1970).

¹²⁴ In light of the poor performance of many aggressive funds during the recent market decline, the assumption that demand is strongest for aggressive funds may no longer be realistic. Mr. Bogle has noted "the sharply increased market share of the 'middle-of-the-road', average volatility funds, at the expense of the aggressive, high-volatility funds that were the favorites of the latter part of the past decade." Bogle Address, *supra* note 7, at 5. The experience of the Keystone group illustrates the strength of the demand for aggressive funds in former years. In 1968, K-2 and S-4, two aggressive funds in the Keystone group of what was then twelve funds (two were not offered publicly), accounted for over 70% of fund sales. And Keystone's newly created and aggressive Polaris Fund (previously known as Keystone International Fund, Inc.) was responsible for \$75 million in sales, over 16% of the group's sales, although it was offered during only the last five months of the year. Keystone Custodian Funds Inc., Annual Report 6 (1968).

¹²⁵ The size of the percentage used to figure the fee is more important in terms of the adviser's self-interest than the total fee payable by a fund. An adviser stands to gain most by promoting the performance and hence the sales of a fund which pays a high percentage fee even if that fund presently is small. This assumes, of course, that a very large fund paying a low percentage fee will not be so neglected as to invite many redemptions. But even a significant number of redemptions may represent only load-free transfers to better performing funds in the group.

¹²⁶ *Forbes* has described a situation in which the prospect of increased sales, among other reasons, has seemed to give the adviser a stronger self-interest in some

adviser will perceive its self-interest to be strong, as in a case where the sales of its best selling fund seem to be highly responsive to the fund's short-term performance and where the fund is also paying an incentive fee. At other times the adviser will perceive its self-interest to be weaker. But even funds with the same fee schedules may hold out different rewards for the adviser. The sales of one may appear, for example, to be more responsive to performance, or the percentage fee paid by a smaller fund may not be scaled down as much as that of a larger fund.

Although this analysis suggests that an adviser may have a stronger self-interest in some funds than in others, it does not mean that advisers necessarily will perceive their self-interest in terms of immediate compensation. A well-established adviser may believe its long-range interests are best served by devoting extra effort to its weakest funds in order to maintain the image of the complex as a whole—even if such funds include, for example, a small closed-end fund in which the adviser's financial interest will always be small. Such advisers need not concern themselves so closely with short-term profits or the exigencies of establishing the reputation of at least one fund in the group as do advisers who are less established or in a financially insecure position.

The second characteristic of situations calling for a fairness standard is that more than one fund has an interest in what the adviser is furnishing to the funds. Thus, it is of no concern to Fund A that XYZ proposes to add a third analyst to the two already working directly for Fund C, if Fund A is already receiving all the investment research it can use from the collective research staff. Similarly, Funds B and C, whose investment policies emphasize growth, need not be concerned if Fund A is the only fund to purchase the shares of a company recommended by collective research if the company pays a very high dividend but has little prospect for capital appreciation. The investment objective of each fund narrows the range of investments in which it is potentially interested.

funds than in others. In the summer of 1968, New England Mutual Life Insurance took over Loomis, Sayles, the investment adviser to a large number of private investment accounts and a few no-load mutual funds. Because New England Life's salesmen could not earn commissions by selling no-loads, Loomis, Sayles began developing load funds. The first two of these funds, NEL Growth and NEL Equity, came out in December 1968. Since that time Capital Development Fund, Loomis' best selling no-load, has been closed to new customers, ostensibly to keep it small and flexible but, as *Forbes* remarks, unlike T. Rowe Price, which closed its New Horizons Fund for the same reason, Loomis is not starting up a replacement. Moreover, during the last year, the new load funds performed much better than Capital Developments, "perhaps," *Forbes* speculates, "because of management's preoccupation with getting the new funds invested." *New Design*, *FORBES*, Dec. 1, 1969, at 92, 93. *Forbes* sums up by saying: "The shape of Loomis' future can be seen from the three funds still in registration: Two are variable annuities tailored for NEL's insurance salesmen, while the third is designed for wholly or largely tax-exempt organizations like profit-sharing plans, pension plans and life insurance companies." *Id.*

Regardless of how sound this conclusion is in theory, however, it may overstate what actually happens. Although investment objectives might at first glance appear to delimit fairly precisely the universe of investments in which each fund is interested, in practice objectives are not overly helpful in singling out the particular fund to which an investment should be assigned. In many complexes the objectives of the funds overlap,¹²⁷ and as the number of funds increase¹²⁸ the area of overlap has a tendency to expand.¹²⁹ Moreover, the same security may serve more than one objective, even if the objectives are widely disparate.¹³⁰ Indeed, instead of selecting issues which individually approximate the degree of volatility indicated by the fund's objective, an adviser may select issues of both higher and lower volatility, mixing them in such a way that the sum of the individual parts and not the parts themselves reflect the appropriate degree of volatility.¹³¹

¹²⁷ SEC REPORT, *supra* note 2, at 108.

¹²⁸ During the last decade the number of funds within existing fund complexes has increased markedly. From 1960 to 1970 the advisers of the 49 major complexes have increased the number of funds they sponsor from 105 to 190. Bogle Address, *supra* note 7, at 1.

¹²⁹ Some advisers make an effort to spread the objectives of their funds over the risk-reward spectrum. Thus, Wellington Management advertises that no one fund can serve every need, and has fashioned the objectives of the funds in its group to appeal to a broad range of investors. But as the number of funds in the group has increased from two to twelve, differences between several of the funds have been reduced. Other advisers make no effort to create funds with different objectives. Thus, Oppenheimer Management Corporation has created Oppenheimer A.I.M. Fund, Inc., although it has similar investment objectives to those of Oppenheimer Fund, Inc., a fund also managed by Oppenheimer Management. Oppenheimer A.I.M. Fund, Inc., Prospectus 2 (Feb. 9, 1970). Moreover, as Mr. Bogle has remarked, a number of advisers have created funds which will "terminate their offerings as they approach asset levels that may be inconsistent with the implementation of their investment policies. When this happens, it seems obvious that a new fund must be formed to take the place of the closed fund in the spectrum." Bogle Address, *supra* note 7, at 8. Still other advisers have created funds which differ in the industries in which they concentrate or in the techniques they use (for example, short-term trading, technical market analysis) to achieve the same objective. The objectives of several of the Fidelity Funds are "essentially" identical and "vague" so that each fund can "take on the personality of its manager." Fiske, *supra* note 12, at 86.

¹³⁰ At the end of 1969, 33 of the 75 common stocks in the portfolio of Broad Street Investing, a fund with an objective "to produce favorable current income . . . and long-term growth of both income and capital value," were also in the portfolio of National Investors, a fund with an objective "to produce long-term gain in capital value and future growth of income." Compare Broad Street Investing Corporation, Annual Report (1969), with National Investors Corporation, Annual Report (1969). On June 30, 1969, the largest single holding of Scudder Special Fund, a highly aggressive capital appreciation fund, was American Telephone and Telegraph, a company one would expect to see in the portfolio of a much more conservative fund. Scudder Special Fund, Inc., Third Quarter Report (June 30, 1969). On Scudder Special Fund's investment approach, see *Run, Fox, Run*, FORBES, Aug. 1, 1970, at 55.

¹³¹ At the close of 1969, Broad Street Investing's portfolio contained such low dividend paying issues as Holiday Inns and Burroughs, and its largest single holding, IBM, historically has paid a relatively low dividend. Presumably management is relying on other securities to produce current income and anticipates that growth companies such as Holiday Inns, Burroughs, and IBM in the future will raise their dividend levels or will appreciate in value, thus expanding the fund's asset base for generating future income. Broad Street Investing Corporation, Annual Report (1969).

The third characteristic of situations calling for a fairness standard is the limited availability of whatever the adviser is providing. If there is enough to go around, the adviser can give each fund all that it can use and thus has no cause to indulge in unfairness by preferring a fund in which it has a special interest. For example, if the collective research staff should recommend the purchase of American Telephone and Telegraph on the grounds that its yearly earnings are likely to show a handsome increase, its dividend is expected to grow, and its market price double in the next few years, XYZ can have each fund buy as many shares as seem appropriate to the fund's objective, cash position, and portfolio mix. Its decision as to how many shares each fund should purchase is a business decision, and there is no reason to examine the fairness of its judgment—even if it has a greater interest in one fund than in another. On the other hand, if research recommends a smaller company with a limited number of shares in the public float, the group's trader may be able to accumulate only enough shares to satisfy the needs of a single fund. In this situation, the funds cannot divide up the relatively few shares available without each taking too few shares to be meaningful in terms of their overall portfolios. The bother of administering small holdings may well outweigh any benefit they produce.¹³² When the funds' investment objectives do not indicate which fund should make the purchase, the adviser may be tempted to favor the fund in which it has the greatest self-interest.

¹³² For some larger funds entire industries, though attractive, may be too small to justify an investment. See *Investing: The Case for Bigness*, FORBES, May 15, 1970, at 190, 192:

[Forbes interviewer]: *Still, you rule out some possibly hot new areas that aren't big enough to make an impact on your total size.*

[Richard Johnson, vice president Dreyfus Fund]: *Size is a factor here. There are perhaps areas that we might forego if we thought we could commit only a half of 1% of our assets to the whole idea. I suppose the tape-cassette area would be one of those. It could be defined as a major new investment thought, but the total market value of any direct play would be small.*

Mr. Johnson went on to say, however, that industries of small size often are too speculative for a growth fund such as Dreyfus Fund. *Id.* 194.

In a complex consisting of a very large and a very small fund, the minimum worthwhile holding for the large fund may be so great that it must leave to the smaller fund investments in companies with small public floats. Thus, differences in size might appear to provide a solution to the allocation problem. In practice, however, such differences do not seem to be overly helpful. As funds grow, they frequently increase the number of issues in their portfolios. *E.g.*, Dreyfus Fund, Inc., Prospectus 5 (Mar. 19, 1970):

[E]ighteen years ago . . . the Fund had net assets of about one-half million dollars. Today, the Fund has net assets of approximately 2.3 billion dollars. . . .

Therefore there will be a tendency for the Fund's portfolio to contain securities of many more issuers than in former years.

See SEC REPORT, *supra* note 2, at 295-96.

Moreover, some advisers have earmarked a special portion of large portfolios for smaller than average positions in attractive companies with a limited number of shares in the public float. Three funds with such positions are National Investors, Chemical Fund, and T. Rowe Price Growth Fund. Hedges, *supra* note 80, at 48.

The fourth characteristic of situations calling for the fairness standard is that more than one fund has a claim to what the adviser is providing. The funds in the XYZ group, for example, all have a claim to participate in the investment opportunities turned up by the collective research staff. The research is being done for all of them, and thus they all may expect to participate in its fruits. On the other hand, Funds A and B have no claim to participate in opportunities discovered by the analysts working directly for Fund C. XYZ is free to structure its investment research division however it wishes, and if it chooses to assign certain individuals to a particular fund and to limit the benefit of their work product to that fund, it may do so¹³³—providing, of course, that it continues to meet its duty of care to the other funds. Thus, no fund may claim the services of another fund's analysts or portfolio manager. Similarly, if the adviser has chosen to set up a separate trading department for each fund, no fund may claim to participate in the transactions of another fund's trader. A fund has a claim only to work done at least partially on its behalf.

At this point a summary is appropriate. Ordinarily, an adviser has considerable leeway in how it treats the funds it manages so long as its activities with respect to each fund meet the minimum standard

¹³³ In the Shareholders Management group of funds, not only is each fund run independently of the others but the portfolio of Shareholders' largest fund, Enterprise Fund, has been divided into five parts, each of which is managed independently by a different portfolio manager. Shareholders provides no collective research. Each of Enterprise's five portfolio managers has been described as an "individual entrepreneur," who develops his own network of outside analysts to feed him ideas. "There are no office conferences and little cross-checking among the portfolio managers." The men are "thoroughly competitive." The most important central facility provided by Shareholders is a central trading desk to see that no two portfolio managers are competing for the same stock and to prevent one from buying what another is selling. Mattlin, *supra* note 12, at 73. Thus, in the Shareholders Management group, the fourth characteristic, that more than one fund have a claim, would not seem to be present, except in the area of executions when the trader is buying or selling on behalf of more than one manager.

Competitive Capital Fund, as originally organized, took the concept of competition between portfolio managers even further than Shareholders Management. It divided its portfolio among five outside managers each of whom was paid in accordance with his performance relative to the Dow Jones Industrial Average. The amount of new money which each received depended upon his performance relative to the other managers. See Fiske, *The In-House Performance Derby: Competitive Capital*, INST. INV., Jan. 1969, at 42, 44. Poor performance during the past two years has led to a reorganization at Competitive Capital. It has fired its original managers and hired new ones who are described as a "competitive team." *Another Icon Smashed*, FORBES, Aug. 1, 1970, at 55.

Wellington Management pursues a policy of cooperation between portfolio managers. The portfolio managers and analysts working for particular funds are encouraged to and in fact do share information affecting other funds in the group. See generally notes 86, 89 *supra*. So long as this policy remains in effect, the funds would seem to have claims to the work product but not the services of persons working for other funds in the group. Accordingly, the standard of fairness would apply in situations which also display the first three characteristics. For a description of Capital Research, another complex which places a premium on cooperation, see Welles, *supra* note 12.

of care which industry practice and each fund's needs require. In some situations, however, the adviser's activities may have to meet the more stringent standard of fairness. Four characteristics distinguish situations calling for the standard of fairness: (1) the adviser stands to benefit more from some funds than from others; (2) more than one fund has an interest in whatever the adviser is furnishing; (3) what is being furnished is of insufficient quantity to satisfy all fund needs; and (4) more than one fund has a claim to what is being furnished. The danger of self-dealing in such situations is not that the adviser might take for itself something belonging to a fund (a danger which always exists), but that the adviser, in mediating between the funds' conflicting claims, will make decisions which consistently redound to its own benefit.

E. Safeguarding Fund Interests

In situations displaying the above four characteristics, advisers risk violating their legal duty not to engage in self-dealing if they favor funds in which their self-interest is strongest. Consequently, it might seem that such problems are best left with the courts which, in punishing a few of the most egregious cases, will deter other misconduct. If judicial action is likely, mutual fund advisers, like brokers in the securities industry, might be expected to hire a compliance officer to insure that the adviser's procedures with respect to the funds are within the legal limits.¹³⁴

But the Investment Company Act contemplates the presence of nonaffiliated directors on the boards of mutual funds,¹³⁵ and the presence of these directors and their review of transactions between the adviser and the funds insulate advisers from liability when self-dealing might otherwise be found. Advisers have successfully defended actions alleging a breach of their fiduciary duty by convincing the court that the nonaffiliated directors made a disinterested review of the transactions in question.¹³⁶ Courts have generally been unwilling to delve into the adequacy of the inquiry underlying directors' business judgment.¹³⁷

So long as the presence of nonaffiliated directors reduces the pressure for advisers to adopt effective self-regulatory measures, adequate regulation seems best assured by spelling out fairly precisely

¹³⁴ See *Reynolds & Co.*, 39 S.E.C. 902 (1960).

¹³⁵ See 15 U.S.C. § 80a-10 (1964).

¹³⁶ See *Moses v. Burgin*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,747 (D. Mass. Aug. 18, 1970). See also Plaintiff's Reply Brief After Trial at 51-65, 96-102, *id.*; Defendant's Reply Brief at 5-15, *id.*

¹³⁷ See note 45 *supra*.

the factors which should enter into the nonaffiliated directors' business judgment.¹³⁸ Guidelines delineating the problems upon which the non-affiliated directors should focus their attention, the materials they should require, and the factors they should consider in making a judgment will not only serve as an ethical standard of conduct, but also may provide the courts with the standard they now lack for evaluating the sufficiency of the inquiry which has led up to that judgment. Such guidelines can provide content to the "due care" concept, thus causing the nonaffiliated directors to risk liability for negligence if the guidelines are not followed.

Of course, the possibility remains that any suggested procedures will remain just that—procedures rather than the vehicle for an inquiry into the substantive problems raised. There is no reason to suppose, however, that nonaffiliated directors would elevate form over substance once their duties were more clearly defined. Their ineffectiveness in the past¹³⁹ may be attributable more to their failure to identify their responsibilities, their lack of time and information, and their close identification with the adviser, than to any conscious abdication of their duties.¹⁴⁰ Guidelines would educate them as to what their job requires and would indicate the information with which they should acquaint themselves.¹⁴¹ In addition, the recently enacted amendments to the Investment Company Act help reduce the identification of the non-affiliated directors with the adviser by replacing a number of references to affiliated persons in the Investment Company Act with a new term, "interested persons."¹⁴² Interested persons include not only affiliated persons but also members of their immediate families and persons who have certain business, professional, or personal relationships with the adviser. Furthermore, some advisers are voluntarily strengthening the independence of their nonaffiliated directors by encouraging them to

¹³⁸ The danger of self-dealing might alternatively be dealt with by equalizing the benefit each fund confers upon the adviser. Although incentive fees might be applied to income as well as to growth funds, compare Oppenheimer A.I.M. Fund, Inc., Prospectus 9-11 (Feb. 9, 1970), with Massachusetts Income Development Fund, Inc., Preliminary Prospectus 6-7 (July 29, 1970), differences in the adviser's self-interest, while reduced, may still be present. If, as suggested in Part IV below, the fee is made to depend on the total assets within a complex, the danger of self-dealing will also be reduced.

¹³⁹ WHARTON REPORT, *supra* note 12, at 34. See also note 69 *supra*.

¹⁴⁰ See Mundheim, *supra* note 14, at 1058-59; Rottenberg, *Developing Limits on Compensation of Mutual Fund Advisers*, 7 HARV. J. LEGIS. 309, 324 (1970).

¹⁴¹ See Mundheim, *supra* note 14, at 1058-59. It might be objected that even if the nonaffiliated directors perform their role more effectively, they lack the bargaining power needed to effect meaningful controls over the adviser. "Strong and reasoned objections," however, may induce an adviser to change its course of conduct. Businessmen want to appear to their peers to be doing what is right and, in any case, the nonaffiliated directors can always threaten to air their objections publicly or to require that they be set forth in the fund's proxy statement. *Id.* 1068.

¹⁴² CCH SPECIAL 2 (CCH Mutual Funds Guide Special Edition, Aug. 11, 1970); see S. REP. NO. 184, 91st Cong., 1st Sess. 32-34 (1969).

nominate their own successors when they retire from the board. Thus, new directors do not owe their appointments to the adviser's largesse and may have had no prior relationship with the adviser.¹⁴³ Finally, the independence of the nonaffiliated directors, at least in the view of some advisers, may be increasing. These advisers have observed that in recent years the nonaffiliated directors of their funds have taken a more critical attitude toward the adviser's decisions—an attitude prompted perhaps by studies critical of the effectiveness of the non-affiliated directors.¹⁴⁴

If the nonaffiliated directors are to assume the burden of safeguarding fund interests, the practical question remains of what precisely they should do to insure that their funds are treated fairly.

The nonaffiliated directors should first determine whether their fund is in any danger of receiving prejudicial treatment from the adviser. If the adviser's self-interest in their fund is as great as its self-interest in the other funds in the group, then the first of the four characteristics of situations requiring review for fairness is missing and the nonaffiliated directors have no reason to scrutinize the adviser's resolution of conflicts between their fund and other funds in the group. Thus, the three men who serve as nonaffiliated directors on the boards of the XYZ funds can, in their capacity as Fund C directors, depend on XYZ to safeguard Fund C's interest. For XYZ to do otherwise would be to act against its own self-interest. On the other hand, in their capacity as directors of Fund A, they must actively protect the fund from possible self-dealing on the part of XYZ. XYZ stands to benefit most by favoring either Fund B or Fund C in conflict situations.

Initially, therefore, the nonaffiliated directors should compare the benefit the adviser stands to receive from each of the funds in the complex. Such a comparison will not be easy: even after considering the fee schedules of the various funds, the relative demand for their shares, and the apparent responsiveness of their sales to good performance, the nonaffiliated directors may still be unable to conclude with any certainty that the adviser's self-interest in one fund is substantially greater than in another. If the nonaffiliated directors are unable to conclude that the benefit the adviser receives from certain funds is unusually great, then they need not concern themselves further about the special problems arising when an adviser manages a number of different portfolios.

To discharge their task properly, the nonaffiliated directors should begin with a review of fund performance. Such a review is already

¹⁴³ Nevertheless, in 90% of the cases or more, the nonaffiliated directors continue to be selected by the management of the mutual funds. *MUTUAL FUNDS* 285 (PLI 1970) (remarks of Allan F. Conwill).

¹⁴⁴ See notes 69, 139 *supra*.

conducted by the directors of many funds, but the special problems raised by fund complexes require that the nonaffiliated directors scrutinize the performance of all the funds in the group, not merely the funds on whose boards they serve. They should compare the performance of their funds with the performance of any other funds in the group with like objectives, and they should compare the performance of every fund in the group with the performance of the funds in other groups with like objectives. If, for example, the nonaffiliated directors of Fund A should note that Fund C has been performing well compared with other aggressive funds and Fund A poorly compared with other income funds, they should be alert to the possibility that XYZ has been treating Fund A unfairly.

Although review of performance is helpful, the nonaffiliated directors cannot rely solely upon such review to protect their fund's interests. Relative performance figures may be unreliable over a short period of time. Moreover, adverse performance in itself does not mean that the adviser is preferring some funds over others—the adviser may simply be better at managing funds with certain objectives. More important, unfair treatment may not yet have revealed itself in performance comparisons. A purposeful effort to favor certain funds in situations displaying the four characteristics discussed above is illegal, even if it has been unsuccessful in the past. The nonaffiliated directors should see that such an effort is thwarted before it becomes manifest in poor performance.

Thus to assure themselves that their fund's interests are protected, the nonaffiliated directors have other inquiries to make. One important inquiry is whether the fund is adequately represented in the investment management process. Usually this representation will be provided by a portfolio manager who acts as an advocate for their fund.¹⁴⁵ Sometimes, however, an advocate will work below the level of final decisionmaking, pressing a fund's interest before an investment committee with final say on all portfolio decisions.¹⁴⁶ When an advocacy process operates properly, it greatly reduces the opportunity for the adviser to engage in self-dealing by favoring some funds over others. Thus in the XYZ group, the directors of Fund A can depend on Mr. Ames, the fund's portfolio manager, to vie with Mr. Bright and Mr. Cap, portfolio managers of Funds B and C, for those investments which, because of the limited availability of the shares, may be made by only one of the three funds.¹⁴⁷

¹⁴⁵ See generally text accompanying notes 90-95 *supra*.

¹⁴⁶ See text accompanying note 95 *supra*.

¹⁴⁷ The trader of the Wellington Management group believes that the problem of allocating shares of attractive companies is especially acute in the area of new issues. When a new issue is "hot" and several funds are potentially interested, the

If their fund has such a portfolio manager, the nonaffiliated directors should get to know him and should satisfy themselves that he is performing effectively as an advocate for the fund's interest.¹⁴⁸ Because the portfolio manager is an employee of the investment adviser, the nonaffiliated directors should approach this task with some delicacy, recognizing the danger of creating unnecessary tensions between the manager and the adviser. The nonaffiliated directors of Fund A should speak regularly to Mr. Ames to see that he is sensitive to possible problems and to discover any instances in which he thinks the fund has been treated unfairly. They may learn, for example, that certain analysts doing collective research have been passing on information to Mr. Bright or Mr. Cap before Mr. Ames and, to protect Fund A from such unfairness, may require XYZ to establish a formal method of disseminating information.¹⁴⁹

An advocacy process does not operate in complexes in which the same portfolio manager or investment committee serves more than one fund. In addition, some problems cannot be resolved by advocates representing the interests of particular funds. In these cases the non-affiliated directors must rely on other techniques to safeguard their fund's interest.

One such technique is a formula or prearranged plan for allocating a limited asset among a number of funds. This technique is often used to apportion purchases or sales when more than one fund has entered an order, known in the industry as an authorization, for the same security.¹⁵⁰ If a block of the stock cannot be bought or sold at an acceptable price, the group's trader usually will begin to execute a series of relatively small orders on the exchange.¹⁵¹ Each fund would

trader determines from the various underwriters how many shares he will be able to buy and gives this information to the group's portfolio managers. The portfolio managers then decide among themselves how the allocation is to be made. New issues represent only a small portion of the shares purchased by the funds in the Wellington Management Group.

¹⁴⁸ Nonaffiliated directors might feel more confident in relying upon a portfolio manager to represent fund interests if the manager's salary depends, at least in part, upon fund performance. In a number of complexes, including Wellington and Shareholders Management, a portfolio manager's salary does depend, to some degree, on the performance of the portfolio (or portfolios) he is managing. But this practice is not universal.

¹⁴⁹ See text accompanying notes 83-89 *supra*. In the Wellington group portfolio managers, as an additional safeguard, are ordinarily notified of transactions proposed by the other managers so that they can press any claim their fund might have to participate.

¹⁵⁰ The following discussion may also be understood in terms of the adviser's duty to seek best execution. See generally text accompanying notes 166-78 *infra*. If the adviser is to secure best execution for several funds making simultaneous purchases or sales through a central trader, it must see that each fund has an opportunity to participate in transactions yielding the best price.

¹⁵¹ See generally note 97 *supra*. Although this pattern is most common, some traders believe it is advantageous to trade in and out of the market and do so even though a block is available in their price range.

like the trader to fill its authorization first because timing may be important and even skillfully placed orders may have an adverse effect on the market price.¹⁵² In resolving the funds' competing claims, many advisers have adopted a formula allocating to each fund a share of daily purchases (or sales) in the ratio of its authorization to the total authorizations of all the funds.¹⁵³ Thus, if Fund A has authorized two thousand shares, Fund B five thousand, and Fund C three thousand, Fund A would receive one-fifth of the shares purchased (or sold) each day, Fund B one-half, and Fund C three-tenths.¹⁵⁴ Theoretically, this seems the best way to allocate purchases and sales because it serves each fund's needs, as reflected by its authorization, to the same degree each day with comparably priced stock.¹⁵⁵

Nevertheless, such a formula may sometimes cause a fund to incur greater commissions on its portfolio transactions than might otherwise be necessary. Because the volume discount on the minimum commission rate applies only to purchases or sales made during a single day, the longer a fund takes to fill its order, the greater the commission expense it will incur for the same number of shares.¹⁵⁶ Thus, if

¹⁵² For a few examples of the difficulties traders may experience in buying or selling large blocks of stock, see SEC REPORT, *supra* note 2, at 255-57.

¹⁵³ See, e.g., Union Capital Fund, Inc., Prospectus 4 (May 1, 1970): "If two or more of the investment companies . . . desire to buy or sell the same security at the same time, the purchases and sales are normally made as nearly as practicable on a pro rata basis in proportion to the amounts desired to be bought or sold by each company." Nearly identical language appears in the National Investors, Whitehall and Broad Street Investing (all members of the Union Service group) prospectuses of the same date.

¹⁵⁴ Under rule 410 of the New York Stock Exchange, each fund is a separate account and thus the funds as a group ordinarily cannot make a joint purchase or sale of the same stock. 2 CCH N.Y. STOCK EXCH. GUIDE ¶2,410 (1969). *But see* note 156 *infra*. Although the rule requires that the commission be figured separately on each fund's daily purchases (or sales), it does not prevent traders from allocating their total daily purchases or sales among a number of funds. The trader will tell the broker who is executing the order that, for example, it is being made on behalf of Funds A, B, and C. At the end of the day, the trader, after figuring how many shares should go to each of the funds, will call back the broker to tell him how many shares should be included on each fund's order slip.

¹⁵⁵ Executions in one complex normally are allocated pro rata in accordance with the relative size of each fund's authorization, but when a portfolio manager or analyst working for a specific fund has recommended a security after having conducted extensive investigation, his fund is given preference in purchasing up to 1% of fund assets, with the other funds following as a group.

¹⁵⁶ The nonaffiliated directors might want to explore the possibility of creating a broker-dealer subsidiary, either of the adviser or of the funds, for the purpose of purchasing stock on behalf of all the funds in the group. So long as the purchase, confirmation, and delivery are made for only one account and the shares then allocated by the broker-dealer among the funds, the funds would be able to pay the discounted commission on all shares except the first one thousand. If the new, proposed minimum commissions rates are adopted, the savings will be even more substantial because of the steep reduction in commissions for very large orders. The broker-dealer need be only a shell, neither a member of a stock exchange nor of the National Association of Securities Dealers, Inc. (NASD). It need only satisfy the SEC capital requirements. By creating such a broker-dealer subsidiary for the purpose of bunching orders, an adviser would be able to do for their funds what the banks have long been doing for their trust accounts. *See* American Stock Exchange Information Circular No. 210 (Nov. 13, 1968); New York Stock Exchange Member Firm Educational Circular No. 249 (Nov. 27, 1968).

Funds A and B each authorize the purchase of four thousand shares of Company Z and the trader can accumulate only four thousand shares a day, each fund, under the formula, will receive two thousand shares the first day, and two thousand shares the second. If Company Z's stock is selling at \$30 a share, this means that each fund will pay \$340 commission for the first thousand shares it purchases each day and \$180 commission on the second thousand.¹⁵⁷ Each fund will pay a total commission, therefore, of \$1040 for its four thousand shares. If, on the other hand, Fund A were to buy all four thousand of its shares on the first day and Fund B all four thousand of its shares on the second day, each fund would pay a commission of \$340 plus \$540 (\$180 + \$180 + \$180) or \$880—a savings of \$160.

The prospect of securing such savings has led some advisers to reconsider their use of a formula allocating executions on the basis of the funds' respective authorizations. At least one adviser is considering the feasibility of replacing the formula with an arrangement permitting only one fund to be in the market during a single day. Fund A would buy (or sell) on the first day, Fund B would buy (or sell) on the second, and so forth. The sequence would be prearranged and the opportunity to go first rotated among the funds. Under one formulation of this plan, if Fund A authorizes six thousand shares and Fund B six thousand, and Fund A is able to purchase four thousand shares on the first day, Fund B would then have the opportunity to purchase at least four thousand shares, even if this requires that Fund B make purchases on days two and three. If Fund B has purchased four thousand shares by the end of day three, Fund A would begin buying again on day four and so forth.

Whether the nonaffiliated directors select a formula based on the relative size of authorizations, a plan of sequential purchases, or another method of allocating executions may well depend on factors peculiar to their complex. The nonaffiliated directors might consider, for example, whether the adviser ordinarily is able to deal with allocation problems through block purchases (or sales) in the third or fourth markets.¹⁵⁸ This might depend on the type of stock usually requiring allocation, the size of typical authorizations, and the adviser's attitude toward non-stock exchange transactions. The nonaffiliated directors might also consider whether brokerage commissions are being recaptured for the funds.¹⁵⁹ If they are, the cost of a pro rata formula in terms of extra commission dollars may be greatly reduced.

¹⁵⁷ See 2 CCH N.Y. STOCK EXCH. GUIDE ¶1,702, at 2,381.14 for the formulas for determining the minimum commission rate.

¹⁵⁸ See notes 170-71 *infra*.

¹⁵⁹ See text accompanying notes 175, 198-208 *infra*.

If their fund is not served by a portfolio manager, the nonaffiliated directors may themselves have to insure that their fund has had the opportunity to invest in those companies with too few shares in the public float to be purchased by more than one fund in the complex. A formula, such as the one adopted for allocating executions, will not be helpful here because a formula cannot take into account fund objectives, liquidity, and other factors relating to the character of the fund's portfolio.

To safeguard their fund's interests, the nonaffiliated directors might use a chart listing all the issues in which the funds in the group have made significant transactions during the last month and over the last three-month period.¹⁶⁰ From such a chart the directors could readily determine the investments in which the fund had not participated and could begin voicing their concern if over a period of time all of the most attractive investments appeared to be going to funds in which the adviser's self-interest seemed to be stronger. In many complexes the directors review the fund's portfolio transactions every month,¹⁶¹ and where the funds have common boards, they are already scrutinizing the investments made by all the funds in the complex. But such a chart would not be overly burdensome even for directors who sit on a single fund board because their principal job, at least until their suspicions were aroused,¹⁶² would be to detect patterns of purchases, not to scrutinize particular transactions.

¹⁶⁰ In a complex consisting of several funds with identical directorates, information on the portfolio transactions of all funds will automatically be available to all the directors. But if each fund has different directors or a complex also includes investment counseling accounts, information on the portfolio transactions of all the funds and accounts ordinarily will be unavailable to the directors of any one fund. Nevertheless, if an adviser places itself in a position of possible self-dealing, it has no right to refuse such information to a director who needs it to prevent possible prejudice to his fund. Disclosure to a limited number of individuals does not amount to a recognizable invasion of the funds' or accounts' right of privacy. Cf. W. PROSSER, *LAW OF TORTS* 835 (3d ed. 1964). Moreover, disclosure would not seem to violate any confidential relationship existing between the adviser and his advisees. Physicians, whose confidential relationship with their patients is well established, may disclose confidential information if necessary to protect third persons. See *Berry v. Moench*, 8 Utah 2d 191, 331 P.2d 814 (1958); *Simonsen v. Swenson*, 104 Neb. 224, 177 N.W. 831 (1920). See generally Note, *Medical Practice and the Right to Privacy*, 43 MINN. L. REV. 943 (1959). An analogy can be made to investment advisers when disclosure is needed to protect the interest of a fund. "An occasion is conditionally privileged when the circumstances induce a . . . reasonable belief that (a) facts exist which affect a sufficiently important interest of . . . a third person" RESTATEMENT OF TORTS § 593(1) (1938). The Comment to this section suggests that such interests include "lawful business, professional, property or other pecuniary interest."

¹⁶¹ Prior to the monthly meetings of the boards of directors of the Union Service funds, each director receives a written report on executive committee authorizations of purchases and sales of securities for that month and on all completed purchases and sales. At the meeting the fund's portfolio supervisor discusses business prospects of various companies and the reasons particular companies were bought or sold.

¹⁶² As Mr. Justice Holmes stated in *Bates v. Dresser*, 251 U.S. 524, 529 (1920): "Some animals must have given at least one exhibition of dangerous propensities before the owner can be held." But when "hints and warnings" have been given, the directors' suspicions should be aroused. One signal might be significantly lower risk-adjusted performance compared to other funds in the group.

As the number of funds in a complex increases, however, such a chart will become less helpful, and it may become valueless in complexes consisting of several funds and a large number of discretionary accounts. In such cases the chart might include so many companies as to be meaningless when accorded the relatively superficial analysis which can reasonably be expected of the nonaffiliated directors. Moreover, in such complexes, a formula or prearranged plan for allocating executions may be impractical because of the very large number of accounts.¹⁶³ Fortunately, the risk of self-dealing in such complexes, at least from the funds' standpoint, is reduced by the fact that an adviser's self-interest in its mutual funds is ordinarily greater than in any one discretionary account.¹⁶⁴ Moreover, in some complexes the investment counseling division is completely isolated from the fund management division. Finally, the need for the nonaffiliated directors to detect a misallocation of investment opportunities (but not to adopt a formula for allocating executions) is eliminated in many of the larger complexes because the funds and accounts in such complexes usually are managed by portfolio managers who represent their interest in a conflict situation.¹⁶⁵ If, however, the nonaffiliated directors find it necessary to conduct their own review, they might single out a manageable number of competing funds or accounts from those posing the greatest threat of adviser self-dealing and make spot checks of allocations of opportunities and executions between those funds and accounts and their fund.

III. ASSIGNMENT OF BROKERAGE

An analysis similar to that used to examine an adviser's duties in managing fund portfolios may be used to examine its duties towards

¹⁶³ See INSTITUTE ON SECURITIES REGULATION, *supra* note 111, at 332 (remarks of Leonard M. Leiman). At least one broker-dealer has worked out with the SEC and the New York Stock Exchange a procedure "to permit an allocation among a group of customers that wish to buy the same kind of securities." *Id.* 332-33 (remarks of George A. Blackstone).

In addition to using a formula to allocate purchases or sales of a stock which more than one fund or investment counseling account has authorized, Scudder, Stevens & Clark has a special committee which convenes specifically to identify any other salient factors which should be considered in the course of the allocation procedure.

¹⁶⁴ The Wharton School and the SEC staff have concluded in separate studies that serving as a mutual fund investment adviser is generally more profitable than providing like services to investment advisory clients. WHARTON REPORT, *supra* note 12, at 495-96; SEC REPORT, *supra* note 2, at 120-21. Investment counseling accounts, unlike mutual funds, are prohibited from paying an adviser an incentive fee unless the adviser fits into one of the exemptions allowed by the Investment Adviser's Act. The most important of these applies to advisers who have less than 15 clients and do not hold themselves out generally to the public. Investment Adviser's Act §§ 205, 203(b), 15 U.S.C. §§ 80b-5, 80b-3(b) (Supp. V, 1970).

¹⁶⁵ See generally INSTITUTE ON SECURITIES REGULATION, *supra* note 111, at 326-28 (remarks of Leonard M. Leiman).

all fund assets; for example, fund names¹⁶⁶ and brokerage generated by fund portfolio transactions. Discussion here will be limited to fund brokerage.¹⁶⁷

In supervising orders to buy and sell a fund's securities, an adviser has a fiduciary duty to direct executions "in such a manner that the result for the [fund is] most favorable under the circumstances."¹⁶⁸ That is, the adviser must seek "best executions."¹⁶⁹ Several factors should enter the adviser's business judgment on what constitutes the best execution of a specific trade. The most important is the average price per share. The adviser must seek the highest average price for shares the fund is selling and the lowest average price for shares the fund is buying. But the average price per share does not alone determine the price paid or received in a transaction. The commission which must be paid in making the trade also enters into a calculation of the price. For example, a purchase (or sale) in the third¹⁷⁰ or fourth market¹⁷¹ at a price per share slightly less favorable than the price on the New York Stock Exchange may nonetheless represent the "best execution" if such trades are made on a net basis or involve the payment of a sufficiently lower commission than the New York Stock Exchange minimum commission. The speed with which a broker can dispose of a large block is also important. An adviser may find it essential to liquidate a holding immediately, even at a price below the current market price, because it expects the price to plummet in the near future, or because it needs the cash to make other investments or to meet redemptions. Moreover, even if an adviser can get a better price elsewhere, it may still elect, in some circumstances, to pay a broker a higher price because of the superior service the broker provides. An exceptionally speedy confirmation, for example, may be

¹⁶⁶ See *Taussig v. Wellington Fund, Inc.*, 313 F.2d 472 (3d Cir. 1963); SEC Investment Co. Act Release No. 5510 (Oct. 8, 1968), in 4 CCH FED. SEC. L. REP. ¶77,619.

¹⁶⁷ See generally *Commissions and Service Charges*, N.Y. Stock Exch. Const. art. XV, §§ 1-12, in 2 CCH N.Y. STOCK EXCH. GUIDE ¶1,701-12 (1970).

¹⁶⁸ *Consumer-Investor Planning Corp.*, SEC Securities Exchange Act Release No. 8542 (Feb. 20, 1969), in [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶77,677. See also *Hubshman Management Corp.*, SEC Securities Exchange Act Release No. 8557 (Mar. 20, 1969), in 4 CCH FED. SEC. L. REP. ¶77,678.

¹⁶⁹ See *Delaware Management Co.*, SEC Securities Exchange Act Release No. 8128 (July 19, 1967), discussed in *Fleischer, Regulation, INST. INV.*, Dec. 1967, at 14.

¹⁷⁰ In addition to being traded on the exchanges, many listed securities can be bought and sold in a specialized segment of the over-the-counter market commonly called the "third market." SEC REPORT, *supra* note 2, at 159-61.

¹⁷¹ When institutional buyers and sellers deal directly with one another, their trading is referred to as the "fourth market." Brokerage commissions are not paid in such transactions. *Id.* 161; *A One-Man Stock Market*, FORBES, Mar. 1, 1970, at 70-71.

The funds in a complex may also save brokerage commissions by selling stock directly to one another in compliance with the procedures described in Investment Company Act rule 17a-7, in 3 CCH FED. SEC. L. REP. ¶48,367 (1969).

very important if the adviser is attempting, by a series of transactions, to dispose rapidly of a large block.¹⁷²

The many considerations entering into the question of "best execution" make the trader's task difficult. The difficulty is compounded by the devices currently available for recapturing in cash or valuable services at least part of the commission payable on a trade. The adviser must consider not only the price per share and the commission payable but also the possibility of recovering in the future part of the commission paid today.¹⁷³ Since the abolition of "giveups,"¹⁷⁴ advisers have used two principal devices for recovering commissions. The first is a brokerage subsidiary, either of the adviser or of the funds, with a membership on a regional stock exchange.¹⁷⁵ By routing its transactions through such a subsidiary and by participating in its profits, a fund can receive what in effect is a cash rebate of a portion of the commissions it has paid the subsidiary. The second and more

¹⁷² The secrecy with which a broker can execute a trade may also be important. See note 96 *supra*. See also *A One Man Stock Market*, *supra* note 171, at 71 (secrecy in handling orders important to development of fourth market). To avoid risking disclosure that it is purchasing or liquidating the stock of certain companies, Union Service sometimes uses a number of different brokers to execute the total order. At least one commentator has expressed skepticism over the ability of an adviser to keep its transactions secret. MUTUAL FUNDS 136 (PLI 1970) (remarks of Eugene Rotberg).

¹⁷³ The opportunity for a fund to recover part of the value of its brokerage commissions has led some commentators to refer to brokerage as an "asset" of the fund. *E.g.*, Butowsky, *Mutual Fund Brokerage*, 3 REV. OF SEC. REG. 915 (May 20, 1970): "The ability of investment companies to direct transactions to particular brokers or dealers is a valuable asset of the investment company" See also Fleischer, *supra* note 169, at 13.

In *Kurach v. Weissman*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶92,607 (S.D.N.Y. Mar. 13, 1970), defendants, in settlement of a shareholder's claim, proposed that the net profits derived from the fund's principal underwriter (a subsidiary of the adviser) on fund portfolio transactions be credited against the management fees payable by the fund to the adviser. The SEC urged the court to reject this proposed settlement on the grounds that it was illusory and "offered no benefits to Fund shareholders which they were not in any event entitled to receive." *Id.* at 93,724. The court rejected the SEC's argument and approved the settlement, reasoning that the settlement was of value to the funds because a broker affiliated with an adviser is not legally obligated to turn over its commissions on fund portfolio transactions to the funds. It has been suggested, however, that the court never ruled that brokerage was not a fund asset. See 46 BNA SEC. REG. & L. REP. X-5 (1970) (remarks of Meyer Eisenberg before PLI program on "The Institutional Investor," Apr. 10, 1970).

¹⁷⁴ New York Stock Exchange Const. art. XV, § 8, in 2 CCH N.Y. STOCK EXCH. GUIDE ¶1,708 (1970). See generally Rottenberg, *supra* note 140, at 314 n.27.

¹⁷⁵ See SEC REPORT, *supra* note 2, at 109-10, 172-73. See also Investors Stock Fund, Inc., Prospectus 4 (Jan. 13, 1969):

An amount equal to any net profit . . . which IDSS (the IDS brokerage subsidiary) may realize from transactions attributable to the Fund, is credited to the Fund as a reduction of the amounts otherwise due to Investors Diversified Services, Inc. under the investment advisory and services agreement between it and the Fund.

The prospectus does not indicate what would happen if IDSS were to incur a loss. Presumably, IDS would bear such a loss since the prospectus indicates that the fund is to participate only in "net profits," not net profits or losses. See also *Conference*, *supra* note 54, at 832-33 (remarks of Robert M. Loeffler); MUTUAL FUNDS 114-23 (PLI 1970) (remarks of Robert M. Loeffler).

common recovery technique is for the adviser to place portfolio business with brokers who furnish services such as investment research¹⁷⁶ or who sell fund shares.¹⁷⁷ Commonly known as "reciprocal business," this technique recovers for the funds a "benefit" which is not quantifiable and may in some cases be of questionable value.¹⁷⁸

When deciding which—if either—of these devices to use, the adviser must consider certain provisions of the Investment Company Act, common law fiduciary duties, and business practicality.

A. Statutory Considerations

It has been suggested that the benefits the adviser derives from reciprocal business may be a form of compensation which, under section 15(a)(1) of the Investment Company Act,¹⁷⁹ must be precisely described in the investment advisory contract.¹⁸⁰ Perhaps to protect themselves from such an interpretation of section 15(a)(1), some advisers have included in their funds' prospectuses a statement that the adviser uses reciprocal business but that a "dollar value" cannot be placed on the benefits obtained and that they do "not tend to reduce the adviser's over-all expenses."¹⁸¹ Other advisers admit that outside research "may tend to reduce [the adviser's] cost," but go on to say that the dollar value "is indeterminable," that it "may in fact be negligible," and, apparently contradicting their earlier statement, that it "does not tend to reduce [the adviser's] normal and customary research activities."¹⁸²

Evidently advisers believe that if their costs are not reduced, the benefits obtained through the use of reciprocal business are not a form

¹⁷⁶ Almost every adviser uses brokerage to reward brokers who have provided the adviser with investment research. SEC REPORT, *supra* note 2, at 163-64. One exception, however, is Bear, Stearns & Co., a New York Stock Exchange firm. It has created an investment advisory unit which proposes to compensate other brokerage firms with cash rather than brokerage orders. Nevertheless, the fact remains that the unit will rely heavily on Bear, Stearns research, and brokerage which does not go to other brokers will presumably continue to go to Bear, Stearns.

¹⁷⁷ A few advisers such as IDS have captive sales forces and thus have no need to use brokerage to promote sales of fund shares. Among dealer-distributed mutual funds, however, the practice seems to be almost universal. SEC REPORT, *supra* note 2, at 164-67; Bogle, *supra* note 9, at 913. Other services purchased with fund brokerage include wire and teletype services and pricing of portfolio securities. SEC REPORT, *supra* note 2, at 164.

¹⁷⁸ See text accompanying notes 211-15 *infra*. Although it may be difficult to place a dollar value on outside research or sales of fund shares, some of the services which may be obtained with brokerage do have clearly defined values. Thus, the cost of a new Arthur Lipper service is advertised as being \$5,000 in cash or \$10,000 in brokerage commissions. *Numbers Game*, FORBES, Dec. 15, 1969, at 73.

For an interesting article on the practices of banks with respect to reciprocal business, see Fiske, *How Banks Pass Out Commissions*, INST. INV., Dec. 1969, at 29.

¹⁷⁹ 15 U.S.C. § 80a-15(a) (1) (1964).

¹⁸⁰ See, e.g., Bogle, *supra* note 9, at 914.

¹⁸¹ E.g., United Vanguard Fund Inc., Prospectus 8 (Oct. 20, 1969).

¹⁸² E.g., Allstate Enterprises Stock Fund, Inc., Prospectus 14 (Jan. 2, 1970).

of compensation and need not be precisely described in the advisory contract. Perhaps the key to the factual issue they raise lies in the carefully hedged language of some prospectuses that reciprocal practices do not "materially" reduce the adviser's costs.¹⁸³ Section 15(a)(1) would seem to require that *any* reduction be precisely described.

The solution to this problem may simply be to include in the advisory contract a statement that, in addition to the management fee, the adviser receives as compensation benefits obtained through reciprocal business. Advisers, however, may be reluctant to acknowledge that reciprocal business is a form of compensation because it would then enter into the calculation of the fee's reasonableness. Moreover, such an acknowledgement in the advisory contract might not be sufficiently precise to satisfy the statutory requirement. The value, in the words of many advisers, is "indeterminable," and there is no accurate way of knowing how much reciprocal business will be available in the coming year. Nevertheless, the management fee depends on a number of other unpredictable factors, including the fund's net asset value and, in the case of incentive fees, portfolio performance. Thus, drawing an analogy to the management fee, it would seem that an adviser could discharge its obligation under section 15(a)(1) by including an appropriately drafted clause in the advisory contract.

A recent case, however, suggests that no statement relating to reciprocal practices need be included in the advisory contract. In *Moses v. Burgin*, Judge Wyzanski found that outside research obtained with fund brokerage was not compensation within the meaning of section 15(a)(1) because the research was given to the adviser for the fund's benefit.¹⁸⁴ The fund had no obligation to secure outside research for the adviser and any benefit which the adviser received was, in the judge's opinion, purely incidental to the primary purpose of benefiting the fund. But Judge Wyzanski's view of fund brokerage fails to appreciate the reality of the situation. The adviser controls the purchase of research with brokerage commissions and in many cases would have to supplement the services it provides the funds were

¹⁸³ *E.g.*, The Gibraltar Growth Fund, Inc., Prospectus 13 (June 2, 1969). Mr. Bogle has acknowledged that services obtained with reciprocal business may be of value to the adviser:

Brokerage commissions generated by portfolio transactions—like management fees and sales revenues—must be counted in assessing the total resources available to the management company in carrying out its responsibilities for management, distribution, and administration. The value of commissions as a resource is demonstrated by management companies that act as brokers for their fund portfolio transactions, and particularly by one company, which for 40 years has been managing a fund group at cost in return for receiving substantially all of the fund brokerage commissions.

Bogle, *supra* note 9, at 912.

¹⁸⁴ *Moses v. Burgin*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,747 (D. Mass. Aug. 18, 1970).

it not for the outside research it obtains.¹⁸⁵ Indeed, one might imply from the prior practice of the parties that the adviser has the right to use fund brokerage to obtain research. Apparently in response to this argument, Judge Wyzanski noted that when giveups to the adviser were discontinued "no one supposed that an implied condition of the advisory contract had been broken" ¹⁸⁶ But his argument ignores the fact that the adviser continued to receive outside research from brokers with which it placed business directly. Even after giveups were prohibited,¹⁸⁷ complexes were able to obtain research from brokerage houses by placing portfolio business directly with them.

Perhaps the need to describe reciprocal business as compensation under section 15(a)(1) should turn on the possibility of recovering the value of the brokerage commissions for the fund shareholders. Because the purpose of section 15(a)(1) is to notify shareholders of the cost to them of investment management, it seems unreasonable to require advisers to describe reciprocal business as compensation if the brokerage involved would otherwise have no value to fund shareholders. If, on the other hand, the brokerage might be recaptured, it does have a dollar value to fund shareholders and consequently should be described as advisory compensation when used to obtain services which reduce the adviser's expenses.¹⁸⁸

A second challenge to reciprocal business stems from a recently suggested interpretation¹⁸⁹ of section 17(e) of the Investment Company Act of 1940.¹⁹⁰ Section 17(e) prohibits advisers from receiving any compensation for the purchase or sale of fund portfolio securities except "usual and customary broker's commission[s]" in the course of the adviser's business as a broker. The section is basically an "anti-kickback provision."¹⁹¹ It prohibits an adviser from being paid by a broker for the opportunity to handle portfolio transactions. But it

¹⁸⁵ Compare note 80 *supra*, with note 81 *supra*.

¹⁸⁶ [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,747, at 99,271.

¹⁸⁷ See note 174 *supra*.

¹⁸⁸ What must be described under § 15(a)(1) may not be identical with what the nonaffiliated directors should consider when negotiating the management fee. For example, if a fund might recover in cash 20% of the value of its brokerage commissions through a brokerage subsidiary, it must disclose any arrangement by which it furnishes the adviser a certain amount of brokerage for use in obtaining outside research or in rewarding sales of fund shares. If a brokerage subsidiary is not created, the value to the adviser of reciprocal business, according to the view suggested above, need not be disclosed. Nevertheless, the nonaffiliated directors should consider this value when negotiating the fee. Moreover, they should consider the value of the brokerage to be not the 20% in commissions which the fund might have recovered from a brokerage subsidiary, but, for example, the 50% which it is worth to the adviser as reciprocal business.

¹⁸⁹ Butowsky, *supra* note 173, at 915.

¹⁹⁰ 15 U.S.C. § 80a-17(e) (1964).

¹⁹¹ Butowsky, *supra* note 173, at 915.

does not prohibit an adviser from handling fund portfolio transactions itself, charging normal commissions in the course of its "full-scale brokerage business."¹⁹²

The problems posed by section 17(e) for reciprocal business arise in the area between these two extremes.¹⁹³ The specific problem relating to fund complexes is whether the prohibition of section 17(e) extends, as has been suggested, to the use of brokerage as a reward for sales of fund shares. To the extent that such sales benefit the adviser and not the funds by increasing the fund's net asset value and hence the total advisory fee,¹⁹⁴ they are arguably a form of kickback for placing portfolio business with a broker, and as such are statutorily prohibited.¹⁹⁵ The difficulty with this theory is that it prevents the fund directors from deciding how the brokerage should be used¹⁹⁶—despite the fact that this decision involves considerations which are by no means clear cut. Because fund directors are in a better position than the courts to judge whether the sales promoted with fund brokerage do in fact benefit the fund, they should be able to do so without fear that the courts will second-guess them by ruling that their decision was statutorily prohibited under section 17(e).

Nevertheless, if section 17(e) should be found to extend to reciprocal business, then adviser's duties in assigning brokerage as a reward for sales of fund shares require no further examination. An adviser may not do so, and even a contractual provision assented to by a fund's board of directors and shareholders would be ineffective in overriding the statutory proscription.¹⁹⁷

B. *Fiduciary Duties*

Assuming that reciprocal business is not statutorily prohibited, under what circumstances may the adviser use reciprocal business and when do its fiduciary duties indicate that it should recapture for the funds a portion of the commissions generated by fund portfolio transactions?

If an adviser is already a member of a regional exchange, it may, under exchange rules, credit the value of brokerage commissions re-

¹⁹² West, *Mutual Fund Brokerage*, 3 REV. OF SEC. REG. 903 (June 19, 1970).

¹⁹³ *Id.* 904.

¹⁹⁴ See generally text accompanying notes 58-61 *supra*.

¹⁹⁵ Butowsky, *supra* note 173, at 919.

¹⁹⁶ See West, *supra* note 192, at 904.

¹⁹⁷ In *Moses v. Burgin*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶92,747, at 99,269-70 (D. Mass. Aug. 18, 1970), Judge Wyzanski ruled that the directors as a matter of business judgment could approve the use of giveups—redounding to the benefit of the funds rather than to the adviser—to encourage sales of fund shares. Thus, he obviously assumed that such a decision was not statutorily prohibited. However, plaintiff in that case did not allege that § 17(e) had been violated.

ceived from the funds against the management fee paid by the funds.¹⁹⁸ Such a credit would insure that the funds pay and the adviser receive the exact amount of compensation deemed appropriate in the advisory contract. Nevertheless, there is no legal requirement that the commissions received by an affiliated broker be credited against the adviser's fee.¹⁹⁹ As an alternative, the nonaffiliated directors can consider the value of the commissions retained by the adviser as part of the adviser's compensation for managing the funds and adjust the formula for determining the fee accordingly.²⁰⁰

When an adviser is not a broker-dealer member of an exchange, the only means of recapturing brokerage commissions for the Funds in cash (as opposed to services such as outside research) is through a brokerage-subsidary, either of the funds or of the adviser, with a membership on a stock exchange. The New York Stock Exchange prohibits such subsidiaries but several regional stock exchanges handling transactions in New York Stock Exchange listed stocks do not. If the

¹⁹⁸ A New York Stock Exchange interpretation ("Rule" 440A), 2 CCH N.Y. STOCK EXCH. GUIDE ¶2,440 (1969), allows a member firm to reduce the fee it charges for "statistical and investment advisory services" by the amount of brokerage it receives from the customer. If sufficient brokerage is generated, the fee may be reduced to zero, as indeed it is for many of the large portfolios managed by member firms. Testimony of Mr. Bishop, vice president New York Stock Exchange, *quoted in* Plaintiff's Reply After Trial at 23, *Moses v. Burgin*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶92,747 (D. Mass. Aug. 18, 1970). Under similar rules on the Pacific Coast and the Philadelphia, Baltimore, Washington Stock Exchanges, IDS and a number of other advisers credit the profits or a share of the profits earned by brokerage-subsidaries on fund portfolio business against the advisory fees payable by the funds. Nevertheless, Judge Wyzanski in *Moses v. Burgin* concluded that rule 440A permits a credit for only "that miniscule portion of the advisory fee which covered publications such as investment letters, loose-leaf and like investment services, and the conventional statistical information stockbrokers give customers in return for their business." *Id.* at 99,258. It does not permit "a credit against that part of the advisory fee which represented research in depth or which represented managerial advice beyond what brokers customarily give customers." *Id.* This conclusion seems insupportable in light of the practice of New York Stock Exchange member firms in providing sophisticated investment management services and other services including assistance in the preparation of income tax reports in return for the brokerage commissions generated by very large investment accounts. Even accepting defendant's explanation that rule 440A does not allow a rebate but a credit against the cost of advisory services which the customer already has paid as part of his brokerage commissions, Trial Brief of Defendants at 64, *Moses v. Burgin*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶92,747 (D. Mass. Aug. 18, 1970), it is hard to see why the large commissions generated by large accounts do not have a large enough research component to command high-priced, in-depth research services. Judge Wyzanski's reading of rule 440A would force the funds to pay for such research twice, with the advisory fee and with their brokerage commissions, although rule 440A according to defendants allows a "refund for investment advice for which the customer has already paid an advisory fee." *Id.* 65; see SRLR Comment, 69 BNA SEC. REG. & L. REP. A-1, A-2 to 3 (1970).

The Seventh Circuit in *Thill Securities Corp. v. NYSE*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶92,756 (7th Cir. Aug. 27, 1970), has remanded to the district court for consideration on the merits the question whether the anti-rebate rules violate the antitrust laws. Both *Moses* and *Thill* are discussed at length in Analysis, 69 BNA SEC. REG. & L. REP. B-1 (1970).

¹⁹⁹ See *Kurach v. Weissman*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶92,607 (S.D.N.Y. Mar. 13, 1970), discussed at note 173 *supra*.

²⁰⁰ See MUTUAL FUNDS 152-53 (PLI 1970) (remarks of Robert M. Loeffler).

broker-dealer subsidiary is owned by the funds, they can participate directly in its profits; if owned by the adviser, the adviser can keep the profits and credit their value against the management fee.

The SEC has taken the position that the decision to create a subsidiary belongs to the "best business judgment" of management, which the SEC defines to include both the adviser and the fund's directors.²⁰¹ Although the SEC has not spelled out the factors which should enter into this judgment, one of the most important is the cost of maintaining a member broker on a regional exchange. Curiously, concrete cost data has not emerged from discussions concerning the virtues of creating a broker-subsubsidiary;²⁰² but for large complexes which already maintain rather elaborate trading departments, the additional cost, spread over the transactions of all the funds in the group, would not seem to be excessive compared with the savings in commission dollars such a subsidiary might be expected to produce.²⁰³ Perhaps this is why advisers have offered other reasons for not creating broker-subsubsidiaries. The president of one adviser has suggested, for example, that institutional membership may involve "substantial financial liabilities," and that it may impair the liquidity of the central market place, which he sees as crucial to the ability of mutual funds to buy and sell large quantities of stock and to value precisely the securities in their portfolios.²⁰⁴ Advisers also claim that a broker-dealer subsidiary may provide poorer executions and distract the adviser from its primary function of investment management.

Whether such considerations are in themselves adequate to justify an adviser's decision not to create a broker-subsubsidiary²⁰⁵ is a matter of some dispute. The assumption that the interests of institutional investors are best served by the New York Stock Exchange version

²⁰¹ Letter of SEC General Counsel Philip A. Loomis, Securities Exchange Act Release No. 8746 (Nov. 10, 1969).

²⁰² See generally MUTUAL FUNDS 114-23, 129-69 (PLI 1970).

²⁰³ Robert Loeffler, vice president—law of IDS, does not believe that the costs of IDSS, IDS's brokerage subsidiary, are so high that a \$1 or \$2 billion complex could not afford to create such a subsidiary and still enjoy substantial savings. He asserts that many of the expenses of IDSS are directly related to volume and that a smaller complex with one-quarter the volume of IDS might incur only one-half the expenses. For the most part IDSS performs the same function as was previously performed by IDS's central trading department and the additional costs are primarily costs of accounting and other paper work. He estimates that total expenses do not exceed 25% of IDSS's gross income.

²⁰⁴ Bogle, *supra* note 9, at 914. See also John C. Bogle, Mutual Funds—New Challenges, Old Myths, Keynote Speech Before the 21st Annual International Mutual Fund Dealers Conference, Sept. 15, 1969, summarized in 16 BNA SEC. REG. & L. REP. A-11 (1969); Stein, *A Fund Man Rejects NYSE Membership*, Wall St. J., Apr. 15, 1970, at 18, col. 4.

²⁰⁵ Professor Mundheim reads General Counsel Loomis' letter, *supra* note 201, as placing the burden on management to explain why creation of a brokerage subsidiary is not in the funds' interest. MUTUAL FUNDS 167-68 (PLI 1970) (remarks of Robert H. Mundheim).

of the central auction market has been subjected to serious criticism.²⁰⁶ In addition, the trading departments of many of the larger complexes already have the technical and physical facilities required of a member firm.

Because the adviser may lose some of the benefits of reciprocal business if it creates a broker-subsiary,²⁰⁷ it has a conflict of interest when making that decision.²⁰⁸ Consequently, the nonaffiliated directors, who presumably do not have such a conflict of interest, have an important role to play weighing the merits of creating such a subsidiary in light of the particular circumstances of their fund.

When a broker-subsiary is created, it reduces the commissions the adviser can use for reciprocal business. Although advisers may argue that in some cases the services obtained from broker-dealers in return for brokerage are worth more than the commission dollars which might have been recaptured, they will have difficulty showing that research and sales, services of nonquantifiable value, are worth more to the fund than hard cash. There may be situations, however, when considerations of best execution will justify the trader in placing transactions with brokers who provide outside research or sell fund shares.

If a broker-subsiary is not created, the adviser is no longer dealing in cash equivalents and thus has considerably more leeway in assigning brokerage. But the adviser should not have unbridled discretion. As in the case of the adviser's management of fund portfolios, the nonaffiliated directors should assume the responsibility for seeing that the fund's brokerage is used in a way which most benefits the fund.

C. Pooling Brokerage

1. Brokerage as a Reward for Research

Most advisers make no effort to segregate by fund the brokerage they use to reward outside research.²⁰⁹ In many complexes, requests for "reward" brokerage may come from anywhere in the investment management division, and usually do not specify a particular fund as bene-

²⁰⁶ See letter from Donald E. Weeden, executive vice president, Weeden & Co., to the SEC, Dec. 19, 1969, on file in Biddle Law Library, University of Pennsylvania Law School (comments of Weeden & Co. in response to Securities Exchange Act Release No. 8791 (Dec. 31, 1969)); MUTUAL FUNDS 143-45 (PLI 1970) (remarks of Eugene Rotberg & Donald Schwartz).

²⁰⁷ The services obtained with reciprocal business are generally not considered to be a rebate. See *Moses v. Burgin*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,747 (D. Mass. Aug. 18, 1970).

²⁰⁸ See MUTUAL FUNDS 165-67 (PLI 1970) (remarks of Donald Schwartz).

²⁰⁹ E.g., Scudder, Stevens & Clark Common Stock Fund, Inc., Prospectus 5 (Apr. 18, 1969):

[I]t is the practice to place . . . brokerage business with brokers and dealers who supply supplementary research and statistical information to the firm of Investment Counsel for the Fund

ficiary of the research.²¹⁰ Thus, the trader may place portfolio business with a broker without even knowing which fund the broker has benefited.

Traders explain that by pooling brokerage they eliminate time-consuming paperwork and have a better chance to reward brokers quickly and with the appropriate amount of brokerage. The larger pool of brokerage enhances their ability to find a transaction which they can trust the broker to handle and which generates the desired amount of commissions. In addition, advisers suggest that the fund or funds which a particular piece of research has benefited frequently cannot be identified. Such research may keep a fund from making a trade or may prove helpful only at some future date. More important, outside research usually supplements in-house research and seldom is of direct benefit to any one fund.²¹¹

Thus, advisers have good business reasons for pooling the brokerage they use as a reward for outside research. Under most circumstances these reasons should be sufficient to convince the nonaffiliated directors that it is in their fund's interest to pool its brokerage with that of the other funds.²¹² But if the adviser relies heavily upon outside research and individuals working for particular funds have the power to assign brokerage,²¹³ the nonaffiliated directors of funds in which the adviser's self-interest is relatively small should scrutinize the assignment of brokerage more carefully. They might first speak to the fund's analysts and portfolio manager to determine whether they have been assigning all the brokerage they think the fund needs.²¹⁴ If they have, the fund, by pooling its brokerage, is not losing out on any outside research which it otherwise might have used. At the

²¹⁰ In *Wellington Management*, for example, the brokerage request forms which are used to request brokerage as a reward for research specify the broker-dealer to receive the brokerage, the person at the broker-dealer who supplied the information, the subject to which the information related, and the analyst or portfolio manager in *Wellington's* investment management division who is making the request. The slips do not specify which fund was benefited.

²¹¹ See generally text accompanying notes 80-86 *supra*. But see note 81 *supra*.

²¹² See *Moses v. Burgin*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,747 (D. Mass. Aug. 18, 1970).

²¹³ This would seem to be the case with the funds in the Shareholders Management group. Each portfolio manager has his own brokerage budget which he uses in cultivating analysts who work for brokerage houses. The portfolio managers rely heavily upon the research furnished by these outside analysts because Shareholders Management has no in-house research department. See generally Mattlin, *supra* note 12; notes 80, 133 *supra*.

²¹⁴ In some complexes the portfolio managers and analysts have a great deal of leeway in assigning brokerage and, for the most part, are able to utilize all the brokerage they need for research purposes. More commonly, however, the portfolio managers and analysts must limit themselves to a predetermined share of the brokerage allowed to the investment management division. Though portfolio managers vary widely in their desire to utilize such brokerage, at least one has complained privately that he would like to be able to assign substantially more brokerage to brokers who furnish information directly to him.

worst, the fund is contributing brokerage worth more than the research it is receiving—brokerage which otherwise might simply have gone to waste.²¹⁵

But if the fund does have other uses for its brokerage,²¹⁶ or if the portfolio manager and analysts have not been assigning all the brokerage that they want,²¹⁷ the nonaffiliated directors should determine how their fund's brokerage budget compares with the amount of brokerage which it has been contributing to the pool used to reward outside research.²¹⁸ If the fund's budget is smaller than its contribution, the non-affiliated directors have a firm basis for arguing for a larger budget.

2. Brokerage as a Reward for Sales

The nonaffiliated directors will have a more difficult task overseeing the adviser's use of brokerage to reward sales of fund shares.

²¹⁵ If, however, the nonaffiliated directors have not been completely satisfied with the reasons the adviser has offered for not creating a broker-dealer subsidiary with a seat on a regional exchange, *see* text accompanying notes 201-08 *supra*, they might want to compare, as suggested below, the amount of brokerage the fund is contributing to the pool used to reward outside research with the amount of brokerage allowed to the portfolio manager and analysts working directly for the fund. By determining whether the fund is contributing more brokerage than is assigned for its benefit, *see* note 218 *infra*, they can get a better idea of what the fund is losing by not creating a broker-subsidary.

²¹⁶ The fund, for example, might have reason to promote sales of its shares. *See generally* text accompanying notes 220-24 *infra*.

²¹⁷ *See* note 214 *supra*. One commentator has argued that mutual fund managers, with a little imagination, could utilize considerably more brokerage than they are now in securing helpful outside research. They might, for example, enlist the aid of outside analysts in monitoring each of the stocks held in the fund's portfolio. Ellis, *Is "Recip" Smart Money?*, *INST. INV.*, Dec. 1969, at 38, 102. *But see* note 80 *supra*.

²¹⁸ If brokerage is assigned both by analysts doing collective research and by persons working for particular funds, the comparison is a little more difficult. The nonaffiliated directors should compare the amount of brokerage allowed to their fund with the amount of brokerage their fund has contributed to the pool multiplied by the percentage of total brokerage which has not been assigned by analysts doing collective research. To put it in actual figures, assume that Fund A has contributed 60 to the brokerage pool, Fund B 40. Fund A's staff is allowed to assign 30, Fund B's 10, and the remaining 60 is assigned by analysts doing collective research. Thus,

Fund A is contributing $60 \times \frac{100-60}{100}$ or 24 and has a budget of 30 for its own

research. Fund B is contributing $40 \times \frac{100-60}{100}$ or 16 and has a budget of only

10. It should be remembered, however, that as the amount of brokerage assigned by collective research increases, the need for doing such calculations decreases because collective research, unlike research done for particular funds, presumably benefits all the funds equally. In 1969 over 60% of the brokerage allowed to Wellington Management's investment management division was assigned for collective research. Any danger of prejudice to particular funds was reduced still further by the fact that some of the brokerage budgeted to particular funds may have been used for primary coverage or monitoring by the funds' portfolio managers and analysts or may have rewarded information which benefited all the funds equally after being shared at the morning meeting. *See generally* note 89 *supra*.

Unlike brokerage for research, which may improve portfolio performance and thus benefit both the adviser and the funds, brokerage for sales may benefit only the adviser.

The benefit to the adviser is obvious. Because the formula used to compute the management fee almost always relates in part to the value of assets under management,²¹⁹ an increase in assets produced by improved sales almost always means an increase in the advisory fee.

The benefit to the funds is less readily apparent. Improved sales may mean a reduction in the expense ratio as fixed costs are spread over increased assets.²²⁰ A steady inflow of new money may reduce the risk that some securities will have to be sold prematurely in order to meet redemptions²²¹ and in some cases may promote better performance.²²² An increase in the adviser's compensation may also enable it to hire more or better analysts and portfolio managers, thus enhancing its ability to do a good management job.²²³ But whether improved sales actually will produce meaningful benefits in any particular case is unclear. For a large fund and often for a large complex, the benefit of additional reductions in the expense ratio or further strengthening of the adviser may be of minimal value.²²⁴ Moreover, the danger of a net outflow of cash has not been so great as to keep

²¹⁹ See SEC REPORT, *supra* note 2, at 97-101.

²²⁰ Bogle, *Portfolio Transactions and the SEC Report Analysis-Recommendations—Impact*, in CONFERENCE ON MUTUAL FUNDS 75, 81 (P. Geerlings ed. 1967); see SEC REPORT, *supra* note 2, at 252-55.

²²¹ Mr. Bogle has observed:

[D]espite the excellent record of an assumed investment of \$10,000 in the typical aggressive fund, the actual shareholder experience in most average volatility funds has been far superior. Why? Because this latter group of funds, with its *steadier capital flow* and more stable shareholder base, avoided the pitfalls that come with extreme variations in performance

Bogle Address, *supra* note 7, at 5 (emphasis altered).

²²² Robert L. Sprinkel and Richard E. Boesel, respectively, chairman and president of Competitive Capital Fund, have tentatively concluded from a study they are now conducting that cash flow can materially affect performance. They claim that "if a fund has a positive or negative cash flow of 10 percent there is little effect on its performance, but when you get up to a 30 percent positive cash flow, there is a definite positive effect on performance." Fiske, *supra* note 133, at 46. But see text accompanying notes 224-33 *infra*.

²²³ See SEC REPORT, *supra* note 2, at 252, 255; cf. CONFERENCE ON MUTUAL FUNDS 69 (P. Geerlings ed. 1967) (remarks of Theodore Zimmerman). The benefits of using reciprocal business to reward sales were summed up in one fund's proxy statement in these words: "[T]his practice . . . may help to build the Fund or to maintain it at a sufficient size to function economically and efficiently and to enable the Fund to fulfill its continuing obligation to redeem its shares without necessarily requiring it to sell portfolio securities." Invest Fund, Inc., Proxy Statement 5 (Dec. 17, 1969).

²²⁴ The SEC has concluded:

Although the largest funds have lower operating expense ratios, lower portfolio turnover rates and greater management resources, these funds have not had superior performance as would be expected. . . . Accordingly, there is no reason to believe that the shareholders of the largest funds would benefit from further growth.

SEC REPORT, *supra* note 2, at 263. But see Conference, *supra* note 54, at 683-89 (remarks of William B. Moses, vice chairman, Massachusetts Investors Trust).

advisers from creating funds which terminate sales to new shareholders once they reach a certain size.²²⁵

Indeed, in some circumstances sales of fund shares may be more burden than benefit to a fund.²²⁶ Although the relationship between performance and size is not fully understood and is a matter of some debate,²²⁷ a number of portfolio managers have claimed that they can do a better job on a smaller fund than on a larger.²²⁸ They cite the difficulty larger funds may experience when acquiring a meaningful position in certain stocks. Some investments must be ruled out entirely²²⁹ and others must be made with great care so as not to disturb the market price.²³⁰ In addition, a portfolio manager has less time to devote to each portfolio company as the number of different holdings is increased.²³¹ This problem becomes especially acute if

²²⁵ *E.g.*, Polaris Fund, Inc., Prospectus 1 (July 30, 1969): "The management of the Fund believes that attainment of its objective will be aided by limiting its size. Accordingly, when total net assets of the Fund reached \$100,000,000, the Fund ceased selling to new shareholders." The argument that a continual cash inflow promotes portfolio performance by assuring that portfolio decisions will be based on informed investment management and not on an extraneous need for cash to fund redemptions is viewed with skepticism in *MUTUAL FUNDS* 146-49 (PLI 1970).

²²⁶ See I. FRIEND, M. BLUME, & J. CROCKETT, *supra* note 123, at 31: "The widespread use of brokerage business as a reward for selling fund shares is potentially harmful to fund investors."

²²⁷ The SEC was unable to find any relation between fund size and performance. See note 224 *supra*. However, it speculated:

Should the growth of the largest funds and fund complexes continue, these funds might soon reach the point—relative to the size and conditions of the markets and the economy—where their portfolio mobility would be so seriously impaired as to affect gravely the interests of their shareholders. It is indeed possible that the future investment experience of the largest funds, even if their sizes were to continue near the present levels achieved only recently, might be so affected.

SEC REPORT, *supra* note 2 at 263. This conclusion has not gone unchallenged. See Conference, *supra* note 54, at 685-88 (remarks of William B. Moses); *cf. Investing: The Case for Bigness*, FORBES, May 15, 1970, at 190 (interview with Richard A. M. C. Johnson, vice president Dreyfus Fund). The most recent and authoritative study on the investment performance of mutual funds concluded that "there does not seem to be any consistent relation between performance and size." I. FRIEND, M. BLUME, & J. CROCKETT, *supra* note 123, at 60.

²²⁸ The portfolio manager of one well-known fund has asserted that he could do a better job on a \$50 million portfolio than on the \$300 million portfolio he is managing. He has specifically requested that the adviser close sales of his fund to new shareholders when the fund reaches \$500 million.

²²⁹ See note 132 *supra*.

²³⁰ See SEC REPORT, *supra* note 2, at 255-56. Nevertheless, improved facilities for block trading have reduced the liquidity problem to some extent. Moreover, where the problem does exist, it is not limited solely to larger funds. Smaller funds have experienced similar problems when investing in certain over-the-counter and even American Stock Exchange companies with unusually small public floats. Afuture Fund, for example, invests the bulk of its assets in over-the-counter and American Stock Exchange companies. Its positions in some of these companies are large relative to the total number of shares available in the market. The capitalizations are thin, the daily volume small, and for some of the over-the-counter companies the market is not well-developed. Even Afuture avoids some investments when only a few small houses are making a market in the stock.

²³¹ See, *e.g.*, Mattlin, *supra* note 12, at 31:

Fletcher and Carr waited far too long to bring in new money managers for a fund too big for two men . . . to run themselves. . . . Two of the five

management, in an effort to keep a large inflow of new money from diluting overall investment quality, increases the number of holdings too rapidly.²³² Finally, too rapid an inflow of new money may have an adverse effect on the efficiency with which shareholder accounts are administered.²³³

The full import of such problems is difficult to assess in the context of a particular fund or complex. Moreover, advisers might overcome investment management problems resulting from increased size by dividing a fund's portfolio among several managers.²³⁴ In the final analysis it often may be impossible to know whether sales benefit or burden a fund.

Nevertheless, the nonaffiliated directors should recognize that the interests of their fund and the advisers may diverge over sales of the

men now running Enterprise . . . were hired in 1968 but the other three weren't brought in until last year. . . .

. . . With more than 350 positions in the portfolio to master and no time to master them, things got out of hand as the market ran away from them.

²³² Some advisers have attempted to deal with this problem by terminating the sale of fund shares. Undated letter to potential investors from Curran W. Harvey, president, Rowe Price New Horizons Fund, Inc.:

The New Horizons Fund, in the best interest of its shareholders, suspended sale of new shares to the general public in October, 1967. This action followed a very rapid increase in subscriptions Fund assets escalated from \$26,000,000 in December, 1966, to over \$104,000,000 only nine months later With most of the stocks in the Fund's portfolio and new candidates for investment selling at prices far above our buy limits, it was simply impossible to invest the large flow of new money to advantage; consequently, management restricted sale of new shares.

New Horizons recently has resumed offering its shares to new investors. Neuwirth Fund, Inc. offered similar reasons for discontinuing sales to new investors in April 1969. Like New Horizons, Neuwirth has resumed sales of its shares. Wall St. J., July 16, 1970, at 8, col. 3. The feeling that attractive investments in growth companies might be limited was not universal at the time New Horizons suspended sales. In 1968 Fred Carr, former portfolio manager of Enterprise Fund, stated that there was an almost unlimited supply of emerging growth companies. Welles, *supra* note 81, at 113.

²³³ See Mattlin, *supra* note 12, at 30: "The back office snafus that developed when Enterprise grew from a fund of under \$30 million at the beginning of 1967 to one of almost \$1 billion by the end of 1968 are nearly over" See SEC v. Enterprise Fund, Inc., [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,600 (D. Cal. Feb. 27, 1970) (injunction against further sales and order to improve record keeping).

²³⁴ See generally note 94 *supra* & accompanying text. If a fund's portfolio manager is exceptionally capable, there is some doubt whether the fund, when it gets too large for the manager to handle alone, can maintain its performance record by dividing up responsibility among a number of new managers. See Mattlin, *supra* note 12, at 74:

It would be hard to find anyone on the Street who doesn't say something like "Rader is one of the ablest men around."

. . . But Rader can't follow 500 stocks. In the final judgment, Enterprise can only do as well as its five portfolio managers, and it is hard to believe that five men running \$800 million can do as well as one man running \$200 million. "Look, it isn't likely that they'll all be good," says another fund man. "And if even one of the five has a bad year, the fund can't be a top performer. All you are going to get, really, is the average performance of five guys."

fund shares and, consequently, should satisfy themselves that their fund's interests are actually served by increased sales. They would have to do this, however, even if the adviser managed no other funds²³⁵—the problem whether sales benefit a fund is not unique to fund complexes. A problem which is unique is whether the non-affiliated directors should allow the brokerage of their fund to be used to promote sales of other funds in the group,²³⁶ and alternatively, whether they should allow the adviser to use the brokerage of other funds to promote sales of their fund's shares.

As a matter of practice, complexes have taken a variety of approaches in their treatment of brokerage as a reward for sales. Some advisers completely segregate each fund's brokerage, assigning only Fund A's brokerage as a reward for sales of Fund A's shares.²³⁷ Other advisers pool the brokerage, submitting to the central trader a list of brokers to be rewarded and leaving to him the decision which brokerage is to go to which broker.²³⁸ Still others take a middle course, assigning Fund A's brokerage only to brokers who have sold at least some Fund A shares but measuring the amount of brokerage by the broker's total sales of all the funds in the complex.

Traders maintain that the efficiencies of pooling brokerage for research are equally applicable to pooling brokerage for sales. Indeed, some traders suggest that it is even more important to pool brokerage

²³⁵ See SEC REPORT, *supra* note 2, at 173-75; Butowsky, *supra* note 173, at 919.

²³⁶ See generally Bogle, *supra* note 9, at 913; Butowsky, *supra* note 173, at 919; West, *supra* note 192, at 903.

²³⁷ E.g., Scudder Special Fund, Inc., Prospectus 6 (July 25, 1969).

²³⁸ E.g., Broad Street Investing Corp., Prospectus 6 (May 1, 1970) (emphasis added): "[T]he Corporation has placed, and expects to continue to place, brokerage orders with broker-dealers who sell its shares and the shares of associated mutual funds." This practice is also followed by a number of other major fund complexes including Fidelity, Putnam, Massachusetts Financial Services, Keystone, and Anchor.

A few advisers have submitted to fund shareholders contract proposals which would expressly allow the adviser to pool brokerage used to reward sales. Among these are advisers of Fundamental Investors, Anchor Capital Fund, Keystone Custodian Funds, Massachusetts Investors Trust, Massachusetts Investors Growth Stock Fund, and the Wellington Management Funds. Shareholder approval would not relieve the nonaffiliated directors of the responsibility to conduct the type of review suggested below. Such a review seems necessary if they are to make an informed judgment as to whether contractual permission to pool brokerage should be continued when the advisory contract comes up for renewal. One adviser has argued that shareholder approval is appropriate with respect to the subject of pooled brokerage because it may help to protect the fund directors from liability in future lawsuits involving the placement of fund portfolio transactions, an area of the law currently wrought with uncertainty. Memorandum to the SEC Regarding 1969 Annual Meeting Proxy Statement of Ivest Fund, Inc. 9-10, Nov. 4, 1969. As a legal matter, however, such directors would seem to have the power to approve the pooling of their fund's brokerage even without shareholder approval. See *Moses v. Burgin*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,747 (D. Mass. Aug. 18, 1970); West, *supra* note 192, at 904. But see Butowsky, *supra* note 173, at 919: even with shareholder approval, the use of Fund A's brokerage to promote sales of Fund B's shares constitutes "compensation of the common affiliate prohibited under 17(e)." Butowsky's argument here is subject to the same criticism as is his argument concerning reciprocal practices generally. See text accompanying notes 189-97 *supra*.

which goes to reward sales because many smaller broker-dealers specializing in fund sales have, at best, limited capacities for executing portfolio transactions.²³⁹ The trader needs a great number of transactions to draw upon if he is to find one of appropriate size which such broker-dealers can handle effectively.²⁴⁰ In addition, pooling is important from the standpoint of timing. If the sales of one fund are unusually high one month, the fund may not generate sufficient brokerage to reward all sales of its shares. Pooling the brokerage solves this problem and removes any pressure on the adviser to churn the fund's portfolio in order to meet the brokerage needs.²⁴¹

Nevertheless, these efficiencies are meaningless to funds which do not stand to benefit from improved sales. For these funds, use of their brokerage to promote sales of their shares at best wastes their brokerage and at worst may encumber them with too great or too rapidly growing assets.²⁴² Consequently, the nonaffiliated directors should determine whether sales already offset redemptions and, if so, whether an increase in fund size is actually a disadvantage from the fund's viewpoint. If they conclude that fund expansion is unwise, they should prohibit the adviser from using the brokerage of their fund or of any other fund to reward sales of their fund's shares.

In many instances the nonaffiliated directors will perceive no harm to their fund from an increase in net assets which results from

²³⁹ The difficulty smaller broker-dealers have had in handling fund portfolio transactions has led some 120 of them to band together into a cooperative trading corporation called IBDA, Inc. "IBDA is intended to give smaller firms which specialize in mutual fund sales the capacity to execute the large trades required by mutual funds. It has \$2 million in working capital, three full-time securities traders and clearing services. The 120 firms sold a total of \$200 million in mutual fund shares in 1969, or about 3% of all shares sold in the U.S. [that] year. The 120 firms combined have 4000 salesmen and 240 offices." Rustin, *Small Brokers Form Cooperative to Seek Mutual-Fund Commissions Lost in SEC Ban*, Wall St. J., Mar. 30, 1970, at 4, col. 3.

²⁴⁰ In Union Service, which pools fund brokerage, the treasurer's office prepares slips which specify the name of the firm and the dollar value of portfolio business to be placed with it. The slips do not specify which fund's shares the broker has sold. With these slips before him, the trader, when he can, places portfolio business with the indicated brokers.

In Scudder, Stevens & Clark, which does not pool fund brokerage for sales, the slips prepared by Scudder Fund Distributors to assign brokerage to brokers who have sold fund shares specify the fund which was sold as well as the value of the commissions to be placed.

In Wellington Management, the underwriter provides the Fund trading department with information on the value of shares of each fund dealers have sold, and with this information the trader prepares a ledger for each fund which shows the amount of brokerage each broker has received and the dollar value of shares which the broker has sold. Using these lists he attempts to reward brokers, when possible, but points out that the requirement of best execution often prevents him from rewarding some brokers for a considerable amount of time after they have sold fund shares.

Mutual funds commonly assign broker-dealers commissions equal to about five percent of fund shares sold. Ellis, *supra* note 217.

²⁴¹ See *Moses v. Burgin*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,747 (D. Mass. Aug. 18, 1970).

²⁴² See text accompanying notes 224-33 *supra*.

greater sales than redemptions. In such a case they have no reason to object to pooling of fund brokerage. Indeed, pooling may produce indirect benefits for the fund. An increase in the net asset value of other funds in the group may reduce the fund's management fee if the fee is scaled down in accordance with the total assets of all the funds in the group.²⁴³ Alternatively, the increase may result in greater overall compensation for the adviser and thus enhance its ability to hire qualified investment management personnel.²⁴⁴ In addition, an increase in the net assets of what is now a small fund in the group may make it a better investment vehicle for fund shareholders who may want to transfer to it in the future.²⁴⁵ If the nonaffiliated directors determine that the fund will benefit from brokerage-induced sales, they have the responsibility of assuring that the fund, by pooling its brokerage, does not receive a lesser benefit than it would have received if its brokerage were not pooled. If they represent a fund in which the adviser's self-interest is comparatively strong, they can assume that if the adviser favors any fund, it is likely to favor the fund on whose board they serve.

If, on the other hand, they represent a fund in which the adviser's self-interest is comparatively weak, they must assume the responsibility for seeing that their fund does not receive prejudicial treatment. They

²⁴³ See text accompanying notes 291-300 *infra*.

²⁴⁴ See SEC REPORT, *supra* note 2, at 255.

²⁴⁵ Bogle, *supra* note 9, at 913. Load-free or reduced-load transfer rights between the funds in a complex are common in the industry. Although described as "an invaluable service" by Mr. Bogle, such rights are a curious sort of benefit to a fund and its shareholders. They might be thought to make the fund more competitive in attracting new sales, but even if sales are in the fund's interest, the principle function of load-free transfer rights seems to be to keep shareholders within the complex when their investment needs change, when they become disenchanted with the fund which they currently own, or when they believe the market is in for a decline and want to switch to a more conservative investment. Thus, some investors in Keystone's more speculative funds transfer to the bond funds when they foresee a market decline. (Keystone allows a load reduction but for the most part transfers between the Keystone funds are not load-free.) And Wellington Management's W. L. Morgan Growth Fund was created as an alternative for Wellington Fund shareholders who wanted a more aggressive investment and who otherwise would have redeemed their shares. W.L. Morgan Growth Fund, Prospectus 3 (Dec. 27, 1968). Although the opportunity to transfer load-free from their fund benefits the shareholders who actually do transfer, it is more difficult to see how the right benefits the fund and the shareholders who remain. In fact, the right may actually be detrimental to the fund's interest. An almost 5% decline in the net assets of Investors Selective Fund, Inc., for example, was largely due to the free transfer of investments from the Fund to other funds in the IDS group. Investors Selective Fund, Inc., Annual Report 4 (1968). If too many of its shareholders exercise their transfer privilege, a fund may experience the same problems of cash outflow to which advisers point when justifying continued sales of fund shares. See notes 221-22 *supra* and accompanying text. The right to transfer load-free does not, according to one court, give a shareholder standing to sue derivatively on behalf of the fund into which he might have transferred: "[U]ntil such a transfer is accomplished, a shareholder . . . [of one fund] has no interest, beneficial or otherwise, in the corporations." *Verrey v. Ellsworth*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,469, at 98,217 (S.D.N.Y. July 31, 1969). See generally Butowsky, *supra* note 173, at 919.

might require the adviser to keep an accounting of the amount of brokerage the fund has contributed to the pool and the amount of brokerage which actually has gone to reward sales of the fund's shares. If over a period of months it becomes clear that the fund is contributing substantially more brokerage than it is receiving, the nonaffiliated directors may conclude that, despite the efficiencies of pooling and the possible indirect benefits of promoting sales of the other funds, the fund is being disadvantaged by pooling its brokerage. In making this conclusion, however, they should be aware that many advisers believe that an increase in the brokerage used to reward sales of certain funds will not lead broker-dealers to sell those funds' shares if the brokers are not already inclined to do so. Brokers expect a certain amount of brokerage, but they are not "puppets" whose sales can be controlled by the amount of brokerage they are provided.²⁴⁶ Consequently, the nonaffiliated directors might require the adviser on a trial basis to bring the total brokerage assigned for fund sales more in line with the amount the fund contributes to the pool. If, after broker-dealers are notified, the increase does not spur fund sales, then the nonaffiliated directors might allow the adviser to reduce the brokerage to the original level.

IV. THE ADVISORY FEE AND OTHER FUND EXPENSES

As mentioned above, section 15(a)(1) of the Investment Company Act²⁴⁷ requires that the advisory contract between a fund and its investment adviser precisely describe all compensation to be paid thereunder. This description usually takes the form of either a fixed percentage of fund net asset value,²⁴⁸ a percentage of net asset value scaled down for increased assets,²⁴⁹ or a percentage of net asset value supplemented by a bonus or penalty determined by the fund's performance relative to some objective standard, such as the Dow Jones Industrial Average.²⁵⁰ The compensation which a fund pays its adviser under the advisory contract is commonly known as the "management

²⁴⁶ Judge Wyzanski, however, apparently does not subscribe to the theory that an increase in brokerage will be ineffective in promoting a particular fund's sales. He suggests that an important benefit of pooling is that it allows the trader to encourage a steady flow of new customers. By averaging brokerage, the trader does not unduly encourage sales by providing rich rewards immediately after a period of high sales. *Moses v. Burgin*, [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,747 (D. Mass. Aug. 18, 1970).

²⁴⁷ 15 U.S.C. § 80a-15(a) (1964).

²⁴⁸ SEC REPORT, *supra* note 2, at 89. See generally text accompanying notes 101-04 *supra*.

²⁴⁹ SEC REPORT, *supra* note 2, at 89. See generally text accompanying note 104 *supra*.

²⁵⁰ 35 SEC ANNUAL REPORT 129-30. See generally text accompanying note 105 *supra*.

fee." It is the major but not the only expense borne by the fund.²⁵¹ Other expenses may include officers' and directors' salaries, insurance premiums, auditors' fees, printing costs, and the cost of administering shareholder accounts.²⁵² In a few complexes, usually those with very large funds, the adviser assumes all such expenses,²⁵³ but usually the adviser assumes only some of the expenses and leaves the rest to be paid by the fund.²⁵⁴ Expenses commonly assumed by the adviser include the salaries of affiliated officers and directors as well as the office rent and other office expenses of the fund.²⁵⁵ Each adviser, however, has its own policy toward assuming fund expenses and it is difficult to generalize.²⁵⁶ Several advisers assume all fund expenses but charge the funds an administrative fee in addition to the management fee.²⁵⁷

The Investment Company Act conceives that a fund's directors, especially its nonaffiliated directors, will negotiate the management fee with the fund's investment adviser.²⁵⁸ It requires that at least forty percent of a fund's board consist of nonaffiliated directors²⁵⁹ and that the advisory contract, after initial approval by a majority of the fund's outstanding shares, be approved annually by the shareholders or by a majority of directors, including a majority of nonaffiliated directors.²⁶⁰ Nevertheless, these safeguards have not been wholly effective in assuring adequate representation of shareholder interests.²⁶¹

Consequently a number of shareholders have sought court rulings that their funds' advisory fees have been excessive. Casting their actions as derivative suits, shareholders have alleged violations of both the Investment Company Act and state law. Those cases which have not been settled out of court, however, have all resulted in rulings favorable to the adviser.²⁶² These rulings have depended in great measure on the legal doctrine that shareholder approval shifts the standard for judging the fairness of a contract between interested boards from one

²⁵¹ This discussion does not relate to the brokerage commissions incurred on fund portfolio transactions. Such commissions are always paid by the fund.

²⁵² See SEC REPORT, *supra* note 2, at 46 & n.92.

²⁵³ *Id.* 92.

²⁵⁴ *Id.* 90-92.

²⁵⁵ *Id.* 90-91.

²⁵⁶ *Id.* 90.

²⁵⁷ *Id.* 92-94.

²⁵⁸ See Conference, *supra* note 54, at 739 (remarks of Abraham Pomerantz); *id.* 750 (remarks of Robert M. Loeffler); Mundheim, *supra* note 14, at 1063.

²⁵⁹ Investment Company Act § 10(a), 15 U.S.C. § 80a-10(a) (1964). The Act, however, exempts a few no-load funds from the 40% requirement. § 10(d), 15 U.S.C. § 80a-10(d) (1964). As a matter of practice a majority of the members of most fund boards are nonaffiliated. See SEC REPORT, *supra* note 2, at 130; note 103 *supra*.

²⁶⁰ Investment Company Act § 15(c), 15 U.S.C. § 80a-15(c) (1964).

²⁶¹ See text accompanying notes 134-44 *supra*; notes 54, 69 *supra*. See also I. FRIEND, M. BLUME, & J. CROCKETT, *supra* note 123, at 31-32.

²⁶² SEC REPORT, *supra* note 2, at 133.

of fairness to one of waste.²⁶³ Courts have been willing to assume that the approval of the nonaffiliated directors was not disinterested and have upheld management fees that may have been excessive on the grounds that they did not constitute a waste of fund assets.²⁶⁴

To facilitate closer judicial review of fund management fees, the SEC in 1966 recommended to Congress that the Investment Company Act be amended to require that all compensation paid by the fund to its investment adviser be "reasonable."²⁶⁵ After hearings on this proposal and long discussion with industry spokesmen, the SEC abandoned the reasonableness test and, with the support of the Investment Company Institute, recommended an amendment²⁶⁶ which would make the adviser a fiduciary with respect to the fee.²⁶⁷ There is some question whether this changes existing law.²⁶⁸

A. The Fee and Other Expenses Within a Complex

Discussion concerning the management fee has tended to focus on the fee paid by individual funds, generally disregarding the fact that a fund may be one of a group served by the same adviser.²⁶⁹ This fact, however, has great significance. Frequently the funds in a group have common directors who, when negotiating the fee for one fund, must consider the fees the other funds pay the adviser. In this respect the funds are interdependent. Together they must provide the adviser with adequate compensation to hire the employees and maintain the facilities necessary to responsible management of the complex.²⁷⁰ If one fund pays the adviser too little, another fund may have to pay the

²⁶³ *E.g.*, *Saxe v. Brady*, 40 Del. Ch. 474, 486, 184 A.2d 602, 610 (Del. Ch. 1962).

²⁶⁴ *Id.* at 479, 486, 184 A.2d at 605, 610. For a discussion of *Saxe v. Brady* and other cases relating to the compensation of mutual fund advisers, see SEC REPORT, *supra* note 2, at 132-43. See also Rottenberg, *supra* note 140, at 325-30, and sources cited therein.

²⁶⁵ SEC REPORT, *supra* note 2, at 143-47. The recommendation was drafted into legislation as S. 1659, 90th Cong., 1st Sess. (1967); H.R. 9510 & H.R. 9511, 90th Cong., 1st Sess. (1967) (proposed § 15(d) of the Investment Advisers Act).

²⁶⁶ S. 2224, 91st Cong., 1st Sess. (1969) (proposed § 36(b) of the Investment Company Act). For a description of the legislative developments since the SEC's initial 1966 recommendations, see Rottenberg, *supra* note 140, at 333-35. Mr. Rottenberg's comments on the change to a fiduciary standard are especially interesting. *Id.* 350-54.

²⁶⁷ For a complete text of the amendments, see CCH SPECIAL 2 (CCH Mutual Funds Guide, Special Edition, Aug. 11, 1970).

²⁶⁸ Compare Hearings on H.R. 11995, S. 2224, H.R. 13754, & H.R. 14737 Before the Subcomm. on Commerce & Finance of the House Comm. on Interstate & Foreign Commerce, 91st Cong., 1st Sess., pt. 1, at 187, 199-203 (1969) (SEC's interpretation), with *id.* 441 (Investment Company Institute's interpretation). The argument that the adviser is not a fiduciary with respect to the fee is grounded in the proposition that the fee is set by arms-length negotiations between the adviser and the non-affiliated directors. See Conference, *supra* note 54 at 753 (remarks of Mr. Jaretzki); *id.* 758 (remarks of Mr. Loeffler). But see *id.* 752 (remarks of Mr. Pomerantz).

²⁶⁹ The SEC seems to have acknowledged the lack of attention accorded to the complex aspect of management fees. See SEC REPORT, *supra* note 2, at 185.

²⁷⁰ *Cf. id.* 255.

adviser too much. Directors who serve on only one fund board may have a somewhat a different viewpoint because they do not control the total compensation to be collected by the adviser. Nevertheless, funds with entirely different boards are still to a great extent interdependent.

Many of the costs of operating a fund complex are incurred on behalf of several if not all the funds in a group. Only in this way can an adviser and the funds realize the efficiencies inherent in the complex form of organization. An adviser may realize these efficiencies not only by performing a function collectively for all of the funds,²⁷¹ but also by doing a job separately for each fund and standardizing the procedure,²⁷² and by utilizing the aggregate purchasing power of all the funds as a bargaining tool to reduce the cost of particular products or services.²⁷³ To illustrate, counsel, in preparing a fund's prospectus, may

²⁷¹ Portfolio valuation is an area in which the adviser may enjoy meaningful savings by doing the job once for all the funds. IDS, for example, with its sophisticated computer facility, *see* note 273 *infra*, treats all the funds as one for the purposes of portfolio pricing. Thus, it feeds into the computer only once the price of stocks which may be held in a number of fund portfolios. An analogous type of savings results when an adviser is able to use the same facility for a number of funds that it would have had to use for one fund. Thus, IDS is able to hire one receptionist for the entire complex and can furnish all six funds with about the same amount of office space as it would have had to furnish had it managed only one fund.

²⁷² Standardization seems to be most important with respect to the documents which must be prepared for each of the funds. For example, the shareholders report of each fund in a group often contains a president's letter which is almost identical, save for the fund's name and a short paragraph describing the fund's performance during the past year. Similarly, the layout for each report frequently is the same. Standardization, however, has its dangers because it may lead to documents painted with too broad a brush and not focused on a fund's specific needs.

²⁷³ As an executive of one adviser puts it, the combined purchasing power of all the funds provides "clout" during negotiations with suppliers.

The combined accounts of all the funds allows an important efficiency in the administration of shareholder accounts. When a fund is small, with no more than 10,000 shareholder accounts, it can administer its shareholder accounts itself without too much difficulty. A future Fund, for example, with under 6000 shareholders, is able to handle its shareholder accounts with 6 or 7 employees and a computer time-sharing arrangement. When a fund grows beyond this size, however, more sophisticated techniques become necessary and many funds have turned to such outside service organizations as Investment Companies Services Corporation (a subsidiary of Keystone) or the State Street Bank in Boston. But the few organizations capable of doing a good job are over-loaded with business, *see* Keystone Custodian Funds, Inc., Annual Report 10-11 (1968), and a number of advisers have experienced considerable difficulty in getting the job done properly. *E.g.*, *Hearings on H.R. 11995, S. 2224, H.R. 13754, & H.R. 14737 Before the Subcomm. on Commerce & Finance of the House Comm. on Interstate & Foreign Commerce*, 91st Cong., 1st Sess., pt. 2, at 807, 819 (1969) (remarks of Norman F. Dacey):

During the past year-and-a-half . . . the Fund's shareholder accounting has continued its descent into a state of chaos. Errors go uncorrected, despite a flood of complaints from shareholders and investment dealers. Redeeming shareholders are frequently paid far more than their accounts are worth. A computer-gone-wild rushes shares in and out of shareholders' accounts without rhyme, reason or explanation. . . . [S]hare certificates were constantly being presented for redemption by persons of whom the bank had no record.

Thus, a few of the larger complexes have begun to establish their own in-house, computerized system. One adviser cites as the advantage of having its own system the quality and reliability which comes from doing the job itself. It contrasts this with the "sloppiness" with which the accounts previously were handled. In addition, it points out that by locating all distribution and shareholder processing records in

compose certain passages which may be duplicated in the prospectuses of the other funds in the group—thus doing the job once for all the funds. For other sections, he may develop a standard wording into which he can fit the facts peculiar to each fund. Finally, the adviser may secure a reduced fee from the printer by promising him the business of all the funds in the group.²⁷⁴

The fact that an expense produces a benefit for more than one fund has no apparent bearing on whether it is paid by the fund or by the adviser. Thus, registration fees and state and local taxes, expenses incurred by a single fund for its sole benefit, typically are paid directly by the fund,²⁷⁵ while salaries of portfolio managers, also expenses which ordinarily benefit only one fund, are almost always paid by the adviser.²⁷⁶ Similarly, the cost of shareholder reports, always incurred at least in part for the joint benefit of all the funds,²⁷⁷ is often paid directly by the funds²⁷⁸ while the cost of collective research, also of joint benefit to the funds, almost always is paid by the adviser.²⁷⁹ The

one spot—in one computer—it is able to effect all purchases, transfers, and accumulations almost instantaneously, thus eliminating the “float” which existed when it was farming out the administration of its shareholder accounts to outside organizations. It also notes that it is saving the profit it was previously paying to these organizations but says that this is a secondary consideration. An in-house data processing system may also be helpful in other areas, including portfolio pricing, *see* note 271 *supra*, and possibly investment management. The uses to which such a system can be put have been summed up as follows:

A massive data processing system utilizing three of the most advanced IBM computers keeps track of approximately 50,000 transactions a day involving 1.8 million customer accounts. This system is used extensively by investment analysts and managers as well as by accountants and administrative personnel. Output of the system is the primary source of home office, sales office, and individual customer information. One vital new use for the system is the automatic logging of incoming mail, the triggering of needed processing, and the creating of follow-ups to make certain that each transaction is completed and acknowledged. In-process service items such as redemption requests, account change notices and status inquiries are thus effectively controlled and monitored.

Investors Diversified Services, Inc., Growing Through Service 15 (Oct. 1969). Besides IDS, some of the other complexes which have developed or are developing their own in-house data processing systems include Keystone, Union Service, Scudder, Stevens & Clark, and the Delaware group. It should be noted that a complex would seem to need at least 70,000 shareholder accounts to support its own system and even then development of the system is unlikely to proceed without numerous difficulties.

²⁷⁴ Usually a separate prospectus is prepared for each fund in a complex. But in the United group of funds, *see* note 34 *supra*, a single prospectus is used for all four of United Fund, Inc.'s portfolios. Most of the passages apply equally to all four of the funds, although the prospectus does give separate treatment to each fund's investment policy and portfolio holdings. The fact that many passages can be made to apply to the entire group of funds suggests the extent to which standardized passages can be used in complexes in which each fund has its own prospectus.

²⁷⁵ *See* SEC REPORT, *supra* note 2, at 92.

²⁷⁶ *See id.* 46.

²⁷⁷ *See* note 272 *supra*.

²⁷⁸ *See* SEC REPORT, *supra* note 2, at 92.

²⁷⁹ *Cf. id.* 46.

fact that expenses may concurrently benefit more than one fund is, however, of great significance.

First, it means that many of the expenses which a fund itself pays are not attributable directly to the fund; rather, they represent the fund's share of expenses which have been incurred jointly with other funds in the group. The adviser decides initially how these expenses are to be divided, but its decision is subject to review by the non-affiliated directors who, as representatives of the fund's interest, have the duty to see that the fund does not bear an unwarranted share. Thus, if counsel has spent a substantial amount of time preparing the prospectus for Fund A, and, using this prospectus as a model, has spent a comparatively short time preparing prospectuses for the other funds in the group, the nonaffiliated directors of Fund A should see that Fund A does not bear the entire cost of the first prospectus while the other funds, in effect, get a free ride. Fund A should participate with the other funds in the efficiencies of being part of a complex. More simply, hours spent on a fund should not always determine the cost to be borne by that fund. Rather, it often may be fairer for the total cost to the complex of funds to be divided according to some other criterion.²⁸⁰

Second, because many expenses are incurred for the joint benefit of several funds, the cost to the adviser of operating any one fund is not immediately identifiable. Yet the nonaffiliated directors need to know these costs if they are to keep the adviser from appropriating for itself the savings which come from running the fund as part of a complex. Knowledge of costs, and hence the profit the adviser is making on their fund, is especially important because negotiations between the nonaffiliated directors and the adviser are qualitatively different from negotiations within the normal business community. The nonaffiliated directors are in no position to switch advisers, and thus have no way to solicit the competitive bids which in most businesses tend to keep profits at a reasonable level.²⁸¹

The belief that separate management contracts for each fund do not reflect the efficiencies of running a group of funds has led a few commentators to suggest that the management fee be viewed in terms

²⁸⁰ See text accompanying notes 285-88 *infra*.

²⁸¹ See SEC REPORT, *supra* note 2, at 126-27; Mundheim, *supra* note 14, at 1066-67. But see Conference, *supra* note 54, at 736-38 (remarks of Mr. Loeffler). It might be objected that an efficient adviser which has increased its profit margin through diligent management is penalized if the amount of its compensation is made to depend upon its costs. The nonaffiliated directors, however, may choose to allow the adviser a greater profit margin upon a showing that the adviser has been especially conscientious in keeping its costs at a low level or, for that matter, upon a showing that the adviser has done an outstanding job. Compare MUTUAL FUNDS 294-97 (PLI 1970) (remarks of Alan R. Gordon & Allan F. Conwill), with *id.* (remarks of Richard M. Meyer).

of the total assets within the complex.²⁸² This suggestion recognizes that much of the work done for the funds is done collectively. But it leaves unanswered the central question of how to allocate the total fee among the funds.

A better way of approaching the fee is to consider it from the viewpoint of each fund, but to introduce into the calculation the actual cost to the adviser of running each fund.²⁸³ Presumably, if each fund's fee is reasonable in terms of its cost, the total fee paid by all the funds will be reasonable. The difficulty, of course, is determining the cost of running any one fund. The problem is identical to the one confronting directors who, in reviewing expenses payable directly by the fund, must decide how to divide up those expenses incurred jointly with other funds in the group.

The solution to this problem would seem to lie in the development of formulas allocating expenses according to the relative benefit each fund enjoys. Because the benefit which individual funds derive from particular expenses will vary, the formulas also will vary—each formula being tailored to a different expense.²⁸⁴

B. Formulas for Allocating Costs

We can begin with the expense of preparing fund prospectuses. As suggested above, a fair distribution of expenses would not permit

²⁸² This recommendation has come from such diverse sources as Mr. Bogle, Chairman of the Board of Governors of the Investment Company Institute, and Norman F. Dacey, a recent critic of the mutual fund industry. Compare Bogle, *supra* note 9, at 913 ("One possibility . . . would be reductions in management fee rates on a "complex" basis. Reductions based on the total assets of the complex, and pro-rated to the individual funds, would translate the growth of the complex into cost savings benefits for all of the funds."), with *Hearings, supra* note 273, at 814 (remarks of Norman F. Dacey) ("The Commission does exert pressure upon funds to reduce their fees proportionately as their assets grow, but it does not take into account the total of the fees received by the manager from all the funds in their care.").

²⁸³ An alternative to this approach which follows the Bogle-Dacey line more closely and which produces the same result is for all the funds to negotiate a single fee keyed to the costs incurred in managing the entire complex and then for the funds to divide up this fee in accordance with the formulas suggested at text accompanying notes 285-88 *infra*.

²⁸⁴ Use of such formulas is not a novel idea. IDS, for example, employs a variety of formulas for purposes of internal cost accounting.

When expenses are paid by the adviser, the costs of particular services are harder to identify because, unlike the expenses borne directly by a fund, they are not broken down in a fund's income statement. Nevertheless, the nonaffiliated directors should be able to get cost breakdowns from the adviser who will usually account separately for each fund's expenses. The mutual fund bill, as originally introduced, contained a provision which would have required a breakdown of the fee for other management expenses. This provision was later deleted. But David Silver, counsel for the Investment Company Institute, has indicated that most nonaffiliated directors "do request and get this kind of breakdown." *MUTUAL FUNDS* 312 (PLI 1970). For at least a rough breakdown of the cost of managing a group of funds, see the annual reports of any of the Union Service Funds.

one fund to bear the heavy cost of the first prospectus while the other funds pay a lower cost for prospectuses based upon the first. A formula effecting a fair allocation would divide among the funds the total cost of preparing all the prospectuses according to the number each fund is expected to use. Such a formula is "fair" because it renders the cost per prospectus the same for all funds in the group. Thus, it keys the expense to the benefit each fund enjoys.

The cost of administering shareholder accounts is another expense for which a formula can easily be devised. Here a fund benefits according to the number of its shareholder accounts.²⁸⁵ Thus, each fund should bear as its share of the cost of administering all the funds' shareholder accounts an amount proportionate to the number of its accounts relative to the total number of accounts in the complex. Again, such a formula is "fair" because it renders the cost per account the same for all funds in the group.

The allocation of prospectus and shareholder accounting expenses poses no real difficulty because both the extent to which each fund benefits and the expense incurred thereby is readily identifiable. It is not always easy, however, to devise an appropriate formula. For example, one might suppose that the fee for common directors should be divided evenly among the funds—if five funds, each fund taking one-fifth. But on closer scrutiny, it might appear that the directors spend very little time on one fund, considerably more on another. The total fee should be allocated accordingly. If the directors spend more time on a fund because it has greater net assets or because it has a greater number of portfolio holdings, then a formula reflecting relative net asset value or the relative number of portfolio holdings might be applied. If the time depends on the number of portfolio transactions, a formula based on the relative number of transactions might be used. One way of dividing the cost of common directors, however, will ordinarily be inappropriate. To divide the cost according to the number of hours spent on each fund would be to abandon the concept of allocating collective costs and to disregard the fact that the hours spent on the first fund may reduce the hours which must be spent on the others. It would deny the first fund the efficiency of being operated as part of a complex.

One of the most important expenses to be allocated is the cost of investment management services which are not incurred specifically

²⁸⁵ See text accompanying note 273 *supra*. Investment Companies Services Corporation bases its charge for administering shareholder accounts on the type of services desired and the number of separate accounts. It does not base its charges on the dollar size of particular accounts.

for the benefit of one fund. Such costs include, among others, the salaries of the collective research staff and their supervisory personnel, secretarial expenses and office rent for the investment management department, and library maintenance. These and other costs necessary to maintain the investment management division—salaries of management, accountants, and so forth—are all business expenses of the adviser necessary to keep it operational and thus should be considered to be a part of the cost of investment management.²⁸⁶

One way of apportioning these expenses is to divide them evenly among the funds, thereby treating each as a separate entity benefiting equally from the collective management effort. But this method of dividing costs fails to reflect the fact that larger funds, by virtue of their greater assets, stand to realize a greater benefit from the collective effort than smaller funds. A formula resulting in a fair allocation would divide the total costs of collective management according to the relative net asset values of the funds. Because the costs so allocated would ordinarily be passed on to each fund shareholder according to the relative value of his investment in that fund, each dollar invested in the complex, regardless of the fund to which it belongs, would bear the same charge for collective investment management. This seems appropriate because each invested dollar will derive about the same benefit from the collective investment effort.²⁸⁷

In a few situations, however, all or part of the collective research effort may be of no possible benefit to a fund. A conservative bond fund, for example, may benefit only from research on the "blue chip" companies whose bonds it may purchase. Here the fund should share only in the costs which conceivably could produce it some benefit. If efforts to identify precisely the expenses from which a fund may be deriving a benefit are taken too far, however, they may result in a plethora of special exceptions that undermine the simplicity of a single formula effecting a rough but useful approximation of costs. For most complexes, therefore, the most appropriate method

²⁸⁶ In complexes such as IDS, where the adviser runs a number of other businesses in addition to its mutual funds, the question may arise as to how to divide up the operational costs of maintaining the adviser. How, for example, should the salary of a top IDS executive be divided between its mutual funds, its insurance, and its real estate operations? A precise answer may require sophisticated cost accounting, but for our purposes a rough estimate would seem sufficient.

²⁸⁷ A concrete example may be helpful. Assume a complex of 3 funds, Fund A with \$1 million in assets, Fund B with \$4 million, and Fund C with \$5 million. The total cost of collective investment management is \$100,000. Fund A would bear one-tenth of the cost of collective management or \$10,000, Fund B four-tenths or \$40,000, and Fund C five-tenths or \$50,000. Each dollar invested in Fund A would bear, therefore, as its share of the cost of collective investment management,

\$10,000		\$40,000		\$50,000
\$1,000,000	or 1¢, Fund B	\$4,000,000	or 1¢, and Fund C	\$5,000,000 or 1¢.

for allocating the costs of collective investment management will be relative net asset values.²⁸⁸

C. *Evaluating the Fee and Expenses*

Through the use of such formulas the nonaffiliated directors will be better able to judge whether the fund is paying a fair share of those jointly incurred expenses which it and the other funds pay directly, and whether the fund is paying the adviser a reasonable management fee. A reasonable fee would cover the costs the adviser has incurred in running the fund and would also allow the adviser a fair profit. To deny the adviser a profit would be to internalize fund management since the fee would provide only for salaries and other expenses incident to fund management.

In deciding how much profit to allow the adviser, the nonaffiliated directors should recognize that the adviser deserves a return on its invested capital and may also merit some payment for the entrepreneurial risk it took in setting up the fund, although the latter rationale becomes more attenuated as a fund becomes older. The nonaffiliated directors should also consider the adviser's efficiency and the quality of its services, possibly by comparing the fund's performance and expense ratio with the performance and expense ratio of funds with like objectives in other complexes. If their fund's expense ratio is comparatively high and its performance undistinguished, the non-affiliated directors have reason to reduce the adviser's profit margin and to drive a harder bargain the next time the management fee comes up for negotiation.²⁸⁹

²⁸⁸ As suggested above, not all investment management expenses are incurred collectively. The salaries of analysts and portfolio managers working directly for a fund are not costs of collective research and therefore should be attributed directly to the funds for which the analysts or portfolio managers work. To illustrate, in the case of the complex described in note 287 *supra*, if Fund A has a portfolio manager who is paid \$20,000, Fund B a portfolio manager who is paid \$20,000 and Fund C a portfolio manager and two analysts who together are paid \$100,000, each

dollar invested in Fund A is responsible for	\$20,000	
	\$1,000,000	or 2¢ in addition to

the 1¢ for collective investment management or a total of 3¢, Fund B	\$20,000
	\$4,000,000

or .5¢ in addition to the 1¢ for collective management or a total of 1.5¢, and	
Fund C	\$100,000
	\$5,000,000
a total of 3¢.	

²⁸⁹ In complexes dominated by a large, conservative Fund D, the adviser may be forced to admit to Fund D's nonaffiliated directors that it is overcharging Fund D to offset losses on or to lower expense ratios of other funds in the group. Fund D's nonaffiliated directors can then squarely face the issue whether the present or future benefit Fund D might realize from the subsidized funds outweighs the present savings to be gained from a share of expenses or from a fee more accurately reflecting

Thus, an initial allocation of expenses is necessary if the non-affiliated directors are to make an informed judgment on the reasonableness of the management fee. But once they decide on an amount which seems reasonable, they can implement their decision, if they wish, with one of the formulas traditionally used to compute the fee, so long as they adapt the formula each year to produce the desired amount of compensation.²⁹⁰ Because such formulas are entrenched in the mutual fund industry, it seems helpful to examine, in terms of the suggested analysis, a few of the more common fee arrangements.

The traditional management fee, a fixed percentage of net assets, has the virtue, when applied to all the funds in a complex, of imposing the same charge on each dollar of net assets, regardless of fund. But such fixed percentages do not allow for the economies of scale which ordinarily accompany an increase in the assets under management. An adviser ordinarily does not have to spend as much managing its second billion dollars in assets as it does managing its first.²⁹¹ To permit the funds to share in the savings which come from increased size, many advisers have adopted what is commonly known as a scaled-down fee.²⁹² On a fund's first \$100 million in assets, it may pay .5 of 1 percent, on its second \$100 million, .4 of 1 percent, and so forth as the fund's assets increase. Although a scaled-down fee overcomes some of the difficulties associated with a fixed percentage, it also is deficient in several respects when used in a complex.

First, it looks only to the assets of particular funds and thus may fail to reflect the savings generated by the total assets of all the funds under common management. Much of the criticism of management fees within a fund complex has been directed to this problem.²⁹³ Nevertheless, the problem may be more imaginary than real because the percentage fees payable by each fund may be scaled down at lower

the actual costs attributable to Fund D. They might include in their calculation the opportunity for Fund D shareholders to make load-free transfers to the subsidized funds and the likelihood that the subsidized funds may grow into meaningful contributors to the adviser's overall compensation.

Some advisers have suggested that they will be unable during difficult times to raise their fee to certain funds even if an increase is necessary to allocate costs in a fairer manner. Consequently, if Fund D reduces its fee, albeit on rational grounds, the adviser will be unable to make up its loss of revenue from other funds in the group and may find its ability to manage the funds' portfolios impaired. The non-affiliated directors of Fund D, if convinced by this argument, might continue the subsidy temporarily, but should remember that the adviser is under no pressure to reallocate its fee if Fund D continues to pay a disproportionate share.

²⁹⁰ If an adviser and a fund want to adopt an incentive fee, they should set the base for the fee at a level providing the adviser with costs and a fair profit. Any bonus or penalty would simply reduce or augment this amount.

²⁹¹ SEC REPORT, *supra* note 2, at 94-96, 108. *But see* Bogle, *supra* note 9, at 912.

²⁹² SEC REPORT, *supra* note 2, at 89, 100-01. The SEC notes that scaled down fees were adopted "against the pressures generated by the settlement of shareholder litigation and the publication of the Wharton Report." *Id.* 110.

²⁹³ See note 282 *supra*.

assets levels than they would have been if they were applied to the total assets within the complex. For a complex of two funds each with \$200 million in assets, it makes no difference whether each fund pays .5 of 1 percent on its first \$100 million, .4 of 1 percent on its second \$100 million, or whether the funds together pay a fee of .5 of 1 percent on their first \$200 million of collective assets, .4 of 1 percent on their second \$200 million. In either case the funds will be paying the adviser a total fee of \$1.8 million.

The second problem with a scaled-down fee based on the assets of each fund is its inherent unfairness to the smaller funds in a group. Even on a scaled-down fee schedule, the smaller funds ordinarily are not large enough to realize meaningful savings, at least as compared with that enjoyed by the larger funds. But a small fund can claim with equal validity that its assets are the ones which generated the efficiency because such efficiency is based on the total assets under management.

The better approach, and the one several complexes have adopted, is to scale the fee downward according to the total assets within the complex—with the portion of that total fee which each fund pays measured by the proportion of its net assets to the total net asset value of all the funds in the group.²⁹⁴ Thus, each dollar invested within the group would bear the same cost,²⁹⁵ a result which best accords with the benefits of investment management.²⁹⁶

Nevertheless, even a scaled-down fee based on the total assets within a complex requires further refinement if it is to allocate costs properly. In complexes where certain expenses such as the salaries of portfolio managers are incurred for the sole benefit of one fund,²⁹⁷ it may be necessary, if these expenses are substantial, to reduce the percentage payable on total assets, offsetting the reduction in the adviser's compensation with a special charge to the funds enjoying the benefits of special service. In the same vein, funds for which much of the collective

²⁹⁴ The Keystone Custodian Funds have this type of fee arrangement as do, in a sense, the Union Service funds, which share the expenses of Union Service Corporation in accordance with their relative net asset values. See SEC REPORT, *supra* note 2, at 108.

²⁹⁵ See note 287 *supra* & accompanying text.

²⁹⁶ See text accompanying note 286 *supra*. If the percentages are adjusted each year to produce for the adviser a certain amount of compensation, it may seem more logical to figure the fee with a single, fixed percentage rather than with a series of scaled-down percentages of total net assets. But a scaled-down fee schedule helps protect both the adviser and the funds from the effects of a marked change during the course of the year in the amount of net assets under management. If net assets double, the adviser's fee will not double—a desirable result because the adviser's costs almost certainly will not double. If net assets are halved the fee will not be halved—similarly desirable because the adviser with many fixed costs will probably not be able to halve its expenses.

²⁹⁷ See note 288 *supra*.

research is irrelevant should not have to pay as large a percentage as that paid by the benefited funds.²⁹⁸

With such adjustments, a scaled-down fee based on the total net assets in a complex is a rational way to allocate the expenses of investment management. Such a fee, however, has serious shortcomings when applied to noninvestment management, or what are usually known as "administrative" expenses. As noted, the benefit each fund derives from administrative expenses may depend on some other standard besides relative net asset values.²⁹⁹ In addition, there is no point in scaling down the fee if increased net assets do not generate proportionate cost savings—that is, if the expenses applicable to the second hundred million are no smaller than the expenses applicable to the first.³⁰⁰

In those complexes in which the funds have themselves been paying a wide range of administrative expenses in addition to the management fee, the nonaffiliated directors should apply what they judge to be the most appropriate formula to each expense the fund has incurred jointly with other funds to insure that the fund is paying no more than its appropriate share. In those complexes in which the adviser has been paying the fund expenses, the nonaffiliated directors should consider the possibility of separating the administrative expenses from the investment management expenses and paying the adviser a separate administrative fee.³⁰¹ Thus, the fund would pay a management fee keyed to collective net assets and an administrative fee keyed to some other standard such as the relative number of shareholder accounts.³⁰²

²⁹⁸ Keystone seems to have taken this into account in setting its fee for Keystone Custodian Fund Series B-1, a bond fund which invests only in highly marketable "obligations of the U.S. Government . . . and . . . other bond issues of high or good grade." Keystone Custodian Fund Series B-1, Prospectus 1 (Feb. 28, 1969). B-1 pays a management fee, based on the ratio of its market value to the combined market value of all Keystone Custodian Funds, which is scaled down from .25 of 1% while the other funds pay a management fee which is scaled down from .5 of 1%. Two of the other funds in the group are also bond funds, but they invest in more speculative types of securities.

²⁹⁹ See text accompanying notes 285-88 *supra*.

³⁰⁰ Although an increase in net asset value, or in the number of funds, or in the number of shareholder accounts may allow efficiencies in the administration of shareholder accounts, see note 273 *supra*, or in the preparation of shareholder reports and prospectuses, see note 272 *supra* & accompanying text, the efficiencies may not be as great as they are in the area of investment management. Even with a highly computerized system, for example, a large clerical staff is still needed to administer shareholder accounts, and as the number of accounts grows, the manpower needs increase. Thus, once a complex reaches a size sufficient to support its own in-house data processing system, additional efficiencies may be limited at best. Size may also produce no real savings with respect to other administrative expenses such as fund accounting. In the IDS group, for example, each of the funds has its own full-time accountant.

³⁰¹ For a discussion concerning the desirability of an administrative fee, see MUTUAL FUNDS 312-17 (PLI 1970).

³⁰² In some large complexes, the cost of administering shareholder accounts may so overshadow the other costs that a formula based on the relative number of shareholder accounts can be used for all the administrative expenses. Those few funds which today pay an administrative fee in addition to a management fee use a formula

Whether the funds pay their administrative expenses directly or pay the adviser an administrative fee, the logical extension of the foregoing analysis might be to pass on at least some of the administrative expenses to the shareholders as a per account charge rather than as a charge per dollar of investment. Thus, instead of imposing an equal charge on each dollar invested in the fund, the fund might impose an equal charge on each shareholder account, regardless of whether the account were large or small. If the cost of administering shareholder accounts is unrelated to the dollar size of the accounts, why should larger accounts have to pay more than smaller accounts for their administration? The answer of at least one adviser in rejecting a per account charge is that such a charge is too burdensome on the small investor.³⁰³ In light of the public outcry that has accompanied the New York Stock Exchange's efforts to raise the minimum commission on small trades, the adviser's decision may have been politically wise. Nevertheless, if larger accounts are in fact subsidizing smaller accounts, the nonaffiliated directors should be aware of this when they decide how expenses should be passed on to fund shareholders. Policy reasons may justify such a subsidy, but an intelligent evaluation of these reasons requires that the subsidy be identified as such.

V. DISCLOSURE

Disclosure plays a central role in the administration of the federal securities acts. Reports filed with the SEC facilitate its regulatory function and provide interested persons with a wealth of information on reporting companies.³⁰⁴ Prospectuses used in selling a company's shares acquaint investors with the enterprise in which they are investing and alert them to any special risks which may be involved. In addition, disclosure forces companies to implement policies rational enough

keyed to net asset value. See SEC REPORT, *supra* note 2, at 92-94. A fund that pays almost all its own expenses should not also pay an administrative fee. The administrative fee should replace part of what today is known as the management fee; it should not merely be a supplement designed to afford the adviser an additional source of compensation.

³⁰³ A \$10 per account charge, for example, will increase by only 3.3% the total expenses borne by a \$100,000 account which has been paying a fee of .3 of 1% or \$300. On the other hand, the same charge will increase the fee payable by a \$1000 account from \$3 to \$13, an increase of 333%.

³⁰⁴ Before a mutual fund conducts any business, it must comply with the registration and reporting requirements of the Investment Company Act of 1940 and the Securities Act of 1933. Specifically, a fund must file a notification of registration with the SEC on Form N-8A. CCH MUTUAL FUNDS GUIDE ¶2,012, at 1,312. Within three months after filing this notification, the fund must file a registration statement under the Investment Company Act of 1940 using as a guide Form N-8B-1. *Id.* ¶2,013-14, at 1,313-14. The securities issued by the mutual fund must be registered under § 5 of the 1933 Act, 15 U.S.C. § 77e (1964). The registration statement prescribed by Form S-5 contains the information found in Form N-8N-1 plus financial statements and exhibits. CCH MUTUAL FUNDS GUIDE ¶2,021-23A, at 1,340-61. In addition, the fund must register its shares under the states' "blue sky" laws.

to withstand public scrutiny. Although a detailed discussion of disclosure is beyond the scope of this study, this section will outline a general scheme of disclosure appropriate to the problems of fund complexes.

If prospectuses are to be read by the ordinary investor, they must be short, nontechnical, and straightforward. Intricacies will go over most investors' heads, and will discourage them from reading the sections of the prospectus which are most important and which, hopefully, they can understand.³⁰⁵ For these investors a summary prospectus highlighting only the essentials would seem to be most appropriate.³⁰⁶

The prospectus should first explain that a mutual fund is a company that has as its main asset a portfolio of securities, that the investor is buying shares representing a portion of that portfolio, that the portfolio is managed in light of a predetermined investment objective, and that the value of the shares will fluctuate with the value of the portfolio securities. It should point out that shares in the fund are continuously offered (if this is the case) and may be redeemed at any time.³⁰⁷

The prospectus should then describe the objective the fund seeks to achieve. It should state the objective in a sentence or two and elaborate upon it by describing the policies and approach taken to achieve the objective.³⁰⁸

Having explained what a mutual fund is and having delineated the fund's investment goal, the summary prospectus should describe the way in which the fund seeks to achieve this goal. For example, the prospectus should name the fund's directors³⁰⁹ and point out that the actual job of running the fund is done by the investment adviser, XYZ, pursuant to an advisory contract.³¹⁰ The prospectus should identify the affiliated directors³¹¹ and should name any other funds to which the adviser provides investment advisory services.³¹²

³⁰⁵ See SEC DISCLOSURE STUDY GROUP, DISCLOSURE TO INVESTORS—A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 77-83 (1969) (the Wheat Report).

³⁰⁶ SEC administrative policy does not presently contemplate a summary or short-form prospectus for mutual funds. But § 10(b) of the 1933 Act authorizes the SEC to promulgate rules permitting the use of a "summary prospectus" which "omits in part or summarizes information" contained in the full § 10(a) prospectus. 15 U.S.C. § 77j(b) (1964). Rule 434A promulgated by the SEC under § 10(b) of the 1933 Act specifies when such a summary prospectus can presently be used and might be amended to encompass a short-form mutual fund prospectus. 17 C.F.R. § 230.434a (1970).

³⁰⁷ Such an explanation is embodied in the summary statement suggested in the SEC's Proposed Guidelines to Form S-5. SEC Investment Company Act Release No. 5634 at 3-4 (Mar. 11, 1969).

³⁰⁸ See *id.* 5.

³⁰⁹ *Id.* 4.

³¹⁰ *Id.* 14-15.

³¹¹ *Id.*

³¹² *E.g.*, Ivest Fund, Inc., Prospectus 4 (Jan. 1, 1970, revised Feb. 25, 1970): Wellington Management Company is a mutual fund management and distribu-

At this point, the prospectus should deal briefly with any salient information concerning the investment process by which the fund is managed. Thus, if the fund is managed by a portfolio manager, the manager should be named in the prospectus and perhaps a summary of his experience during at least the last five years should be given. This is a disclosure ordinarily not made in fund prospectuses, but which seems especially relevant in light of the responsibility which may be vested in a portfolio manager and the publicity which some managers receive in both the mass media and the shareholder reports of many funds.³¹³ Although naming the portfolio manager in the prospectus may reinforce the "star" system, the system already is well entrenched and it seems important to inform investors that the portfolio manager whose fund they think they are buying is or is not in fact running the fund. To place the role of the portfolio manager in the proper perspective, the prospectus should also indicate whether he relies on research prepared by either a collective research staff or the staffs of the other funds, whether he has his own staff of analysts, and like information.

A chart portraying the fund's historical performance should follow such disclosures and should include a statement in bold letters that past performance was achieved under a number of different methods of investment management and that the present method, vesting decision-making power in Mr. Y, has been operating since, for example, June 1968. This statement is needed to make historical performance meaningful because a sterling record under a certain portfolio manager loses some of its relevance if the manager is no longer working for the fund. Of course, advisers may argue that top management, the group that hires the portfolio managers, is the most important contributor to the fund's success. But top management is not the only important contributor and should not object if additional information is included to enable investors to make a better informed appraisal of past performance.

The summary prospectus should also describe the sales charge and the advisory fee. Description of the advisory fee should focus on the expense ratio rather than on the percentage payable to the adviser and might point out whether each dollar of fund assets is bearing a charge

tion company which acts as investment adviser to six funds (Wellington, Windsor, Gemini, Exeter, Exeter Second, and Exeter Third Funds) In addition to the Fund, IVEST, Inc. serves as investment adviser to Explorer, Technivest, W. L. Morgan Growth and Trustees' Equity Funds.

³¹³ See note 92 *supra*. The need to name the portfolio manager in the prospectus is most pressing when the adviser has publicized or has allowed the portfolio manager to be publicized in other advertising media, so that his name is generally associated with the fund. If the portfolio manager is not associated in the public's mind with any one fund and if portfolio managers are continually shifted from fund to fund, the need for disclosing the portfolio manager's name may be indicated.

which is higher, lower, or about the same as that borne by other funds with like objectives. Finally, the prospectus should describe the services available to shareholders, such as voluntary accumulations plans, periodic withdrawal plans, and load-free exchange privileges.

If an adviser wishes to use a summary prospectus, it must also prepare a full-scale prospectus containing more detailed information which may be of interest to sophisticated investors.³¹⁴ The summary prospectus should indicate prominently that a more detailed prospectus is available and can be obtained on request from the fund or from broker-dealers selling fund shares.³¹⁵ Broker-dealers should keep such prospectuses in stock so that they can fill customer requests without delay.

The full prospectus should include the same information contained in the summary prospectus but should also deal with more technical problems. These include investment restrictions, fund policy towards dividend and capital gains distributions, the fund's tax status and the percentage of the fund's portfolio represented by unrealized appreciation, the precise formula for determining the management fee, the expenses borne directly by the fund, a description of the common stock, policy for pricing shares, treatment of fund brokerage, and legal proceedings.³¹⁶ In addition, the prospectus should highlight the conflict of interest problems raised by a fund complex.

The prospectus should indicate that because the adviser serves a number of other funds, in some situations the fund may have to compete with these other funds for the adviser's services or for particular investment opportunities. At times, the fund may have to forego recommendations of the collective research staff because insufficient shares are available to satisfy the portfolio needs of all the funds in the group. At other times, the fund may have to take a smaller position or pay a higher price than otherwise would have been necessary.³¹⁷ If another fund in the group has a similar objective but pays the adviser

³¹⁴ Section 10(b) of the 1933 Act expressly requires that a summary prospectus be "in addition to the prospectus permitted or required in subsection (a)," the full, statutory prospectus. 15 U.S.C. § 77j(b) (1964).

³¹⁵ Present rules authorizing the use of a summary prospectus require this legend. SEC Reg. 434A(e), 17 C.F.R. § 230.434e (1970).

³¹⁶ For the present requirements of the complete prospectus, see SEC Investment Act Release No. 5634 (Mar. 11, 1969).

³¹⁷ Such a disclosure appears in the prospectus of only a few funds. *E.g.*, Oppenheimer A.I.M. Fund, Inc., Prospectus 2 (Feb. 9, 1970):

2. Because of the similarity in investment objectives of the Fund and Oppenheimer Fund, Inc. it is possible that the two funds could compete for the same security at the market place which competition, should it occur, might have a detrimental effect on the price of the security involved and on the size of the position obtainable so that the Fund might be disadvantaged in not being able to acquire as large a position in such security as it might have desired

a performance fee as opposed to the fund's straight percentage of net assets, the potential difference in the adviser's self-interest is sufficiently great that this also should be disclosed. The prospectus should then describe, at least in general, the techniques for resolving these conflicts. Thus it might state that portfolio decisions are made separately for each fund,³¹⁸ and that when two funds wish to buy or sell the same security executions are allocated pro rata or in a manner deemed equitable by the adviser.³¹⁹

The prospectus need say no more regarding the special complex problem of pooling fund brokerage than that fund brokerage is (or is not) pooled with that of the other funds when used to obtain research or to reward sales of fund shares.³²⁰ The question of pooling is a relatively minor problem and cannot be properly appreciated without reference to such other factors as the fund's need for additional outside research and the benefit to the fund of additional or improved sales of the other funds' shares. Consideration of such factors is better left with the nonaffiliated directors.

All prospectuses presently describe in detail the fee arrangement between the fund and the adviser, but in only a few instances do prospectuses include a statement that the fee is *not* reduced in accordance with the combined assets of all the funds in the complex.³²¹ It is hard to see why such a disclosure should be made since the fee arrangement is negotiated by the nonaffiliated directors and since a fee figured on total assets may be no lower than a fee figured on the respective assets of each fund: if the fee is to be figured on total assets the points at which the percentage is reduced may simply be set at higher levels.³²²

³¹⁸ *E.g.*, *id.* 12:

The Fund's portfolio security transactions are conducted independently of those of Oppenheimer Fund, Inc. for which the Management Corporation is also investment adviser, except when decisions are made to purchase or sell securities by the two funds simultaneously The two funds have similar objectives of capital appreciation, but it is not anticipated that investment decisions relating to the same security will ordinarily be effected contemporaneously because for the most part different personnel will be making investment recommendations in respect of the two funds.

³¹⁹ *Compare* United Funds, Inc., Prospectus 10 (July 3, 1969) ("When the same security is purchased or sold for two or more Funds at the same time, the amount of each purchase or sale is prorated among the Funds on the basis of the size of the respective authorized purchases or sales."), *with* Ivest Fund, Inc., Prospectus 5 (Jan. 1, 1970, revised Feb. 25, 1970) ("If purchase or sale of securities consistent with the investment policies of the Fund and one or more of the other investment companies or clients served by the advisers are considered at or about the same time, transactions in such securities will be allocated among the several investment companies and clients in a manner deemed equitable to all by the advisers.").

³²⁰ See notes 210, 238 *supra*.

³²¹ See, *e.g.*, Oppenheimer A.I.M. Fund, Inc., Prospectus 2 (Feb. 9, 1970): 3. The Fund and Oppenheimer Fund, Inc. do not reduce advisory fees as combined assets of the two are increased, although the basic fees for the funds are each reduced as their respective net assets increase

³²² See text accompanying notes 291-95 *supra*.

The annual report filed in accordance with Form N-1-R is a third vehicle for disclosure and should include even more detailed information than is contained in the prospectus and registration statement. The N-1-R should describe in detail the techniques used to allocate investment opportunities and daily purchases and sales of shares for which more than one fund has entered an order. Who makes the decision which fund is to invest in a company which, because of its small public float, may be purchased by only one fund? What formula is used or what factors are considered when executions are allocated? Who makes this decision? How much of the fund's brokerage was used to obtain research and how much to reward sales of the shares of all the funds in the group? How much to reward sales of the funds shares?

VI. CONCLUSION AND SUMMARY OF RECOMMENDATIONS FOR THE NONAFFILIATED DIRECTORS

The emergence of the "complex" as the dominant form of organization within the mutual fund industry has added a new dimension to the problems raised by the external management relationship between most funds and their investment advisers. Each fund in a complex must be concerned not only with problems arising in its direct dealings with the adviser but also with problems arising in the adviser's dealings with it and the other funds. Problems arise in the areas of investment management, fund brokerage, and fund expenses.

Although the adviser initially will resolve these problems, a fund's nonaffiliated directors should review the solution which the adviser has adopted, especially when the adviser has a stronger self-interest in other funds in the group. If a nonaffiliated director sits on the boards of several funds, he should consider the danger of prejudice from each fund's viewpoint. Considerations of efficiency may render different boards for each fund impractical and, so long as the nonaffiliated directors have an equal self-interest in all the funds, overlapping boards seem unobjectionable. Indeed, they may prove beneficial by affording the directors an overview and hence allowing them to compare the treatment the adviser gives to the various funds they serve. For example, their acquaintance with the different companies in each fund's portfolio will help them to judge whether any of the funds have been consistently missing good investment opportunities which because of the small public float could be purchased by only one fund. To conclude this study we will draw together some of the recommendations as to what the nonaffiliated directors should do to perform their role effectively.

1. They should acquaint themselves generally with each of the funds in the complex. They should know when each fund was formed, its investment objective, and its net asset value. They should know each fund's sales volume and its fee arrangement with the adviser. On the basis of such information they should decide whether the adviser has a stronger self-interest in some funds than in others. In making this decision, they should consider the relative importance of each fund's sales to the total sales of all the funds in the complex, the relative dependence of each fund's sales upon portfolio performance, and the relative lucrativeness of each fund's fee arrangement. They should be particularly sensitive to incentive fees, especially if their fund's fee is unrelated to performance. They should focus specifically upon the benefits their fund offers the adviser as compared with the benefits offered by other funds with similar investment objectives.

2. If the nonaffiliated directors conclude that the adviser's self-interest in their fund is comparatively weak, they should assure that the fund's interest is protected in situations where the adviser may favor other funds in the group. To do so effectively, they must understand the process by which the fund's portfolio is managed. They might garner information on the investment process in interviews with the director of investment management, the fund's portfolio manager or a member of its investment committee, the central trader, and possibly an analyst in the collective research department.

Some relevant questions would be:

a) To what extent does the adviser rely upon outside research and to what extent upon in-house research?

b) Is research done with particular funds in mind or does a collective research staff pursue whatever investments seem most promising?

c) Has a formal system been established for distributing research to the portfolio decisionmakers?

d) Are fund portfolio decisions made by a portfolio manager or investment committee working solely for the fund, or by an individual or committee which manages all the funds in the group?

1) If by a manager or an investment committee serving several funds does some person or group in the investment management division represent only the fund's interest?

e) How does the central trader execute transactions, especially when more than one fund wishes to purchase or sell the same security?

With the answers to such questions the nonaffiliated directors will be in a good position to judge whether the procedure by which the fund is managed provides a solution to the conflicts which potentially might arise between the funds. Thus, if each fund conducts its own research and keeps this research for its sole use and if each has its own trader to handle its executions, no problem of allocating investment opportunities or executions arises. Alternatively, if the adviser does collective research or a central trader serves all the funds, a portfolio manager or other representative may champion the fund's interests. If their fund has such a champion, the nonaffiliated directors' principal duty is to see that he is doing an effective job. Through regular interviews, they should assure themselves that he is sensitive to possible conflicts and should determine whether he has encountered any instances in which he thinks the fund has received adverse treatment. The nonaffiliated directors should handle such interviews delicately so as not to create tension between the portfolio manager and the adviser. They should also ascertain whether the portfolio manager's salary is affected by fund performance and whether formal methods of disseminating information give him equal access to the basic research product.

If the fund does not have someone to champion its interests, then the nonaffiliated directors themselves should assume the task. They might want to use a chart which lists the significant holdings of each fund in the complex and indicates all purchases and sales for the month. After a few months, the nonaffiliated directors may be able to detect from such a chart a pattern in which certain funds always seem to be investing in the seemingly attractive companies with too few shares available to go into more than one or two portfolios. If they do detect such a pattern, they should have the adviser explain why the fund has not been investing in such companies. If the adviser answers that such investments are inconsistent with the fund's investment objective, the nonaffiliated directors might want to ask whether the objective might not be better achieved by investing in stocks of diverse quality which, when mixed together, reflect the desired degree of volatility. If, on the other hand, the adviser answers that such investments are too small to have a significant impact on the fund's performance, the nonaffiliated directors might want to explore with the adviser the possibility of increasing the number of stocks in the portfolio or of setting apart a portion of the portfolio for smaller-than-average holdings.

Where the funds do not have separate traders, the nonaffiliated directors should also review the method that the adviser has been using to allocate purchases or sales of securities among the funds in the

group. They should decide whether the method used is evenhanded and might want to consider whether it causes the fund to incur higher commissions by spreading purchases over a greater number of days.

3. The nonaffiliated directors should also direct their attention to the brokerage generated by fund portfolio transactions. They first should consider whether the funds collectively might not be able to support a brokerage subsidiary which could recapture for the funds part of the value of the commissions routed through it. If a subsidiary is economically feasible, they should require the adviser to show convincingly that such a subsidiary would not be in the fund's interest. If the adviser is a broker-dealer and has been keeping the commissions for itself or if a subsidiary has been created and the adviser is continuing to place portfolio business with other brokers in order to obtain benefits such as outside research, the nonaffiliated directors should take into account the value to the adviser of the commissions or benefits when negotiating the next management contract. In the case of the brokerage subsidiary, however, they should be aware that considerations of best execution may sometimes justify the adviser in placing trades with other broker dealers.

If a decision is made not to create a subsidiary, the nonaffiliated directors should focus on the consequences of pooling the fund's brokerage with the brokerage of the other funds. In considering brokerage for outside research, they should determine whether such research is important and whether it is assigned by persons working directly for the fund. If it is not, then they have no reason to concern themselves further. If it is, the nonaffiliated directors of the funds in which the adviser has a comparatively small self-interest might want to determine from the portfolio manager and analysts working directly for the fund whether they have been assigning all the brokerage that they think the fund can profitably use. If they have, there is no problem since the fund is not losing out on any outside research that it might have put to use. If they have not, the nonaffiliated director, with figures secured from the adviser, might make a comparison each month of the amount of brokerage allowed to the fund's analysts and manager and the amount of brokerage that the fund has contributed to the brokerage-for-research pool. If the comparison is unfavorable, they might argue that the fund's brokerage budget be increased.

The nonaffiliated directors should also examine the consequences of pooling brokerage used for sales. If such brokerage is being pooled, they should decide initially whether additional sales of fund shares are in the fund's interest. They might do this by ascertaining whether such sales exceed redemptions and, if so, whether the portfolio manager fore-

sees any difficulty in managing a larger portfolio. In addition, they might consider whether an increase in assets will produce a meaningful reduction in the fund's expense ratio and whether the adviser has been receiving sufficient compensation to maintain a professional and well-staffed investment management division. If the nonaffiliated directors conclude that sales or at least improved sales are not in the fund's interest, they should prohibit the adviser from using the brokerage of the fund or of any other fund in the group to promote sales of the fund's shares. It should be noted, however, that they still might decide to allow the adviser to use the fund's brokerage to promote sales of other funds in the group if growth of the other funds produces indirect benefits for their fund.

If the nonaffiliated directors conclude that an increase in fund net assets is desirable and if the adviser's self-interest in their fund is comparatively weak, they should require a monthly comparison of the amount of brokerage which the fund has contributed to the pool and the amount of brokerage which has gone to reward sales of their fund. If this comparison suggests that the fund is being slighted, they should pressure the adviser into making more proportionate the ratio of the brokerage which the fund contributes to the pool and the brokerage which is assigned as a reward for sales of the fund's shares. Should this prove ineffective in spurring sales, they might allow the adviser free reign in assigning brokerage.

4. Regardless of whether the adviser's self-interest in the fund is large or small, the nonaffiliated directors have an active role to play with respect to fund expenses. The nonaffiliated directors first should examine the expenses (other than the management fee) which are paid directly by the fund itself. They should have the fund's accountant explain how each major expense incurred jointly with other funds has been allocated. If they judge that the allocation is not in accordance with the benefit which the fund enjoys, they should argue that a different basis for making the allocation be adopted.

Second, the nonaffiliated directors should evaluate the reasonableness of the management fee in terms of the actual cost incurred by the adviser for the services which it furnishes the fund. The cost of some of these services such as the salaries of an accountant, portfolio manager, or analyst who works only for the fund will be easily identifiable, but other costs will have to be allocated among the funds in accordance with some formula. The cost of collective research and the general expenses which go to support the adviser's whole organization should probably be allocated in accordance with the funds' relative net asset values; the cost of administering shareholder accounts, if borne by the adviser,

should be allocated in accordance with the relative number of shareholder accounts.

Having identified the cost to the adviser of running the fund, the nonaffiliated directors can then set about negotiating a fee which reflects these costs. If the costs are primarily costs of collective investment management, they should consider a fee which is based on a percentage of net asset value and which is scaled down in accordance with the combined net assets of all the funds within the complex. If the adviser also incurs special expenses in managing the fund, the nonaffiliated directors might want to pay for these expenses separately or they might agree to a higher percentage of net assets than that payable by the other funds. If the fund does not benefit from a significant portion of the collective research, the nonaffiliated directors might argue that the percentage based on total complex assets should be lower than that paid by the other funds. Finally, if the adviser has been paying a substantial amount of nonmanagement expenses, the nonaffiliated directors should consider paying for these expenses with a separate administrative fee, based on some other formula such as the number of shareholder accounts.