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THE INVESTMENT COMPANY AMENDMENTS ACT OF 1970

Walter P. North*

I. Introduction

The June, 1969, issue of the *Notre Dame Lawyer* included an article by the present author on the history of federal investment company legislation.¹ This article is, in a sense, a sequel to that one since it brings the legislative history in that area down to the present time. More accurately, though, this article is not just a sequel; it does more than merely extend the legislative history to date. It undertakes, though briefly, to describe some of the major provisions of the Investment Company Amendments Act of 1970² [hereinafter referred to as the 1970 Act], which is by far the most significant piece of federal legislation in the investment company or mutual fund field since the Investment Company Act of 1940³ [hereinafter referred to as the 1940 Act].

II. Legislative History of the 1970 Act in in Ninety-first Congress

Serious efforts to obtain legislation to provide mutual fund reforms started with the 90th Congress. In that Congress identical draft bills, prepared by the Securities and Exchange Commission, were simultaneously introduced in both the Senate and the House of Representatives on May 1, 1967. There were significant developments during that Congress which had a marked impact on this legislation. These events must accordingly be regarded as noteworthy parts of the legislative history of the Act which ultimately emerged nearly four years later in the closing days of the 91st Congress.⁴ Little purpose would be served by repeating all of the relevant events in the 90th Congress or, for that matter, the events in the 91st Congress through April of 1969, since all of these events are discussed in the June, 1969, issue of the *Notre Dame Lawyer*.⁵ Nevertheless, in

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1 North, *A Brief History of Federal Investment Company Legislation*, 44 *NOTRE DAME LAWYER* 677 (1969).

2 Act of Dec. 14, 1970, Pub. L. No. 91-547, 84 Stat. 1413 [hereinafter cited as 1970 Act]. This act was S. 2224 in the 91st Congress. The Conference Report (H. REP. No. 91-1631, 91st Cong., 2d Sess. (1970)) was accepted unanimously by the Senate on November 30, 1970, and by voice vote in the House on December 1, 1970. It was signed by the President on December 14, 1970, and became Public Law 91-547.

3 15 U.S.C. § 80a. Many knowledgeable persons regard the 1970 Act as the most important piece of legislation during the last thirty years in the field of the federal securities laws — not just in the area of the mutual funds. If such a view is warranted, one should at least hasten to add that the Securities Acts Amendments of 1964 (Act of Aug. 20, 1964, Pub. L. No. 88-467, 78 Stat. 565) represented another very significant development in this general area. The SIPG bill (Act of Dec. 30, 1970, Pub. L. No. 91-598, 84 Stat. 1636) which will provide insurance to protect accounts of investors against possible insolvency of the brokers and dealers through whom they engage in securities transactions was signed by the President only a few days later than the 1970 Act and is also a very notable milestone in securities legislation.

4 See North, *supra* note 1, at 692-95.

5 See *id.* at 695-96, especially footnote 42 which updated developments through April 15, 1969.

the interest of providing a reasonably complete outline of relevant activities during the 91st Congress, there is appended to this article a chronology of all significant mutual fund reform developments which occurred during that Congress, including the few such developments which are already mentioned in the earlier article.

Whenever legislation passes through several versions before final enactment, and whenever there are hearings and floor debates on the various versions, a lawyer seeking to construe a particular provision of the bill which ultimately becomes law, either in the context of advising his client or of conducting litigation, will do well to review carefully the varying ways in which that provision may have been worded in earlier versions and also to examine the portions of any Congressional hearings or debates which may have been directed to it. Obviously, however, a law review article of modest proportions cannot trace the history of large numbers of provisions which undergo substantial changes throughout several versions of a bill or bills on which there are extensive hearings and substantial floor debate over a period of nearly two years (as was the case here). The principal reason for preparing the appended chronology is to provide a lawyer who wants to trace the history of a particular provision in the 1970 Act with a ready means of doing so even though this article cannot so trace the history of all, or of even the more important, provisions of that Act.

In the very early days of the 91st Congress, Senator John J. Sparkman, Chairman of the Senate Banking and Currency Committee, introduced S. 34;⁶ it was identical to S. 3724 as it was finally passed by the Senate in the 90th Congress (the House did not act on S. 3724 during the 90th Congress). The legislative history of the mutual fund reforms, therefore, started off in the 91st Congress exactly where it left off when the 90th Congress adjourned, and made even more significant the events of that earlier Congress.

As is often the case with major remedial legislation, there were widely varying views as to what was in the public interest and what the industry desired. This is attested rather strikingly by the fact that during the course of the 91st Congress, S. 34 was followed by seven other versions of proposed mutual fund reform bills.⁷ Some of these differed so greatly from S. 34 that one could perceive that they were designed in part, at least, to relieve the industry from an already too oppressive pattern of regulation rather than to afford the investing public with long overdue protections. The 1940 Act had never before been amended in a way which added substantially to its original investor protections, and some of the provisions of these bills seem to have been designed to reverse a number of those.⁸

6 91st Cong., 1st Sess. (1969); introduced Jan. 15, 1969.

7 In the order in which they were introduced, these seven bills were: S. 296, H.R. 8980, S. 2224, H.R. 11995, H.R. 12867, H.R. 14737, and H.R. 17333. See attached appendix. Two of these bills (S. 2224 and H.R. 17333) were called "clean" bills. They were introduced to replace earlier bills which had become so patched with additions and changes as to be difficult to work with. Even these clean bills, however, underwent changes before the ultimate enactment of S. 2224.

8 In particular, the bills introduced by Congressman W.S. Stuckey, H.R. 8980, H.R. 12867 and H.R. 14737, 91st Cong., 1st Sess. (1969), and to a lesser extent the bill first passed by the House, H.R. 17333, 91st Cong., 2d Sess. (1970), contained provisions which favored the mutual fund industry — as contrasted with the original provisions of the 1940

While the hearings and floor debates associated with any legislation are significant parts of the legislative history, in the case of the 1970 Act, probably even more important to a proper understanding and construction of the Act are the committee reports. There were three associated with the 1970 Act—the report of the Senate Banking and Currency Committee, May 21, 1969, on S. 2224⁹ (the so-called “clean” Senate bill as it read originally) [hereinafter referred to as the Senate Report]; the Report of the House Interstate and Foreign Commerce Committee, August 7, 1970, on H.R. 17333,¹⁰ [hereinafter referred to as the House Report]; and the Committee of Conference Report, November 25, 1970, on S. 2224¹¹ (in the form in which it eventually was passed by both Houses of Congress) [hereinafter referred to as the Conference Report].

The Conference Report is in some respects the most significant of these three reports since it deals with the bill in precisely the form in which it was ultimately enacted. Also, the “Statement of the Managers on the Part of the House” contained in that report explains how the substantive differences between the Senate and House versions of the bill were resolved. On the other hand, little else is contained in the Conference Report, except a copy of the bill as reported out by the Conference Committee. It supplies literally no legislative history on any aspects of the law except those in which there was disagreement between the two houses of Congress. Resort must be had to one or the other of the two earlier reports to gain insight into other portions of the Act.

The Senate Report, which covered the original version of S. 2224, is particularly noteworthy because the 1970 Act follows the version of S. 2224 much more closely than it follows H.R. 17333 in the form in which it was reported out to the floor of the House in the 91st Congress. Moreover, the Senate Report discusses a number of provisions which are in both the original S. 2224 and the final 1970 Act; and these provisions are not discussed in the later Conference Report (the reason they were not discussed is simply because they were not within the areas of disagreement between the Senate and the House). The Senate Report does contain an excellent explanation of all the major substantive portions of the bill,¹² including those which ultimately found their way into the 1970 Act. It must be remembered, however, that not all of the provisions thus explained were in the Act as finally approved.

Since H.R. 17333 did not pass, one might suppose the House Report on it to be of little value. But to the contrary, it is highly significant in two respects. The version of S. 2224 which was passed by the House and then went to a Conference Committee was identical in every respect (except for the bill number) with H.R. 17333 as passed by the House. Thus, at that stage S. 2224 was the same as the bill which was covered by the House Report, except for one clarifying floor amendment which is not pertinent to the present discussion.¹³ Furthermore, as appears

Act. The details and merits of these provisions which did not find their way into the 1970 Act as finally passed are, however, beyond the scope of this article. For a discussion, see *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAWYER 732, 973 (1969) [hereinafter cited as *Survey*].

9 S. REP. NO. 91-184, 91st Cong., 1st Sess. (1969).

10 H. REP. NO. 91-1382, 91st Cong., 2d Sess. (1970).

11 H. REP. NO. 91-1631, 91st Cong., 2d Sess. (1970).

12 S. REP. NO. 91-184, 91st Cong., 1st Sess., at 15-47 (1969).

13 As part of the parliamentary procedure to get a bill before a Conference Committee,

from the Conference Report, the bill which became the 1970 Act does contain a considerable number of provisions which are patterned after the House version (albeit somewhat fewer than those taken from the Senate version), and all of these provisions are discussed in the House Report. Indeed, this report, which is by far the most detailed of the three, contains a complete section-by-section analysis of the entire bill.¹⁴ Again, however, it must be kept in mind that in a large share of the areas where there were differences between the Senate and the House the provisions discussed in this report are not in the 1970 Act.

It should be apparent from the above and from the attached chronology that this new Act evolved from an unusually long chain of Congressional events—events which go back almost to the beginning of the 90th Congress and continue until the closing days of the 91st Congress nearly four years later. Many of these events, together with the investment company studies and reports which preceded them,¹⁵ provide an almost unprecedented mass of legislative history for the guidance of practitioners and professors of law as well as judges as they struggle with the task of seeking meaningful interpretations of the considerable additions which the 1970 Act makes in the field of investment company law. Hopefully, all of these bits of legislative history will provide a collective impact on the construction and development of the law in the direction of more effective protection of investors—a direction which in the long run will best serve the mutual fund industry as well as the public interest.

III. Substantive Provisions of the 1970 Act

Printed as Public Law 91-547, the Act consists of twenty-four pages; it contains thirty sections; and, excluding technical provisions such as those which merely re-number sections or paragraphs of existing statutes, it amends the federal securities laws in some sixty respects. Obviously, not all of these additions and changes are of great moment. In fact, some of them are not essentially “changes” since they simply clarify or confirm previously taken administrative positions. Even the truly substantive provisions are, however, too numerous to permit meaningful discussion except on a selective basis. Accordingly, only ten or twelve aspects of the Act have been chosen for discussion here, admittedly at the risk of omitting others which could well be of greater interest to some readers.

A. *Amendments to Federal Securities Laws Other Than the 1940 Act*

The short title of the Act, “Investment Company Amendments Act of 1970,” seems to suggest that the 1970 Act amends only the Investment Company Act of 1940. In fact, it also amends the Securities Act of 1933,¹⁶ the Securities Ex-

the House, after passing H.R. 17333 with a floor amendment, amended S. 2224 by striking everything after the enacting clause and substituting the text of H.R. 17333, as passed a few moments earlier. The House then passed S. 2224 as amended. 116 CONG. REC. H9087-H9104 (daily ed. Sept. 23, 1970).

¹⁴ H. REP. NO. 91-1382, 91st Cong., 2d Sess., at 13-46 (1970).

¹⁵ See North, *supra* note 1, at 688-90.

¹⁶ 15 U.S.C. §§ 77a to 77aa (1964).

change Act of 1934,¹⁷ and the Investment Advisers Act of 1940,¹⁸ in ways which perhaps merit brief treatment.

1. SECURITIES ACTS

The amendments to the 1933 and 1934 Acts¹⁹ are designed to simplify certain bank and insurance company operations which are closely akin to mutual fund operations. Most important, interests in bank trusts used to fund employee pension plans, other than self-employed plans known as Keogh or H.R. 10 plans, are exempted from the registration provisions of both the 1933 and the 1934 Acts.²⁰ Interests in collective H.R. 10 plans are similarly exempted as to the 1934 Act, but not as to the 1933 Act, except as the Commission may provide otherwise by rule or order.²¹ Bank common trust funds used for collective investment of assets held as trustee, executor, administrator or guardian are likewise exempt from both of those acts.²²

As to insurance companies, the amendments to the 1933 and 1934 Acts provide exemptions for their so-called separate accounts which are comparable to the exemptions just discussed in relation to bank trusts, including the same

17 15 U.S.C. §§ 78a to 78hh-1 (1964).

18 15 U.S.C. §§ 80b-1 to 80b-21 (1964).

19 These amendments are found in §§ 27 and 28 of the 1970 Act. Section 27 amends §§ 2 and 3 of the 1933 Act by adding two new paragraphs (13 and 14) to § 2 and by amending the wording of subsections (a)(2) and (a)(5) of § 3. Section 28 amends §§ 3 and 12 of the 1934 Act by amending the wording of subsections (a)(12) and (a)(19) of § 3, and by adding a new paragraph (H) to subsection (g)(2) of § 12. Section 29 of the Act also "amends" both the 1933 Act and the 1940 Act in the sense that it provides that those acts shall not apply to interests in insurance company separate accounts under certain conditions set forth in that section.

In amending § 3(a)(2) of the 1933 Act and § 3(a)(12) of the 1934 Act, the draftsmen of the 1970 Act overlooked the fact that those same two sections had been amended earlier in the same Congress (*see* title IV of the Act of Aug. 10, 1970, Pub. L. No. 91-373, 84 Stat. 695) to provide exemptions for certain industrial revenue bonds. Thus the passage of the 1970 Act repealed the industrial revenue bond exemptions. This was corrected by reenactment as a part of the tender offer amendments (Act of Dec. 22, 1970, Pub. L. No. 91-567, 84 Stat. 1497) and signed by the President on December 22, 1970 — only eight days after he signed the subject Act. There was, nevertheless, a brief hiatus in the industrial revenue bond exemptions as a result of this inadvertence, though Congress sought to, and perhaps did, overcome this lapse by making the amendment retroactive to January 1, 1970.

20 *See* note 19, *supra*.

21 *Id.*

22 *See* note 20 *supra*. The subject of bank collective funds for the investment of managing agency accounts is not dealt with in the Act, although the Senate version of the bill which went to conference expressly authorized them and the House version contained a somewhat modified authorization. The Commission and the Comptroller of the Currency, through the administrative action, had previously permitted First National City Bank of New York to maintain such a collective fund for managing agency accounts, but their action in that regard was challenged in litigation which is now pending in the Supreme Court. *Nat'l Ass'n of Sec. Dealers v. S.E.C., First Nat'l City Bank v. Inv. Co. Institute and Comptroller of the Currency v. Inv. Co. Institute*, 420 F.2d 83 (D.C. Cir.) *cert. granted*, 397 U.S. 986 (1969). Oral argument was held in December of 1970. 39 U.S.L.W. 3265 (U.S. Dec. 22, 1970). Apparently the conferees preferred to await the Supreme Court's decision rather than to treat the issue legislatively at this time. In fact, Senator Sparkman said precisely this in his statement on the floor of the Senate. 116 CONG. REC. S18996 (daily ed. Nov. 30, 1970). Moreover, this subject is a highly controversial one, with the mutual funds and their managers and the broker-dealers who sell their shares vigorously contesting the right of banks to enter "their field" with a product which is virtually equivalent to mutual fund shares. For a discussion of this field, *see Commingled Investment Accounts: Banks v. Securities Industry*, 45 NOTRE DAME LAWYER 746 (1970).

distinction between separate accounts used to fund H.R. 10 plans and those used for other purposes such as typical variable annuities.²³

2. INVESTMENT ADVISORS ACT

The amendments to the Investment Advisers Act of 1940²⁴ [hereinafter referred to as the Advisers Act] are more numerous. Beginning one year after December 14, 1970, the effective date of the Act,²⁵ investment advisers whose sole clients are investment companies will now be required to register under the Advisers Act.²⁶ The major significance of this change is twofold. Advisers to mutual funds will be required to register and therefore become subject to the same pattern of regulation and discipline as other advisers who are already required to register under the Advisers Act. More importantly, the tie-in between this requirement and other provisions in the 1970 Act "beef up" that pattern very materially. This strengthening of the disciplinary functions of the Advisers Act becomes strikingly apparent upon comparing the old provisions for revoking or suspending the registration of an investment adviser as contained the former section 203(d) of the Advisers Act with the new ones which are now substituted for them by the 1970 Act.²⁷ Ancillary to this change, but of considerable significance, are the introduction of the concept of a "person associated with an investment adviser" and a provision for barring or suspending persons from being so associated.²⁸

All of the new provisions in the Advisers Act for disciplining investment advisers and persons associated with them follow very closely the format of pro-

23 Although dealing with amendments to the 1933 and 1934 Acts at this point, it should be noted that the relief afforded banks and insurance companies in relation to collective trust funds and separate accounts also involved amending the 1940 Act. Thus, § 3(b) of the 1970 Act amends § 3(c)(13) of the 1940 Act, (redesignated as (11) in the 1970 Act) in such a way as to exclude from the definition of an investment company (and accordingly from registration as an investment company under the 1940 Act) any employee stock bonus, pension or profit-sharing trust which "qualifies" under § 401 of the Internal Revenue Code, any bank collective trust used solely to fund any such trust, and any separate account consisting solely of contributions to pension and profit-sharing plans which so "qualify" or which "qualify" for employer deduction under § 404(a)(2) of the Code.

24 15 U.S.C. §§ 80b-1 to 80b-21 (1964) [hereinafter cited as Advisers Act]. The amendments to the Advisers Act are contained in §§ 23-26 of the 1970 Act. These sections amend the following sections of the Advisers Act: § 202(a), 15 U.S.C. § 80b-2(a) (1964); § 203(b), 15 U.S.C. § 80b-3(b) (1964); § 203(c), 15 U.S.C. § 80b-3(c) (1964); and § 205, 15 U.S.C. § 80b-5 (1964). Sections 203, 15 U.S.C. § 80b-3 (1964) is further amended by inserting new subsections (d) and (f) and renumbering certain existing subsections. A new § 206A is added to the Advisers Act immediately after § 206, 15 U.S.C. § 80b-6 (1964).

25 A number of provisions in the Act have deferred effective dates of one year. Two of them are deferred six months and one is deferred eighteen months. Pub. L. No. 91-547, § 30 (Dec. 14, 1970).

26 Actually the Advisers Act does not require anyone to register under it, but it prohibits the use of the mails or interstate commerce facilities in connection with the business of a non-exempt investment adviser unless he is registered. In the case of an investment adviser to a mutual fund, it would be virtually impossible to avoid use of the mails and interstate instrumentalities. See § 203(a) of the Advisers Act, 15 U.S.C. § 80b-3(a) (1964). The 1970 Act does, however, remove use of the mails or interstate facilities as a requirement incident to all other matters which a registered investment adviser is prohibited from doing. See § 203(d), 15 U.S.C. § 80b-3(d) (1964).

27 For a graphic comparison, see H. REP. NO. 91-1382, 91st Cong., 2d Sess., at 181-83 (1970).

28 Section 23(2) of the 1970 Act adds a new ¶ (17) to § 202(a) of the Advisers Act, 15 U.S.C. § 80b-2(a) (1964), defining the term "person associated with an investment adviser." Section 24(e) of the 1970 Act adds a new subsection (f) to § 203 of the Advisers Act, 15 U.S.C. § 80b-3 (1964), providing for the disciplining of such associated persons.

visions relating to broker-dealers and their associated persons which were a part of the Securities Acts Amendments of 1964.²⁹ Judicial and Commission interpretations of those provisions in the intervening six years, as well as henceforward, should accordingly be helpful, if not controlling, as to the construction to be placed upon these new comparable provisions in the Advisers Act.

Finally, the 1970 Act expands the Commission's statutory authority to grant exemptions to persons and transactions and classes of persons and transactions which would otherwise be subject to the provisions of the Advisers Act as amended by the 1970 Act.³⁰

B. *Amendments to the Investment Company Act of 1940*

The vast majority of the provisions of the 1970 Act are, of course, amendments to the 1940 Act. These amendments will be dealt with, in so far as logical sequence permits, in the order in which they are set forth in the 1970 Act.

1. THE "INTERESTED PERSON" CONCEPT

Section 2(a)(3) of the 1970 Act amends section 2(a) of the 1940 Act by adding a new paragraph 19 defining the term "interested person." The term is applicable to investment companies and to investment advisers or principal underwriters of investment companies. While this term includes persons who came within the previously existing statutory concept of "affiliated persons,"³¹ it also includes many others who have such relationships as could result in bias or influence or conflict of interest situations against which the earlier and narrower affiliated concept has not afforded investor protection.³² The significance of this

²⁹ Act of Aug. 20, 1964, Pub. L. No. 88-467, 78 Stat. 565, amending 15 U.S.C. § 78c-(a)(18) (1964), 15 U.S.C. § 78o-(b)(5) (1964), and 15 U.S.C. § 78o-(b)(7) (1964).

³⁰ Section 26 of the 1970 Act adds a new § 206A to the Advisers Act. Section 25 of the 1970 Act also amends § 205 of the Advisers Act, 15 U.S.C. § 80b-5 (1964), in relation to so-called performance fees under investment advisory contracts. The principal thrust of this amendment is to place restrictions on such arrangements with investment advisers who are advising or managing mutual funds registered under the Investment Company Act, rather than advisers serving other types of investor clients. Discussion of it is accordingly deferred to the portion of this article dealing with amendments to the Investment Company Act of 1940. See text accompanying note 62 *infra*.

³¹ The 1940 Act defines an affiliated person as:

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

³² Section 2(a)(3) adds the following:

(19) "Interested person" of another person means—

(A) when used with respect to an investment company—

(i) any affiliated person of such company,

(ii) any member of the immediate family of any natural person who is an affiliated person of such company,

(iii) any interested person of any investment adviser of or principal under-

new concept rests largely in the manner in which it is tied in with other provisions of the 1970 Act. Thus, for example, sections 5(a) and 5(b) of the 1970 Act amend sections 10(a) and 10(b) of the 1940 Act so that under section 10(a) not just affiliated persons, as before, but all types of persons who come within the new interested person concept are excluded from the forty per cent of the membership of an investment company board of directors which must consist of so-called independent directors. In section 10(b), the former affiliated person restrictions on employing regular brokers and principal underwriters are supplanted by interested person restrictions. Section 8(c) of the 1970 Act similarly amends section 15(c) of the 1940 Act so that all interested persons are excluded from the independent director vote on entering into or renewing contracts with investment advisers and principal underwriters. Section 18 of the 1970 Act amends section 32(a)(1) of the 1940 Act to restrict in like fashion the vote on the selection of independent public accountants who certify investment company financial statements to a majority of the "board of directors who are not interested persons of such registered company"³³

These Amendments will prevent a whole new and enlarged category of

writer for such company,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such company,

(v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and

(vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any other investment company having the same investment adviser or principal underwriter or with the principal executive officer of such other investment company:

Provided, That no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso; and

(B) when used with respect to an investment adviser of or principal underwriter for any investment company—

(i) any affiliated person of such investment adviser or principal underwriter,

(ii) any member of the immediate family of any natural person who is an affiliated person of such investment adviser or principal underwriter.

(iii) any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued either by such investment adviser or principal underwriter or by a controlling person of such investment adviser or principal underwriter,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such investment company has acted as legal counsel for such investment adviser or principal underwriter,

(v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and

(vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since the beginning of the last two fiscal years of such investment company a material business or professional relationship with such investment adviser or principal underwriter or with the principal executive officer or any controlling person of such investment adviser or principal underwriter

³³ Additionally § 5(d) of the 1970 Act amends § 10(d) of the 1940 Act, 15 U.S.C. § 80a-10(d) (1964) so as to substitute the concept of an interested person for that of an affiliated person in that section. In this instance, however, the restrictive effect of the change is minimal because § 10(d) merely defines certain very limited circumstances under which all but one of the investment company directors may be an affiliated (now an interested) person of the investment adviser.

persons who have substantial motivations other than the best interests of the shareholders from participating in important decisions which should be based on shareholder considerations. At the very least, they represent Congressional acknowledgement that, if the interests of shareholders are to be accorded truly paramount treatment, they need protections beyond those afforded by the original 1940 Act. Hopefully, the 1970 Act will provide such protection.³⁴

2. COMMISSION AUTHORITY TO BAR PERSONS FROM THE INDUSTRY

Section 4(b) of the 1970 Act amends section 9 of the 1940 Act by inserting a new subsection (b) which authorizes the Commission, after notice and an opportunity for a hearing, to bar any person from serving "as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter" if such person has, succinctly and generally stated, willfully made false filings with the Commission under the 1940 Act, or if such person has willfully violated or aided and abetted violations of the 1933 Act, the 1934 Act, the Advisers Act or the 1940 Act or any rule under any of them.

As in the case of certain of the amendments to the Advisers Act which are discussed above,³⁵ this addition to the 1940 Act is much in line with the Commission's authority over brokers and dealers under the 1934 Act as amended by the Securities Acts Amendments of 1964.³⁶ By the same token, Commission and court precedents in proceedings to revoke broker-dealer registrations and to bar persons from being affiliated with broker-dealers should provide reliable guidelines in construing this new provision which has now been added to the 1940 Act.

While this new authority to discipline persons identified with the investment company industry is obviously a salutary enforcement weapon when violations of the types which it encompasses do occur, its deterrent effect may well prove to be equally valuable. A person otherwise disposed to make false filings or to violate or induce others to violate the specified acts or rules might well refrain when faced with the prospect of being barred from the industry.³⁷

3. RESTRICTIONS ON FUND HOLDING COMPANIES

This area is too involved to permit any very effective discussion here. Moreover, the new Act leaves much to be desired in affording appropriate additional investor protection.³⁸ Nevertheless, it should at least be noted that section 7 of the

³⁴ See generally Survey.

³⁵ See text accompanying note 24 *supra*.

³⁶ See note 29, *supra*.

³⁷ One advantage of administrative proceedings of this type over court injunctive actions, often overlooked by those critical of regulatory enforcement tools, is that the court injunction in effect permits one bite of the forbidden apple without serious consequences. The injunction, by its own terms, prohibits only future violations, not all future activity in the industry. By contrast, administrative proceedings of the type which may now be brought under the 1940 Act can, if the Commission determines it to be in the public interest, result in an immediate bar from the industry. 1970 Act § 4(b).

³⁸ Indeed, it was the Commission's view as far back as 1966 that fund holding companies should be abolished. See REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON THE

1970 Act extensively amends section 12(d) of the 1940 Act (relating to fund holding companies). Generally stated, the thrust of these amendments is to additionally restrict certain activities of existing holding companies and to place new limitations and conditions on the future establishment and operation of other such companies.

The 1970 Act also seeks to deal as effectively as circumstances permit with foreign-based holding companies which are not registered under the 1940 Act and could accordingly, prior to the 1970 Act, purchase unlimited amounts of the shares of American-based registered investment companies notwithstanding the limitations on such purchases by fund holding companies which are thus registered.³⁹

4. EVALUATION OF THE TERMS OF ADVISORY CONTRACTS

It has long been felt that investment advisory contracts are often not as favorable to funds and their shareholders as they should be because they are not formulated by truly arms-length dealings. When sixty per cent of the fund's board may consist of members who have strong personal reasons for wanting management to thrive, and the shareholders are virtually the captives of management (fund shareholders have yet to "fire" management by voting against a proposed advisory contract or voting to terminate an existing one), provisions which require that advisory contracts be approved by the shareholders in the first instance and that they also be approved by a majority vote of the forty per cent of the directors who are independent are rather unrealistic in terms of affording substantial protections to investors in mutual funds.⁴⁰ In an effort to strengthen those protections, section 8(c) of the 1970 Act adds the requirement that directors must request and evaluate, and investment advisers must furnish, "such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company."

There is little basis, other than pure conjecture, to foretell the effectiveness of this provision in the practical setting of negotiating innumerable investment advisory contracts over the years. Moreover, it is not entirely clear from the wording of this new provision that it applies to annual renewals of such contracts. The Commission has, however, construed it in this fashion,⁴¹ and directors of investment companies would probably be well advised to do likewise. As a minimum, this provision should stand as a reminder to officials in the mutual fund industry of their fiduciary obligation to their shareholders.⁴² It should also

PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H. REP. NO. 2337, 89th Cong. 2d Sess., at 323 (1966). The companion draft bills which the Commission prepared soon after the completion of this report and which were introduced in both houses on May 1, 1967, contained such provisions. See North, *supra* note 1, at 693. It is the author's own view that there is little or no economic reason to permit the pyramiding of sales charges, management fees, administrative costs and other expenses layer upon layer. It is even more difficult to see how the interests of public investors are served by such arrangements.

³⁹ For a discussion of pre-1970 law and SEC recommendations, see *Survey* at 763-67.

⁴⁰ For a discussion of recent court attempts by fund shareholders to challenge such approvals, see *Survey* at 917-30.

⁴¹ SEC Investment Company Act Release No. 6336 (Feb. 2, 1971).

⁴² For a discussion of the SEC position on fiduciary duty, see 1969 *House Hearings*, pt. 1,

assist the Commission in evaluating the bona fides and thoroughness with which responsibilities in this area are met. Finally, it will indeed be surprising, in the context of private derivative litigation, if enterprising shareholders and their counsel are not on the alert to make the most of it whenever they can demonstrate noncompliance or only inadequate token compliance with this new requirement.

5. PREVENTION OF FRAUDULENT PRACTICES

Section 9(c) of the 1970 Act adds a new subsection 17(j) to the 1940 Act. This subsection gives the Commission rule-making authority of an anti-fraud nature with respect to affiliated persons of and principal underwriters for investment companies and affiliated persons of investment advisers of and principal underwriters for such companies. It is patterned closely after the well-known section 10(b) of the 1934 Act,⁴³ concerning which there has been very extensive text and law review treatment and untold court decisions, all of which should be pertinent to the development of the law under this new provision in the 1940 Act.⁴⁴ It is limited, however, to fraudulent practices by the named affiliated persons and principal underwriters "in connection with the purchase or sale,"⁴⁵ directly or indirectly, by such person of any security held or to be acquired by such registered investment company." Another important feature of this new subsection is that the rule-making power granted to the Commission includes the power to make rules which require "the adoption of codes of ethics by registered investment companies" and their investment advisers and principal underwriters "establishing such standards as are reasonably necessary to prevent such [fraudulent, deceptive or manipulative] acts, practices or courses of business." This new rule-making power is doubly significant. It is not only keyed to "codes of ethics" which the Commission may require the industry to adopt, but it also injects the concept of "such standards as are reasonably necessary" to prevent fraud, a concept which is not spelled out in section 10(b) of the 1934 Act.

Some persons who are very knowledgeable in this field incline to the view that, other than the obviously broadening effect of adding the codes of ethics standards to the rule-making power, this new provision does little more than confirm by statute the proposition that prior interpretations of section 10(b) of the 1934 Act and rules promulgated under it could be used to achieve the same results. It would seem, however, that such a view considerably underestimates the

at 199-203. The 1970 Act specifically imposes a fiduciary duty on officers, directors, members of advisory boards, investment advisers, depositors, and principal underwriters of open-end companies, unit investment trusts, or face-amount certificate companies. 1970 Act § 20. Fiduciary duty is also discussed in the text following note 78 *infra*.

43 Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1964).

44 It is common knowledge among members of the securities bar that there are unfortunate variations and indeed some rather direct conflicts in judicial interpretations of this much litigated provision in the 1934 Act and some of the rules under it, particularly SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1970), which may spill over into the development of the law under this new provision in the 1970 Act.

45 This "in connection with the purchase or sale" phrase in § 10(b) of the 1934 Act has been and still is the focal point of much of the variation in court decisions interpreting that anti-fraud provision ever since the long-famous decision in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.) *cert. denied*, 343 U.S. 956 (1952). This phrase should not, however, cause trouble in construing subsection (j) since it is expressly limited to purchases and sales by the persons named therein.

potential of this new provision on several scores. The 1970 provision is limited to the specific area of purchases and sales by certain named "insiders" whose fiduciary duties are presumably higher than those of the mill-run of persons who may be charged with violating section 10(b) of the 1934 Act; it is limited to their purchases and sales of securities "held or to be acquired by" the very investment company in which they are insiders; and the insider relationship per se mitigates against conduct for one's own benefit which does or may take advantage of inside information and correspondingly work at cross-purposes with the best interests of public investors in the very investment company in which the insider holds a position of trust and confidence. Under these circumstances, courts should react more favorably in the breadth of their interpretations of these provisions than they have sometimes reacted in construing the much more general provisions of section 10(b) of the 1934 Act and rules under it. On balance, it is suggested that this new anti-fraud provision is truly a significant part of the 1970 mutual fund reforms.

6. SALES LOADS ON MUTUAL FUND SHARES

Section 12 of the 1970 Act amends section 22 of the 1940 Act, which deals with sales loads on redeemable shares issued by investment companies. These changes thus apply only to open-end investment companies, or mutual funds, since closed-end companies do not issue redeemable shares. While the changes are clarifying and technical, those made in section 22(b) are of considerable substance. The principal features of these amendments, stated briefly and very generally are:⁴⁶

1. The authority of the National Association of Securities Dealers (NASD) to adopt self-regulatory rules as to sales loads, which was formerly governed by the standard of preventing "an unconscionable or grossly excessive sales load," is now stated in terms of an offering price to the public which does not include "an excessive sales load" with a further guideline that sales loads shall "allow for a reasonable compensation for sales personnel, broker-dealers, and underwriters and for reasonable sales loads to investors."
2. After eighteen months, or earlier if the NASD has promulgated its rules in this area, the Commission may change or supplement such NASD rules in the same way that it may now do with certain other NASD rules under section 15A(k)(2) of the 1934 Act.

⁴⁶ Some changes which were considered but did not occur are also significant. It was suggested that retail price maintenance should be abolished and that maximum upper limits on sales loads should be written into the statute. *See, e.g.*, § 12 of S. 1659, H.R. 9510 and H.R. 9511, 90th Cong., 1st Sess., prepared by the Commission and introduced in both houses on May 1, 1967. *See also* North, *supra* note 1 at 692-95. Not only was the retail price maintenance retained, but the rule-making authority to maintain it was removed from possible anti-trust attack by paragraph (4) added to subsection (b) of § 22 of the 1940 Act, which provided that such authority should prevail over any conflicting federal law. 1970 Act § 12. In lieu of upper limits on sales loads, the system of regulating such loads by rules adopted by the National Association of Securities Dealers was retained and strengthened somewhat from the standpoint of the investor. *Id.*

3. As to SECO (S.E.C. Only—not members of the NASD) broker-dealers, the Commission is given rule-making authority comparable to that given to the NASD with respect to its members. Underwriters of fund shares may, however, elect to comply with the NASD rules instead of the SECO rules.
4. The Commission is authorized to grant qualified exemptions to smaller companies or classes of companies if it appears that they are "subject to relatively higher operating costs."⁴⁷

The efficacy of these new sales load provisions remains to be seen. Granted that self-regulation has worked effectively as to some other aspects of the federal securities laws, it may overtax human nature to expect persons to regulate their own incomes in a manner which is consistent with the interest of public investors—especially when the self-regulating scheme is non-competitive and exempt from the anti-trust laws. While there may be plausible or even valid reasons why the normal forces of competition, top statutory limitations, or direct regulation by the Commission, would not be practical or otherwise desirable in the context of sales loads on mutual funds shares, such considerations do not, of course, provide any assurance that the alternative of self-regulation will necessarily result in a more acceptable solution—particularly from the standpoint of the public investor with whom the Investment Company Act is primarily concerned.⁴⁸

7. FRONT-END LOADS ON CONTRACTUAL PLANS

Section 16 of the 1970 Act amends section 27 of the 1940 Act by adding five new subsections.⁴⁹ These subsections provide further regulation of periodic payment or contractual plans issued and sold by mutual funds. The limitations on the extent to which the sales loads on early installments under such a plan may exceed those on later installments (*i.e.*, may be loaded onto the front-end of the plan) have certainly not been very restrictive in the past. Since 1940, section 27(a) has permitted a sales load of up to fifty per cent to be deducted from each of the first twelve monthly payments, with deductions from subsequent payments leveled off so that the total sales load over the life of the plan does not exceed nine per cent of the total payments. If this right to load such a plan in the first year is fully utilized by the issuer, as it often is, it works to the disadvantage of the investor if he surrenders his plan in its early years and, to a lesser extent, if he surrenders it at any time before completion. Even the investor who matures his plan does not have more than half of his first year's payments working for him in the investment portfolio of the mutual fund at any

47 1970 Act § 12, added to § 22(6)(1) of the 1940 Act.

48 The 1970 Act (§ 6) amends § 11(b) of the 1940 Act in a manner somewhat akin to the foregoing discussion of sales loads, but it hardly deserves text treatment here. Prior to the 1970 Act, some investment companies, which issued more than one class or series of shares granted options to their shareholders to convert from one to the other, but only upon payment of a specified sales charge. This was permitted by a provision in § 11(b) which was eliminated by the 1970 Act. Henceforth if such switching is permitted it must be without a sales load.

49 For a discussion of front-end loads see *Survey* at 852-54, 858-62.

time during all the years it takes him to mature it.⁵⁰ Although this section is rather obviously inequitable from the standpoint of the investor, Congress did not (quite apparently because of industry opposition) correct it. Instead, it gave the issuers of such plans two options, either of which affords the investors with some, though certainly less effective, relief.

Under the first option the fifty per cent deduction from payments in the first year and the average deduction of nine per cent over the life of the plan are retained. The plan holder may, however, surrender his certificate evidencing his subscription to and interest in the plan at any time during the first eighteen months after its issuance; if he does so, the issuer must pay him the then value of his account and must also refund all sales load payments in excess of fifteen per cent of his gross payments. Moreover, plan holders who fall delinquent in such manner and to such extent as are described in the amendment must be given advance written notice of their eighteen-month surrender rights, and the notice must state the value of their holdings and the amount they would get back if they were to surrender their certificate.

Under the second option, which must be elected by written notice to the Commission, the sales load on any payment may not exceed twenty per cent, and deductions during the first four years may not average more than sixteen per cent. The nine per cent total over the life of the plan is applicable as with the first option. While the same sales load does not need to be imposed in each of the first four years, monthly deductions must be uniform throughout each of those years separately considered, and the sales load on all monthly payments must be at a constant level after the fourth year.

In addition to the eighteen-month surrender right under the first option, each certificate holder under both types of plans is entitled to a written statement, which must be mailed within sixty days after his certificate is issued, advising him of the charges to be deducted from his payments under his certificate and informing him that he has a right to withdraw within forty-five days after the mailing of the notice. The statement must further specify that upon withdrawal the holder will receive the then value of his account, together with all sales charges he has paid.

The eighteen-month surrender provision under the first option and the forty-five-day right of withdrawal under either option will obviously require the establishment of reserves. The amendment gives the Commission rule-making authority on that subject as well as in other areas, including the form and content of the notice required in connection with both the surrender and the withdrawal provisions.

A mere comparison of the foregoing provisions with those which they replace demonstrates the rather limited extent to which they come to grips with the problem. Viewed as compromise measures in the face of industry opposition, however, they do represent at least some improvement in the protection afforded periodic payment plan investors.⁵¹

⁵⁰ See *Survey* at 858-62.

⁵¹ Other provisions of the 1970 Act grant certain additional protections to investors in two other types of plans: face-amount certificates and unit investment trusts. 1970 Act §§ 15, 17. These are not treated in the text because they represent such a small segment of the total

8. BREACH OF FIDUCIARY DUTY

Section 20 of the 1970 Act amends section 36 of the 1940 Act in two important respects. Since 1940, the test in a Commission action brought to enjoin persons from serving as investment company officers, directors, advisers or principal underwriters and in other named capacities was whether such persons, while serving in any such capacities, had "been guilty . . . of gross misconduct or gross abuse of trust" toward the company they were serving.⁵² The 1970 Act amends section 36 to read that the Commission may bring an action when a person serving in any of the enumerated capacities

has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a *breach of fiduciary duty* involving personal misconduct in respect of any registered investment company for which such person so serves.⁵³ (Emphasis added.)

Probably of equal importance, the new subsection (b) added to section 36 provides:

For purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser . . .⁵⁴

The section further authorizes the Commission or a security holder of the investment company involved, suing on behalf of such company, to bring an action for breach of fiduciary duty against such an adviser and such affiliates of it and any other persons enumerated in subsection (a) who have a fiduciary duty with respect to such compensation or payments. The new subsection also lists six provisions which apply to any such action. While all of these provisions must be taken into account in the context of actual litigation, from the standpoint of investor protection three of them are particularly significant.

1. It is not necessary to show that "any defendant engaged in any personal

picture as to be of little general interest. Thus, on June 30, 1966, the assets of all face-amount certificate companies represented only about 2.3% of the total assets of all registered investment companies; unit investment trusts represented only about 7.5%. See H. REP. NO. 2337, 89th Cong., 2d Sess., at 38 (1966). Moreover, the changes themselves, though substantive in nature, are of no great moment.

The 1970 Act adds a new subsection (i) to § 28 of the 1940 Act which, in effect, restricts sales loads on face-amount certificates to 20% of the payments in the first three years, 10% in the fourth, 7% in the fifth, and 4% in all subsequent years. 1970 Act § 17. Actually, however, over 95% of the face-amount certificates currently being sold are within these new statutory limitations. See S. REP. NO. 91-184, 91st Cong., 1st Sess., at 10 (1969).

The 1970 Act also amends § 26(b) of the 1940 Act in a considerably different, but not too significant, fashion. The amendment provides that substitutions of securities may not be made without advance approval of the Commission by "any depositor or trustee of a registered unit investment trust holding the security of a single issuer." 1970 Act § 15.

⁵² Investment Company Act of 1940 § 36.

⁵³ 1970 Act § 20.

⁵⁴ *Id.*

- misconduct" although, as noted above, "personal misconduct" is part of the new standard for injunctive actions under what is now section 36(a).
2. Approval or ratification of the compensation or payments by the board of directors or by the shareholders is an obstacle to recovery only to the extent that it "shall be given such consideration by the court as is deemed appropriate under all the circumstances."⁵⁵
 3. Money damages are recoverable, limited to the actual damages resulting from the breach of fiduciary duty on which the suit is based and not exceeding the amount of the compensation or payments which triggered the suit. Monetary recovery may, however, be obtained only from the recipients of such compensation or payments and is subject to a one-year statute of limitations dating from the commencement of suit.

These new provisions are particularly salutary in the light of the long-standing ineffectiveness of old section 36. That section, by its express terms, authorized *only the Commission* to bring an action and it was only after a long struggle that implied private suits were quite uniformly sustained in the various federal courts.⁵⁶ Aside from the question of the existence of such a right to sue, the courts had been reluctant from the beginning of private litigation under that section to construe its scope in broadly remedial fashion.⁵⁷ This judicial reluctance is, of course, understandable in view of the horrendous implications of such ugly words as "has been guilty . . . of gross misconduct or gross abuse of trust." Were it not for the fact that section 37 of the 1940 Act, expressly makes larceny and embezzlement from an investment company federal crimes, one might somewhat plausibly conclude that section 36 was intended to cover only "hand-in-the-till" and other equally reprehensible offenses. In light of these considerations the new standard of engaging in an act or practice constituting a breach of fiduciary duty is particularly welcome as a significant improvement in investor protection against wrongdoing by those who are supposed to be serving mutual fund investors in positions of trust and confidence. It should not take the courts long to conclude that this new criterion is a counter-part of what has long been the law in many other areas involving fiduciary obligations. Although the addition of the phrase "involving personal misconduct" might give some pause as to the extent of its restrictiveness on the otherwise broad simple test of "breach of

⁵⁵ For a discussion of the cases dealing with the effect of shareholder ratification on the success of subsequent derivative suits, see *Survey* at 917. See, e.g., *Saxe v. Brady*, 40 Del. Ch. 474, 184 A.2d 602 (1962).

⁵⁹ This long struggle is not a part of the main thread of this article; any extensive citation of authorities is therefore omitted. The leading cases exemplifying the sharp divergence of views which existed in the earlier opinions may, however, be of interest. Compare *Brouk v. Managed Funds, Inc.*, 286 F.2d 901 (8th Cir.), cert. granted 366 U.S. 958 (1961), dismissed as moot 369 U.S. 424 (1962) (the case was settled), with *Brown v. Bullock*, 194 F. Supp. 207 (S.D.N.Y.), aff'd en banc on narrower grounds, 294 F.2d 415 (2d Cir. 1961). While *Brouk* was the most outstanding appellate case which took a narrow view of permitting implied private actions under the 1940 Act, it did not directly involve § 36 as such. Moreover, *Brouk* has since been rather thoroughly disavowed in *Greater Iowa Corp. v. McLendon*, 378 F.2d 783 (8th Cir. 1967).

⁵⁷ For example, in *Brown v. Bullock*, 194 F. Supp. 207 (S.D.N.Y.), aff'd en banc on narrower grounds, 294 F.2d 415 (2d Cir. 1961), U. S. District Judge Herlands interpreted § 36 in about as broad a remedial manner as could possibly be expected. The Court of Appeals for the Second Circuit, however, apparently entertained considerable doubt about its scope; at least, any discussion of § 36 is conspicuously absent from the upper court's opinion which affirmed the result below on other grounds.

fiduciary duty," this should not be difficult to resolve in light of the legislative history, covering the insertion of this phrase, as contained in both the Senate and House reports.⁵⁸

Several aspects of the newly added section 36(b) are equally refreshing. The significance of a provision for both Commission and derivative suits against advisers, their affiliates and other persons having fiduciary duties in connection with compensation and other payments to advisers is self-apparent. In the long run, the deterrent effect of this provision should certainly prove to be a significant contribution to investor protection.

9. PERFORMANCE FEES

As is observed earlier,⁵⁹ the 1970 Act amendment relating to performance fees is in fact an amendment to the Advisers Act. Consideration of it has nevertheless been deferred until the portion of this article dealing with amendments to the Investment Company Act because its principal impact is on fees paid to advisers by investment companies.

Performance fees, as they have heretofore existed, may be briefly described as extra fees paid to an investment adviser under an advisory contract with a mutual fund or other client. These fees, which afford the adviser compensation beyond his basic fee, are commonly measured by a percentage of the net asset value of the fund at periodic intervals, if the fund's performance exceeds the performance of certain predetermined standards. The term "performance fee" is also used to describe a somewhat different bonus arrangement used by some mutual funds, particularly ones placing emphasis on growth. In these cases, the fee paid to the adviser consists of a share of, and is measured by, capital gains and capital appreciation in the portfolio of the fund, rather than measured against the investment performance of some external index of securities.

The Commission originally favored a flat prohibition of all performance fee arrangements with investment companies,⁶⁰ largely because they can only be an incentive to take undue risks with the companies' funds. Such incentives are particularly strong as well as unfair to the investment companies and their shareholders because they are most often written into the advisory contract on a "heads I win tails you lose" basis from the standpoint of the advisers. That is to say, the adviser is rewarded if the performance of the fund exceeds the stated standard, but he is not penalized if its performance sinks below that standard—as a minimum he always collects his full basic fee.

While Congress did not fully accept the Commission's original views, it at least put a stop to the capital gains-capital appreciation type fees and to one-way-street performance fees. This was accomplished by adding a prohibition against performance fees in contracts with registered investment companies unless such fees are tied to an "appropriate index of securities prices or such other

⁵⁸ S. REP. No. 91-184, 91st Cong., 1st Sess., at 36 (1969); H. REP. No. 91-1382, 91st Cong., 2d Sess., at 37 (1970).

⁵⁹ See note 30 *supra*.

⁶⁰ See S. 1659 and H.R. 9510, 90th Cong., 1st Sess. § 26 (1967). Both bills were sponsored by the Commission. See notes 38 and 49 *supra*. See also *Survey* at 886-91.

measure of investment performance as the Commission" may specify by rule or order *and go down in the event of performance below the stated measure in the same proportion as they go up in case of performance above it, over a specified period.*⁶¹ The mechanics of the applicable provisions are not quite all that simple, and the right to utilize such performance fees at all is limited to contracts in which the basic compensation is fixed by reference to asset value of the fund over a specified period (as is the case with most mutual fund advisory contracts). It is also limited in other respects not here pertinent. The foregoing does, however, describe in essence the new limitations on performance fees in a manner which is sufficient for present purposes.

It will be interesting to observe how this limitation on performance fees works over a period of years. With the incentive to take undue risks now offset by the possibility of a reduced advisory fee if such risks "flop," the previous increase in use of performance fee contracts⁶² could quite conceivably now trend in the opposite direction. Moreover, assuming effective disclosure so that the investor knows that his mutual fund shares involve this feature as to his adviser's compensation, there is perhaps little harm in permitting performance fees limited in such a way, as they now are, that the adviser cannot "have his cake and eat it, too."

10. EXCLUSION OF OIL AND GAS FUNDS

While the 1970 Act contains no amendment in the oil and gas funds area, the subject should probably be mentioned briefly because in both the Senate and the House consideration was given to it in formulating the versions of the bill which went to conference⁶³ (though the Conference Committee ultimately omitted it⁶⁴) and because Congress has virtually mandated that it receive further consideration by both the Commission and the affected industry with a view to legislation in the next Congress.⁶⁵

Oil and gas funds, including those which issue redeemable securities, periodic payment plans, or face-amount certificates of the installment type, are excluded from the definition of an investment company required to register under the

61 Section 25 of the 1970 Act, which amends the Advisers Act § 205, 15 U.S.C. § 80b-5 (1964). It should be remembered that what is said in this article about the amendment to § 205 of the Advisers Act relates only to performance fees under advisory contracts with registered investment companies and under certain other contracts, not pertinent here, which involve the investment of funds in excess of \$1 million. There are further restrictions as to advisory contracts with individual clients and with certain trusts, collective funds and separate accounts which are not discussed here.

62 See S. REP. No. 91-184, 91st Cong., 1st Sess., at 45 (1969). See also 35 SEC ANN. REP. 129 (1969), where it is stated that in the Commission's fiscal year ended June 30, 1969, the number of registered investment companies using performance fees was increased by sixty-six.

63 Section 3(b)(5) of the Senate version of the bill which went to conference would actually have abolished the oil and gas exemption from the 1940 Act as to any person "substantially all of whose business consists of owning or holding oil, gas or other mineral royalties or leases . . ." if such person issues "redeemable securities, face-amount certificates of the installment type, or periodic plan certificates"; the House version would not have done so, although consideration was given to the problem during House deliberations on the bill. S. REP. No. 91-184, 91st Cong., 1st Sess., at 38 (1969); H. REP. No. 91-1382, 91st Cong., 2d Sess., at 11-12 (1970).

64 The Conference Committee did, however, dwell upon the oil and gas question. See note 71 *infra*.

65 The precise nature of this mandate is described in note 71 *infra*.

1940 Act.⁶⁶ The use of such funds as a means of financing oil and gas drilling ventures has recently proliferated to such an extent that coverage under the 1940 Act is now considered a pressing need, particularly for the many small investors who are today being sold interests in such ventures. These interests were formerly sold in much larger units to a relatively few, supposedly sophisticated, investors. The oil and gas people, however, insist that the regulatory pattern of the 1940 Act could not lend itself to their industry and that it would be disastrous to them if it were so applied.⁶⁷ While Congress, in the conference committee stage, finally took the industry at its word, at the same time it made it abundantly clear that the industry should be subject to some workable regulatory scheme appropriate for the protection of those who invest in such ventures, albeit a scheme of a somewhat different type than that provided by the 1940 Act. The Commission and the industry are expected to find a mutually acceptable solution promptly, and if they fail to do so the Commission is directed to submit a proposed bill on this subject which Congress would then presumably consider and, if it saw fit, adopt with or without amendments in spite of whatever opposition might continue to be forthcoming from the oil and gas industry.⁶⁸

IV. Conclusion

From the foregoing discussion it is apparent that many of the major provisions in this new law are the result of compromise between the investment company industry and the Commission. It is equally clear that no substantially beneficial legislation in this field would have been forthcoming at this time without such compromise. This is not to say, however, that many, if not most, of the principal features of the Act will not prove reasonably effective over the years. In the few instances in which, as a matter of prognostication, their efficacy may look doubtful, one of two things should happen. Either the misgivings will prove unfounded or, after it is satisfactorily demonstrated that the doubtful provisions or some of them do not cope adequately with the situations which they were designed to alleviate, Congress will enact stronger corrective measures and will be more apt to do so without limiting its action to such matters as the industry finds acceptable. The fact that the industry went along with as good a bill as it is commendable. It is also encouraging since it should ease the way for cooperative implementation and administration and enforcement of the new provisions. On the other hand, however, regulation needed to protect the interests of public investors should not forever remain a matter of what the industry will not oppose.

66 Investment Company Act of 1940 § 3(c)(11), 15 U.S.C. 80a-3(c)(11) (1964).

67 See the discussion of this issue in H. REP. NO. 91-1382, 91st Cong., 2d Sess., at 11-12 (1970).

68 The conferees stated in their report that they were omitting oil and gas fund provisions from present legislation "with the firm understanding that representatives of the oil and gas industry will cooperate with the [SEC] in working out a reasonable regulatory statute consistent with the need for protection of investors in this area." The report then called for submission of an agreed proposal within eighteen months and recited that, absent prompt cooperation from the oil and gas industry, "... it is understood by the conferees that the Commission will submit early in the next Congress appropriate legislation to provide necessary protection in this area." H. REP. NO. 91-1631, 91st Cong., 2d Sess., at 27 (1970).

APPENDIX

CHRONOLOGY OF EVENTS IN THE 91ST CONGRESS — INVESTMENT
COMPANY AMENDMENTS ACT OF 1970

- Jan. 15, 1969 S. 34 introduced by Senator Sparkman (identical to S. 3724 as passed by the Senate in the 90th Congress but not acted upon by the House). 115 CONG. REC. S221 (daily ed. Jan. 15, 1969).
- Jan. 16, 1969 S. 296 introduced by Senator McIntyre. 115 CONG. REC. S424 (daily ed. Jan. 16, 1969).
- Jan. 17, 1969 Analysis of S.34 issued as a Committee Print. SENATE COMM. ON BANKING AND CURRENCY, 91ST CONG., 1ST SESS., ANALYSIS OF S.34 (Comm. Print 1969).
- Mar. 6, 1969 Testimony of SEC Chairman Hamer H. Budge before the Subcommittee on Securities of the Senate Committee on Banking and Currency, discussing, among other things, pending mutual fund legislation.
- Mar. 13, 1969 H.R. 8980 introduced by Congressman Stuckey. 115 CONG. REC. H1764 (daily ed. Mar. 13, 1969).
- Apr. 15-18, 1969 Hearings on S. 34 and S. 296 before the Senate Committee on Banking and Currency. SEC Commissioner Hugh F. Owens testified for the SEC on April 15, 1969. *Hearings on S. 34 and S. 296 Before the Senate Comm. on Banking and Currency*, 91st Cong., 1st Sess., at 5 (1969).
- May 21, 1969 S. 2224 (clean bill) reported out of committee. S. REP. No. 91-184, 91st Cong. 1st Sess. (1969).
- May 23, 1969 Senate floor debate on S. 2224. 115 CONG. REC. S5563-67 (daily ed. May 23, 1969).
- May 26, 1969 Senate floor debate on S. 2224 continued. 115 CONG. REC. S5563 (daily ed. May 26, 1969). Bill amended on the floor and passed by voice vote. 115 CONG. REC. S5605 (daily ed. May 26, 1969).
- Remarks by Mr. Stuckey on Senate action. 115 CONG. REC. E4303 (daily ed. May 26, 1969).
- May 27, 1969 S. 2224, as passed by Senate, referred to House Committee on Interstate and Foreign Commerce. 115 CONG. REC. H4237 (daily ed. May 27, 1969).
- June 10, 1969 H.R. 11995 introduced by Congressman John E. Moss, referred to House Committee on Interstate and Foreign Commerce. 115 CONG. REC. H4695 (daily ed. June 10, 1969).
- July 15, 1969 H.R. 12867 introduced by Congressman Stuckey, with remarks extended in the *Congressional Record*. 115 CONG. REC. H5979 and E5925 (daily ed. July 15, 1969).
- Nov. 6, 1969 H.R. 14737 introduced by Mr. Stuckey, revising earlier bills. 115 CONG. REC. H10714 (daily ed. Nov. 6, 1969).
- Nov. 12-21, 1969 Hearings before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce.

SEC Chairman Hamer H. Budge testified on November 12, 1969. *Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong. 1st Sess., pt. 1, at 172 (1969) [hereinafter cited as 1969 House Hearings].

- Dec. 8-11, 1969 Hearings before the House Subcommittee on Commerce and Finance resumed. Chairman Budge testified again on December 11, 1969. 1969 House Hearings, Pt. 2, at 853.
- Dec. 19, 1969 Statement by Senator McIntyre on the floor of the Senate. 115 CONG. REC. S17288 (daily ed. Dec. 19, 1969).
- Jan. 28, 1970 Remarks by Congressman Fletcher Thompson. 116 CONG. REC. E428-29 (daily ed. Jan. 28, 1970).
- Mar. 23, 1970 Statement by Congressman John E. Moss to the House. 116 CONG. REC. H2214-15 (daily ed. Mar. 23, 1970).
- Apr. 7, 1970 Remarks by Congressman Fletcher Thompson. 116 CONG. REC. E2879-80 (daily ed. Apr. 7, 1970).
- Apr. 29, 1970 H.R. 17333 introduced in the House by Chairman Harley O. Staggers as a clean committee bill. 116 CONG. REC. H3716 (daily ed. Apr. 29, 1970).
- Aug. 7, 1970 H.R. 17333 reported out of committee to the House. H. REP. No. 91-1382, 91st Cong. 2d Sess. (1970).
- Aug. 12, 1970 H. Res. 1193 (H. REP. No. 91-1413, 91st Cong. 2d Sess. (1970)) by the Rules Committee granting rule on H.R. 17333. 116 CONG. REC. H8209, (daily ed. Aug. 12, 1970).
- Sep. 23, 1970 House considered H.R. 17333, amended it, and passed it by voice vote. House then took up S. 2224, amended it by substituting the provisions of H.R. 17333 as previously passed, and passed S. 2224, as amended, by voice vote. House voted to insist upon its amendments and appointed conferees. 116 CONG. REC. H9087-9104 (daily ed. Sep. 23, 1970).
- Oct. 13, 1970 Senate took up S. 2224, as passed by the House. Senate disagreed with House amendments and appointed conferees. 116 CONG. REC. S17895-903 (daily ed. Oct. 13, 1970).
- Nov. 25, 1970 Conference Report on S. 2224. H. REP. No. 91-1631, 91st Cong., 2d Sess. (1970).
- Nov. 30, 1970 Senate accepted Conference Report on S. 2224 unanimously. 116 CONG. REC. S18995-96 (daily ed. Nov. 30, 1970).
- Dec. 1, 1970 House accepted Conference Report on S. 2224 by voice vote. 116 CONG. REC. H10918-19 (daily ed. Dec. 1, 1970).
- Dec. 14, 1970 S. 2224 signed into law by the President as Public Law No. 91-547.