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Rights and Obligations in the Mutual Fund: A Source of Law

James M. Anderson

LEGISLATION

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I. INTRODUCTION

Since 1924 when the newly organized Massachusetts Investors Trust granted its shareholders the continuing right to redeem their shares,[1] the mutual fund as a distinctive enterprise has become an increasingly important financial institution. The more than 325 funds[2] now registered[3] claim a net asset value in excess of 38.2 billion dollars[4] with 48 billion dollars predicted to be within their control by 1970.[5] Their portfolios, which are increasing at a rate of more than 3.5 billion dollars annually,[6] were 5000 per cent larger in 1961 than in 1941.[7] The three and one-half million mutual fund shareholders,[8] who comprise approximately one-sixth of the shareholder market,[9] have been increasing in number by more than one thousand a day,[10] due primarily to the good performance of the funds.[11]

1. WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS: PREPARED FOR THE SECURITIES AND EXCHANGE COMMISSION 37 (1962) [hereinafter cited as WHARTON REPORT].

2. SEC ANN. REP. 111 (1964). These are active, open-end investment management companies (for definition see text accompanying note 21 *infra*).

3. Registration is required under the Investment Company Act of 1940, 15 U.S.C. § 80a(7),(8) (1964). For further explanation of federal regulatory measures see text accompanying note 114 *infra.*

4. SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH 2 (1966) [hereinafter cited as SEC Report]. The aggregate net asset value of all registered mutual funds amounted to $38.4 billion as of June 30, 1966.

5. N.Y. Times, May 9, 1965, § 3, at 1, col. 5.

6. N.Y. Times, Jan. 17, 1966, at 110, col. 2. The $3.5 billion aggregate sales figure for 1965 was achieved by Oct. 31, 1965. The total aggregate sales for 1964 amounted to $3.4 billion.

7. SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS pt. 4, at 95 (1963) [hereinafter cited as SPECIAL STUDY]. The funds used in the sample are only the member funds of Investment Company Institute, the industry trade association, whose 169 open-end members account for the great bulk of mutual fund assets. During the same period the total assets of closed-end investment companies increased by only 200%.

8. SEC REPORT 2. These shareholders represented more than 6.7 million accounts as of Dec. 31, 1965.

9. SPECIAL STUDY pt. 4, at 95.

10. Lobell, *The Mutual Fund: A Structural Analysis*, 47 VA. L. REV. 181 n.1 (1961). This is an average daily increase in investors over the period between 1951 and 1961. The current popularity of mutual fund shares is reflected by the initial offering of the Manhatten Fund which in its first day, Feb. 3, 1966, sold $270 million in shares, and on its next two public days, March 17 and 18, 1966, sold $28 million more in shares. Wall St. J., March 21, 1966, at 7, col. 2.

11. Where the Dow-Jones average rose 10.9% in 1965, the 212 funds averaged a

Such enthusiasm for mutual funds has not been unanimous however. Aware of their speedy growth, the Security and Exchange Commission (SEC) authorized an extensive study of the funds. The result, published in 1962,[12] was highly critical of potential conflicts of interest between fund management and shareholders, and of the possible lack of arms-length bargaining between the fund management and the investment adviser.[13] In 1963 a second report to the SEC, the *Special Study of Securities Markets*,[14] was made public. It criticized mutual fund selling practices, insider trading in portfolio securities, and reciprocal business practices. Finally, the SEC spoke of the future when in December of 1966 it published[15] its recommendations for specific reforms[16] in the investment company industry. Through these pronouncements the SEC has demonstrated its concern for the quality of investment company activity and has articulated some of the reservations held by other members[17] of the investment industry as to the wisdom of utilizing mutual funds as a

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19% appreciation. Only 13 in a sample of 212 funds declined. The losses ranged from a 1% to 10.5% while the gains ranged up to 77.5%. N.Y. Times, Jan. 14, 1966, at 58, col. 3. The funds have even had political support. Vice President Hubert Humphrey said in a speech to a group of fund representatives that "[O]ne of the greatest investments in the Great Society is the mutual fund." N.Y. Times, April 30, 1965, at 45, col. 3.

12. This is the WHARTON REPORT, *supra* note 1. The SEC commissioned the Wharton School of Finance and Commerce of the University of Pennsylvania to conduct the study which was begun in 1958.

13. WHARTON REPORT 3.

14. SPECIAL STUDY pt. 4, 91-92. This report too was prepared by the Securities Research Unit of the Wharton School of Finance and Commerce. Parts 1, 2, 3, and 5 of the study deal with other portions of the securities markets.

15. SEC REPORT. This, the first statement to be prepared by the SEC itself, was published more than a year after the date for which it was originally promised.

16. The SEC REPORT recommended that the Investment Company Act be amended to provide rights of action to private individuals and the SEC in order to enforce the current provisions of the Act as well as to provide the following limitations on investment company activity:

1) Sales loads shall not exceed 5% of share value.
2) Management fees shall be reasonable and shall reflect economies of size.
3) Front end load contractual purchase plans shall be abolished.
4) The standard of conduct required by the Act shall be violated by an "abuse of trust." ("Gross abuse of trust" shall no longer be required.)
5) The definition of "affiliated person" shall be broadened so as to insulate directors from additional persons who are likely to have conflicting interests.
6) The SEC shall be authorized to develop and enforce regulations on insider trading and brokerage practices.

17. Merrill, Lynch, Pierce, Fenner and Smith, the largest brokerage house in the nation, maintains a policy of neither encouraging nor discouraging the purchase of mutual fund shares. Their reason for such a posture is that they ". . . don't like the management fee or the sales load. We feel that the individual investor ean do better on the open market." Interview with Howard B. Olson, Account Executive, Merrill, Lynch, Pierce, Fenner and Smith, in Nashville, Tenn., March 16, 1966.

An active, personal fiduciary stated that he seldom invested funds in his charge in mutual funds because of the high sales load and the insulation of actual portfolio management from the shareholder. Interview, Nashville, Tenn., Nov. 7, 1965.

medium for prudent investment. The continued growth of mutual funds in the face of such criticism[18] and reservations sharply reflects the present and potential importance of this industry in our economy.

Despite the increasing significance of these funds and the attention focused on them, the legal relationships which structure the interaction among the participants of a fund have not been clearly defined or developed and today there is no body of mutual fund common law capable of satisfactorily dealing with the challenges of mutual fund operation.[19] It is the purpose of this paper to seek out existing bodies of law which may, by analogy, provide a starting point for the articulation of mutual fund law.

It is submitted that the absence of a clear starting point for the development of mutual fund law reflects a failure to analyze adequately the problems of the mutual fund with sufficient concern for possible similarities to problems already confronted and resolved in other areas; that such analysis shows the mutual fund to be essentially similar to the corporation for some purposes and essentially similar to a trust for other purposes; that analogies from corporate law and from trust law, both within the structure of statutory regulation, ought to be the primary authoritative sources of mutual fund law; that the reasoning of cases which have decided mutual fund controversies suggests dissatisfaction with the present state of mutual fund common law; and finally that recent developments in the mutual fund industry reflect the need for clear standards which are capable of adequately protecting the participants.

II. The Mutual Fund and Kindred Law

A. *The Fund*

The typical mutual fund arose as a response to investment demands

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18. The criticism in 1963, however, from the WHARTON REPORT and the SPECIAL STUDY appeared to have lost its dampening effect on the sales of fund shares by 1964. N.Y. Times, Jan. 11, 1965, at 106, col. 3.

19. *See, e.g.*, Eisenberg & Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940*, 20 RUTGERS L. REV. 181 (1966); Jaretzki, *Duties and Responsibilities of Directors of Mutual Funds*, 29 LAW & CONTEMP. PROB. 777 (1964); Lobell, *The Mutual Fund: A Structural Analysis*, 47 VA. L. REV. 181 (1961); Lobell, *Rights and Responsibilities in the Mutual Fund*, 70 YALE L.J. 1258 (1961). Note, *The Mutual Fund and its Management Company*, 71 YALE L.J. 137 (1962). *See also* Brown v. Bullock, 194 F. Supp. 207 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (1961), where the district court judge required 41 pages to find an appropriate source of law and to examine issues that normally are more briefly resolved.

caused by increasingly widespread affluence.[20] It is technically referred to as an open-end diversified management investment company,[21] but functionally, the fund is an institutional device designed to unite an investor's money with a diversified, managed portfolio by having the fund issue its own shares to the investor and then invest its shareholders' funds in diversified securities. The funds are "open-end"[22] because their asset value grows with each new share they issue and sell[23] and declines with each share they redeem;[24] "diversified"[25] because their investments are not concentrated in the stock of an individual issuer; "management"[26] because their investments are alterable by the fund management in pursuit of the fund's stated investment policy; and are referred to as a "company"[27] to include trusts and other legal forms that a fund can assume. Mutual funds are to be distinguished from other types of investment companies such as the "unit investment trusts,"[28] "face-amount installment certificate companies"[29] and "closed-end investment companies."[30] Each presents peculiar problems beyond the scope of this paper.

Normally, the operation of a mutual fund involves three partici-

20. For a more detailed history of their development see WHARTON REPORT 37-44, 77-116 (1962).

21. This is the terminology of the Investment Company Act.

22. Investment Company Act, 15 U.S.C. § 80a(5)(a)(1) (1964).

23. From 1958 to 1961 the net asset value of the mutual funds went from $12 billion to $24 billion. Over half of this increase was due to new sales of their own shares rather than appreciation of portfolio shares. SPECIAL STUDY pt. 4, at 270.

24. For definition of "redeemable security" see Investment Company Act, 15 U.S.C. § 80a(2)(a)(31) (1964).

25. Investment Company Act, 15 U.S.C. § 80a(5)(b)(1) (1964). This section also provides that the fund may invest no more than 5% of its total assets in the stock of one issuer and may hold no more than 10% of the outstanding voting shares of any one issuer.

26. Investment Company Act, 15 U.S.C. § 80a(4)(3) (1964).

27. 15 U.S.C. § 80a(4)(3) (1964).

28. Such trusts are normally organized under a trust indenture and sell to investors fractional interests in the group of securities comprising the trust corpus. Each share represents a fractional interest in the "unity" of securities. As of June 30, 1963, 149 such trusts were registered with the SEC. Because of their lack of investment flexibility, they have been less favorably received than the mutual fund.

29. Such companies issue certificates under which the investor agrees to pay a set amount to the company on a periodic basis. The company agrees to repay the investor a specified amount at some future time, which amount represents the investor's payments plus interest. In reality, such a company is a type of savings bank. As of June 30, 1963, there were ten such companies registered with the SEC compared to 350 mutual funds.

30. Such companies seldom sell or redeem their own shares. The number of outstanding shares of a closed-end company is relatively steady—much like an ordinary business corporation. The shares are traded on the exchanges with price fixed primarily by investor interest with no necessary relevance to net asset value. On June 30, 1963, 218 such companies were registered with the SEC.

pants:[31] the fund board of directors,[32] the investment adviser,[33] and the investor. The fund itself is usually organized by a group of individuals who either form their own adviser company or retain another investment adviser company[34] to manage, under contract, the fund portfolio. The founders of the fund then become its directors and establish investment guidelines[35] to control the activity of the adviser, and arrange for a sales organization to market the fund's shares. Once operations begin, the mutual fund usually issues its shares to an underwriter who sells the shares through retailers to the public. The investor buys from the retail securities dealer, and the proceeds, less commissions, are turned over to the use of the adviser to expand the fund's portfolio. The adviser is thus provided with a continuing source of investment capital to be managed while the investor, through the fund shares, is provided with investment advice and the benefits of a diversified portfolio.

B. *The Board of Directors*

Of the three participants, the fund board of directors is the central member. Most funds are corporations,[36] but some, particularly the earlier funds, are business trusts.[37] Still, the Investment Company Act, by treating them identically, reflects the essential similarity[38] of the two forms for regulatory purposes. In either form, a board

31. In the sample of 156 mutual funds studied by the WHARTON REPORT, all but 14 were parties to contracts with an outside investment adviser and hence had three participants. WHARTON REPORT 6. When there are only two separate participants, these two are the fund board of directors and the investor. In these cases the adviser is "internalized" as a part of the fund itself.

32. The term "director" includes any person performing functions essentially equivalent to those performed by a corporate director; that is, a member of a board of trustees of a mutual fund created in the form of a business trust would also be included. For statutory definitions see Investment Company Act, 15 U.S.C. § 80a(2)(a)(12) (1964).

33. For statutory definition see Investment Company Act, 15 U.S.C. § 80a(2)(a)(19) (1964).

34. Testimony of Hugh W. Long, *Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess., pt. I, at 600 (1940).

35. The fund, depending on its objectives, may be categorized as a growth, growth with income, balanced, income with growth, or income. A recent development has been the emergence of speculative growth funds. The Hubshman Fund, for example, acknowledges in its prospectus that its proposed "flexible investment policy may 'involve greater than average risks as well as frequent turnover in the fund's portfolio.'" Wall St. J., March 8, 1966, at 1, col. 6.

36. Approximately 80% of the Wharton sample of mutual funds were corporations with the remaining 20% being business trusts. WHARTON REPORT 45.

37. The trust form has declined in importance in recent years and only 2 of the 38 open-end companies established between 1952 and 1958 were organized as trusts. *Id.*

38. *See* Investment Company Act, 15 U.S.C. § 80a(2)(a)(8), (12), (35) (1964). *See also* Saminsky v. Abbott, 41 Del. Ch. 320, 194 A.2d 549 (1963), *aff'd*, 200 A.2d 572 (1964), *cert. denied*, 379 U.S. 900 (1964), where the court noted that the Investment Company Act approved the business trust form.

of directors or the equivalent holds the legal power to manage.

Often the corporate board of a mutual fund consists of seven men,[39] while boards of trustees most frequently have five members.[40] In actual operation, the scope of the board's activity is somewhat narrower than might be expected. Indeed, fewer than one-tenth of the boards of directors perform active investment decision making duties[41] since that task is usually delegated either to the investment adviser or to his representative.[42] Also, there is little discretion with respect to payment of dividends since in order to avoid taxation on realized income, most funds avail themselves of the provisions of the tax law[43] which exempt the fund from tax if dividends and gains are paid out to investors in the same taxable year as they are realized. Indeed "management," so far as the board is concerned, consists primarily of periodically reviewing the recommendations of the investment adviser, determining whether they are consistent with the general policy of the fund and appraising investment results.

C. *The Adviser*

The second of the participants, the investment adviser, is a separate legal entity from the mutual fund. While a majority of these firms are corporations, some are partnerships or even proprietorships.[44] Three quarters of the corporate advisers have ten or less voting shareholders, and fully one quarter have but one voting shareholder.[45] Employee staffs are also small with over half of the firms employing fewer than ten men.[46] With the exception of the smallest advisers,

39. In the Wharton study sample boards ranged from 3 to 18 members with 7 members found in 37 of 115 cases. WHARTON REPORT 49.

40. In the Wharton study sample 19 of 39 trusts had a single corporate trustee. Of the remaining 20 trusts, 7 had 5 trustees on their board. *Id.*

41. In a substantial number of cases the board's principal function was to fulfill a legal requirement. WHARTON REPORT 49.

42. *Id.* The active management of the fund's portfolio is less frequently delegated to one of the principal officers of the fund who is controlled by the investment adviser. Hence the effect is the same—active management of the fund is delegated to an entity controlled by someone other than the fund.

43. INT. REV. CODE OF 1954, §§ 851-55.

44. Of 163 advisers in the Wharton study sample 82.2% were corporations, 15.3% partnerships and 2.5% were individual proprietorships. The proprietorships typically managed the smaller funds (below $50 million) while the partnerships were most frequently found in the middle range, from $51 million to $300 million. Corporate advisers dominated throughout but were especially dominant in the $300 million to $600 million range. WHARTON REPORT 449.

45. WHARTON REPORT 455. Ownership is the dominant means of control in 95% of the adviser organizations while it is the dominant means of control in only 6% of the mutual funds. *Id.* at 461. It should also be noted that a mere 3.1% of the adviser groups manage 42.9% of the aggregate net assets of the Wharton study sample, while, at the other end of the spectrum, 50.9% of the adviser organizations manage 1.2% of the aggregate net assets. *Id.* at 440.

46. Only 13% of the Wharton study sample have 100 or more employees. *Id.* at 444.

the groups support themselves primarily[47] through fees charged to the fund on the basis of the net asset value managed by them.[48] This fee compensates the firm for the performance of its duties, which are usually determined by the contract between it and the fund board of directors.[49] In most cases, the adviser's primary duties are to make investment decisions relating to the general portfolio structure and to make the day-to-day purchases of portfolio securities.[50] Although the actual powers exercised by the advisers vary, they are in virtually all cases the primary source of instructions as to what action should be taken within the portfolio.

D. *The Investor*

It is the third participant, the investor, who provides capital, the life blood of the mutual fund. Although institutional investors[51] are among fund shareholders,[52] by far the more substantial participation comes from individual investors. The typical regular account holder[53] is a married man, 55 years old, and has about three dependents. He has at most a limited amount of college education. Moreover, he is most likely employed in a capacity involving specialized skills, but

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47. If the adviser also acts as the fund's underwriter he charges commissions on sales in addition to the management fee. If, in addition, the adviser purchases portfolio stock in the market for the fund, he receives broker commissions as well. These are the three major sources of income for advisers who are affiliated with a full service financial house. *Id.* at 437-38.

48. In most cases this is a fixed fee but 14% of the adviser groups charge a fee that varies with the asset value. *Id.* at 480. As the net asset value climbs, the fee percentage drops. *Id.* at 483. Nearly one half of the funds charge .5% of the annual average net assets as of one particular day each year.

49. SPECIAL STUDY pt. 4, at 270. Approximately 1/7 of the aggregate net assets and 1/11 of the total number of adviser organizations in the Wharton study sample were managed by internal advisers, employed directly by the fund and not by a separate organization. Thus, in these cases there is no express contractual relationship between the fund board of directors and an adviser organization. WHARTON REPORT 441-42.

50. WHARTON REPORT 49. Still, the scope or decision delegated to the adviser organization is limited by investment objectives enunciated by the fund board of directors. *See* text accompanying note 35 *supra*. For a good discussion of the potential evils inherent in the fund-adviser relationship see Note, 71 YALE L.J. 137 (1961).

51. Selected American Shares, a mutual fund, found that in addition to individuals, the following were among its shareholders: trustees, guardians, executors, administrators, institutional trustees, nominees, churches, colleges, schools, hospitals, libraries, fraternal associations, welfare associations, cemetery associations, foundations, profit sharing plans, pension plans and employee benefit plans. These institutions accounted for 11.6% of Selected American Share's accounts. N.Y. Times, May 9, 1965, § 3 at 1, col. 5.

52. Institutional investors increased their holdings in 1964 by $1 billion to $2.6 billion. N.Y. Times, April 22, 1965, at 44, col. 2. One newly acquired investor was the 25th Anniversary Gift Fund of the Syracuse University Class of 1952 which announced that all donations would be invested in the One William Street Fund. N.Y. Times, Dec. 17, 1964, at 64, col. 2.

53. The two main shareholder classifications are regular account holders and accumulation plan holders. Regular account holders are those with no formal plans to make new investments in mutual fund shares, but who have made a "lump sum"

somewhat short of professional training.[54] His family earns 8100 dollars a year; his fund holdings amount to 5600 dollars; and his last fund purchase cost 1100 dollars. In addition to his fund holdings the typical shareholder owns 6100 dollars of three other corporate stocks and holds 3800 dollars in cash and United States Savings Bonds as well as 8700 dollars face value of life insurance.[55] He invested his money in mutual funds for a variety of purposes,[56] the most frequently mentioned of which are general savings, retirement income[57] and estate accumulation.[58] The primary reason that the typical shareholder chose a mutual fund over other forms of investment was the prospect of benefit from economical professional management and from diversification.[59] This small and relatively uninformed investor[60] gained most of his knowledge about mutual funds through a sales representative who by interpretation of information required to be disclosed[61] by the fund and by personal contact became the most important influence on the investor's decision to purchase a

investment to which they may or may not add. Accumulation plan holders are those who invest pursuant to a contractual plan which requires monthly or quarterly payments to purchase additional shares. Approximately 63% of fund shareholders are regular account holders while 37% are parties to a contractual plan.

54. SPECIAL STUDY pt. 4, at 273.

55. THE MUTUAL FUND SHAREHOLDER 2 (1963). These are median figures. In addition to this pamphlet published by the Investment Company Institute, SPECIAL STUDY pt. 4, at 274 contains a similar computation of statistics but drawn from a smaller sample. Parallel statistics for accumulation plan holders read as follows: age—43 years; family income—\$9000 annually; value of mutual fund holdings—\$2400; amount of most recent purchase—\$72; number of corporate stocks owned—1.3; value of corporate stock holdings—\$2400; bank accounts and U.S. Savings Bonds—\$1900; life insurance in force—\$14,500. THE MUTUAL FUND SHAREHOLDER 2 (1963).

56. The investor may initiate the inquiry himself or may be approached by a salesman and be persuaded of the wisdom of investment. Salesmen appear to have been more important in influencing the investment decisions of contractual plan buyers than in decisions of regular account purchasers. SPECIAL STUDY pt. 4, at 141.

57. It should be noted that special plans are available for this purpose. One such is the systematic withdrawal account which after retirement provides a monthly check of a specified amount from the shareholder's account paid from dividends and, if required by the amount, from redemptions. Also there are special investment programs geared to the Self-Employed Individuals Tax Retirement Act of 1962 (Keogh Act), 26 U.S.C. § 37 (1964). N.Y. Times, Jan. 6, 1964, at 108, col. 3.

58. SPECIAL STUDY pt. 4, at 285. *See also* THE MUTUAL FUND SHAREHOLDER 15 (1963).

59. THE MUTUAL FUND SHAREHOLDER 17 (1963). SPECIAL STUDY pt. 4, at 287. Almost one half of the contractual plan buyers also cited discipline in saving as a chief reason for acquiring this type of investment. SPECIAL STUDY pt. 4, at 338.

60. N.Y. Times, Oct. 15, 1960, at 29, col. 7 (indicating average mutual fund investor has little knowledge of securities he buys).

61. A prospectus must be shown the investor before purchase. For the information contained therein, see note 119 *infra*. However, 20% of the regular account holders and 10% of the contractual plan holders never see a prospectus. SPECIAL STUDY pt. 4, at 339. Even among those who do there is a low level of knowledge. The legal tone and lack of explanations limit the effectiveness of the prospectus. SPECIAL STUDY pt. 4, at 348.

particular fund.[62] Once his decision was made, the investor either purchased shares issued by the fund for a regular account, or signed a contractual accumulation plan[63] and began periodic payments toward the purchase of shares. In either case his shares were purchased on the over-the-counter market at a price determined by the per share net asset value[64] plus a sales load (commission)[65] which is usually substantial.[66] Despite a significant financial commitment the typical purchaser has only a modest understanding of his investment. More than sixty per cent can not give a reasonable estimate of the rate of the sales commission; seventy-five per cent do not know that there are funds with different sales loads, and seventy to eighty per cent can not estimate what per cent of net asset value is charged as a fee for management and administration.[67] There is also some question as to the knowledge of the investor of the identity of the investment adviser organization.[68] Even without the support of a careful understanding of the investment, most investors expect their fund to do better[69] than the stock market in the next 10 years and most expect it to surpass its own past performance.[70]

Thus in the basic operation of most mutual funds, many small unsophisticated investors are in essence persuaded by salesmen to

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62. Other important influences cited were investor's independent appraisal and advice of friend or relative. SPECIAL STUDY pt. 4, at 297.

63. *See* note 53 *supra* for definition.

64. The per share net asset value for the purpose of fixing share selling and redemption prices is computed twice daily by adding together the current market value of the fund's investments, deducting liabilities and dividing by the number of shares outstanding. Liabilities are generally minor items.

65. Most funds charge sales commissions of varying amounts, but there are some no-load funds the majority of whose shares are sold by mail.

66. Acquisition charges vary among funds and, within funds, vary with dollar amounts of shares purchased or committed to be purchased. Charges of 8% to 8 1/2% are common, 6% or more of which is generally paid to the retail distributor of the shares, the balance being retained by the fund's principal underwriter. The principal underwriter who operates under a contract with the fund and is usually the investment adviser as well, bears the entire cost of literature, statistical presentations and other sales aids provided to investment retailers. WHARTON REPORT 469, 471. The regular account holder and the voluntary plan purchaser each pay the same sales charge on each purchase while the contractual plan holder, as an incentive to continue payments, pays about 50% of his first 12 or 13 payments as a sales charge and then 2% to 5% of the remaining payments. SPECIAL STUDY pt. 4, at 172.

67. SPECIAL STUDY pt. 4, at 343-44.

68. *See* Taussig v. Wellington Fund, Inc., 187 F. Supp. 179, 214 (D. Del. 1960): "[T]his Court was surprised when two of defendants' expert witnesses, particularly knowledgeable in the investment company field, could not name Wellington Fund's investment adviser. No greater knowledge can be imputed to the investing public."

69. SPECIAL STUDY pt. 4, at 344. Performance here means return on investment. The difficulty is that investors measure return by proceeds received without understanding that the source of the fund payments might not be portfolio stock dividends but capital gains derived from sale of portfolio shares—a course of conduct that might have long range adverse effects.

70. *Id.*

purchase shares of a given mutual fund. In so doing they are choosing to submit their money to a mutual fund whose objectives and performance they believe to be consistent with their needs, knowing that their money will become part of a diversified portfolio managed by an organization other than the fund itself, and expecting performance to be superior to that of the market averages.

E. *Kindred Law*

While inquiry into the appropriateness of using other, already developed bodies of law as a primary source of mutual fund law is a useful tool for wise resolution of mutual fund problems, it should be noted that there are problems that might arise for which trust law or corporation law, even if applied in accord with the following discussion, might produce undesirable or unworkable results. It is not contended, however, that these proposed sources of law are capable of providing rules to govern any and all problems of interaction that might arise within the mutual fund, and particularly not within all the variations of form includable under a general definition of the mutual fund. Rather, this paper deals with the core concept of the mutual fund and what will, in most cases, be an appropriate source of law to help solve problems which arise in the basic mutual fund.

It should also be said that those bodies of developed law suggested by this note as relevant to the operation of mutual funds do not necessarily set out the rules identical to those which should be used to regulate the mutual fund. They do not constitute bodies of mutual fund law; they are only bodies of law that can, and, according to this note, should be used as sources of learning from which analogies to the mutual fund can validly be drawn and hence which ought substantially to shape the developing body of mutual fund law.

III. The Corporation

Since most funds are corporations, inquiry into the functioning of the typical business corporation seems proper to determine which functional elements of a business corporation correlate positively with the functional elements of a mutual fund, and thereby to determine which elements of business corporation law ought to be particularly influential in the formation of mutual fund law.[71] The functioning model of the mutual fund[72] bears close resemblance to

71. The underlying assumption is that the whole of corporate law is a reflection of the operation of a typical business corporation. To the extent that another enterprise differs in its typical operation, even though it too is a corporation by form, it is deserving of something other than the whole of corporate law.

72. For description see text accompanying note 20 *supra*.

that of a business corporation[73] in that both rely on investors who supply capital in return for stock certificates; both are managed on a day to day basis by hired managers; and both have boards of directors which bear ultimate legal responsibility for the functioning of the institution.

A. *The Investors*

The investors in the two enterprises seem to be most closely akin. The shareholder's stock certificate in both institutions gives the shareholder a proportionate claim to the property of the organization.[74] In the business corporation the asset value increases as profits are earned or, occasionally, as additional stock is issued and sold; in the mutual fund the same increase is caused primarily by the issue and sale of new shares of stock and, secondarily, by the appreciation of property currently held.[75] In each case too, the shareholders elect directors. This is generally true in the business corporation[76] and always true in the mutual fund.[77] There is also substantial identity in the general profiles of the two shareholders. The business corporation stockholders who hold from one to five hundred shares own 98 per cent of the shareholdings.[78] Although there are more than 8.5 million business corporation shareholders they are generally a class of small, scattered, and indifferent investors.[79] Still, more than 68 per cent of the shareholders earned more than 5000 dollars per year;[80] 55 per cent of the families earning more than 10,000 dollars own shares of stock;[81] and more of those with a college degree own stock than do those in any other educational group.[82] The most stock laden age group is that between 50 and 59[83] while more professional people own

73. The corporate legal form must be distinguished from the functional business corporation however. The former, which is not the subject of analysis in this paper, is a legal structure under which a business may be organized pursuant to the laws of a particular state. It is a static concept requiring only the existence of numerous formalities. The functional business corporation is a dynamic coneept which includes consideration of the interaction among the formalities of the corporate legal form.

74. 11 W. Fletcher, Corporations, § 5100 (rev. vol. 1958).

75. *See* note 23 *supra*.

76. 2 W. Fletcher, Corporations, § 285 (rev. vol. 1954).

77. *See* Investment Company Act, 15 U.S.C. § 80a(16)(a) (1964) (requiring directors be elected by holders of voting securities) and § 80a-18(i) (requiring every share of stock be voting share.)

78. G. Hurff, Social Aspects of Enterprise in the Large Corporation 24 (1950).

79. J. Livingston, The American Stockholder 20 (1958).

80. *Id.* at 27. These statistics originated in Kimmel, Share Ownership in the United States (1952).

81. *Id.* at 29. The next highest percentage was 19.8% of those in the $5000 - $10,000 income range.

82. *Id.* at 29. The percentage of the group with four years or more of college was 29.4%. Ouly 9.6% of the high school graduates owned stock.

83. *Id.* at 30.

stock than any other occupational group except housewives.[84] In a word, the two types of shareholders occupy a very similar position with respect to their corporation, be it a business corporation or a mutual fund.

B. *Management*

Also, the management group in the business corporation is somewhat similar to the management group or investment adviser in the mutual fund. Both are selected and engaged by the board of directors, and both may have their period of affiliation terminated at any time by the board.[85] In the mutual fund, however, shareholders must approve any new management group[86] whereas in the business corporation the board typically performs the entire hiring process by itself.[87] In both cases the apparent quality of the management group is a consideration in the investment choice. Further, in the mutual fund, the investment adviser is normally limited to six of ten places on the board, but where it also acts as the fund's principal underwriter, it is limited to only four of ten places.[88] The business corporation, on the other hand, has no externally imposed limits on the makeup of its board. It may range in composition from exclusively company executives to exclusively non-management representatives.[89] Yet typically, management is represented by one-fourth to one-third of the average of ten to fourteen directors.[90]

Despite their apparent similarity, the management group of the fund does differ from that of the corporation in two critical respects: form and relationship. First, a mutual fund's investment adviser is generally a corporation[91] and as such is, unlike the executive corps of a business corporation, a separate entity with shareholders, a board of directors and its own corporate sovereignty. Indeed, in some extreme cases, the distinction between the adviser and client mutual fund is strictly legal; it is the fund that possesses no office or employees independent of its hired investment adviser. The necessary result of management's corporate nature is to inject an element of insulation between the fund board of directors and the adviser that would not

84. *Id.* at 32. Within the professional group are doctors, lawyers, architects, engineers, dentists. Three times the number of housewives were shareholders than professional men.

85. Investment Company Act, 15 U.S.C. § 80a(15)(a)(3) (1964).

86. Investment Company Act, 15 U.S.C. § 80a(15)(a) (1964).

87. 2 W. FLETCHER, CORPORATIONS § 285 (rev. vol. 1954).

88. Investment Company Act, 15 U.S.C. § 80a(10) (1964).

89. American Tobacco Company subscribes to the former view while the Standard Oil Company of New Jersey subscribes to the latter. HURFF, SOCIAL ASPECTS OF ENTERPRISE 103 (1950).

90. *Id.* at 99.

91. *See* note 44 *supra.*

be present in the normal business corporation arrangement. Thus, a fortiori, the shareholders are more insulated from the actual management of the fund as well. The nature and practical effect of this insulatory feature are uncertain but it, at least, makes communication by the shareholder with management more difficult and creates an uncustomary barrier between ownership and management.

The second critical difference between the fund-adviser and corporation-management relationships is that the adviser is under written contract to the fund, whereas the executive corps is normally bound by no formal agreement with the business corporation. Even though the formal employment contract is terminable at the discretion of the fund board or shareholders, it is in the nature of a more permanent relationship than a mere oral agreement to employ. A conclusion that this usually results in a longer period of affiliation for fund management does not necessarily follow, however, since both the corporation and the fund are strongly affected by inertia. One element of this inertia is implicit in the frequently made accusation that corporate directors merely "ratify decisions which they have not reached, based on arguments and evidence which they cannot appraise."[92] The natural result is a tendency against change, particularly a change where avowed opponents would doubtless gain representation on the board and attempt to influence the independent director's decision. A second element which normally limits shareholder pressure for change is that most investors purchase shares in a corporation because they approve present management and want to take advantage of its expertise. It is doubtful that such an unorganized group would exert much meaningful pressure to oust the current executive corps.

The more significant effect of the express contractual relationship is that it provides less opportunity for positive control of management by the fund directors. In the fund, management's obligations and guidelines are established by their employment contract. They are controlled by the words of the contract which seldom change. Indeed, for the board to change investment objectives requires a full vote of the shareholders.[93] While the board still has the power to terminate the contract at any time without penalty, in terms of practical operation, so long as the adviser stays within the guidelines set out in its employment contract, the board, barring gross abuse of trust by the adviser, would probably feel obliged to continue the relationship at least until the annual renewal date.[94] Further, because the relation-

92. DOUGLAS, DEMOCRACY AND FINANCE 49 (1940).

93. Investment Company Act, 15 U.S.C. § 80a(13) (1964).

94. Each adviser contract must be renewed annually by either the board of directors or the shareholders. Investment Company Act, 15 U.S.C. § 80a(15)(a)(2) (1964). Normally this is done by the directors.

ship is between corporate entities, the fund does not have such complete access to the adviser's records of its dealings on behalf of the fund as would a corporation to the records of its management group. The danger is that the directors cannot keep as close a watch on the fund management as their business corporation counterparts are able to keep on their executive corps.

Management of the mutual fund then does occupy a different place in the fund structure than corporate management does in the normal business corporation structure. The critical differences are two: form and relationship. An incorporated management group under express contract to the unit to be managed is materially distinct from individual managers who may be dismissed summarily. The effect of this difference is to insulate directors and hence shareholders from the workings of management to a degree unknown in the customary corporate arrangement.

C. *Board of Directors*

Although much of the form and operation of the board of directors in both the mutual fund and business corporation has already been discussed, one major area of distinction remains. In the business corporation "[t]he management . . . is almost exclusively in the hands of the board of directors."[95] Whether active management is undertaken by the board itself or by officers who are or who are not members of the board, its supervisory function and its power of removal keep the actual operation of the corporation within the control of the directors.[96] Direct management by the business corporation board, according to one commentator, involves four functions: decision, confirmation, consultation and review.[97] The directors decide those questions that they cannot delegate such as fixing executive salaries; they confirm provisional decisions of executives such as the settlement of lawsuits; counsel executives on policy problems such as those involved in the introduction of new product lines; and review past actions of the executives. Indirect management is effected through corporate officers and committees over which the board has supervisory control and through power of summary dismissal. These two characteristics of business corporation management—direct and indirect control—emphasize the importance of the board of directors in the short-term functioning of the business corporation.

In contrast is the role of the board of directors in the mutual fund, who contract with another for the management of the portfolio. Lattin distinguishes between contractual delegation of management powers

95. N. LATTIN, CORPORATIONS, 211 (1959).
96. *Id.*
97. J. BAKER, DIRECTORS AND THEIR FUNCTIONS 131-32 (1945).

and a similar delegation to an internal executive corps by saying: "There is one essential difference, however, for management contracts anticipate the turning over of the business to outsiders whereas a delegation of powers to a committee of the board or to the corporate officers keeps the authority in the family and gives the board the opportunity to supervise and control the activities of committees and officers."[98] The absence of this opportunity to control is reflected in the earlier discussion of the fund board's activity.[99] The board does not make investment decisions since this function is contractually delegated; it does not make dividend decisions since the tax law effectively controls this; it does not fix executive compensation since that is done by the management corporation; nor does it counsel the portfolio management on new lines of investment since these must be approved by the shareholders. Indeed, all the fund board generally does is meet quarterly in order "'. . . to review periodically the recommendations of the investment adviser to determine whether they are consistent with the general policy and objectives of the company and to appraise the investment results achieved.'"[100] Contrasting this with the business corporation, one must conclude that the board of directors of the latter participates more actively in the management of the corporation than the mutual fund board does in the management of the fund.

D. *Summary of Contrasts*

What then are the points of distinction between the functional models of the business corporation and the mutual fund that cause standard business corporation law to be inappropriate as a body of law to control the mutual fund? There is but one. The mutual fund, unlike the business corporation, contracts with another corporate entity for the latter to undertake the major portion of the former's management duties. As a result, the mutual fund board of directors is one step removed, both functionally and informatively, from the actual management of the investor's money. The board is thereby prevented from closely controlling the use to which the money is put. Since the shareholder has claims only against the board, he is insulated from effective control over his class interest. The business corporation, on the other hand, distributes the duties of management among its directors and officers. As a result, the business corporation board of directors remains close, both functionally and informatively,

98. N. Lattin, Corporations 225-26 (1959).

99. *See* text accompanying notes 36-43 *supra*.

100. Wharton Report 50. This is a description of the activity of the board of directors of Axe-Houghten Fund A. Compare the business corporation board which is said to meet from 10 to 20 times a year. National Industrial Conference Board, Compensation and Duties of Corporate Directors 11 (1946).

to the actual management of the shareholders' investment. The board is thus able to control closely the use of the invested money. Since the shareholders have rights against the board, they are protected by the board's effective control over their class interest. It is this additional gap between management and ownership in the mutual fund that distinguishes it from the business corporation; and it is the probability that this insulation will result in activity not in the best interest of the shareholder that a system of mutual fund law must minimize.

IV. THE TRUST

A. *Trust Distinguished from Business Corporation*

Like the business corporation, the private express trust is a managerial institution which is significantly similar to the mutual fund. The corporation and trust forms are distinguishable, however, in terms of the kinds of legal duties found in each. In the trust, for instance, there is, on behalf of the trustee, a legal duty to the beneficiary to exercise only those "powers as are necessary or appropriate for the carrying out of the purposes of the trust and are not forbidden by the terms of the trust."[101] Business corporation law imposes the same limit on the actions of corporations,[102] but their purpose, generally couched in terms of "field of activity," is broader than the customary trust or mutual fund purpose. For example, a recommended statement of purpose that will satisfy state corporation law for a proposed investment corporation says only "To acquire, dispose of, underwrite and deal in securities and to do a general investment business."[103] In contrast, the mutual fund is required by statute to deliver a prospectus to the potential investor at or before a sale of shares which contains, among other things, a description of the fund and of its objectives[104] in terms which will fully set out the fundamental policy of the fund. The private express trust must of necessity impose active duties on the trustee, for without such an imposition the Statute of Uses would terminate the trust by executing the use.[105]

As a legal consequence of the statement of fairly definite objectives in the trust, there arises on behalf of the trustee an equitable duty to deal with the property in accord with those purposes, and there is bestowed upon him the power to fulfill those purposes. The same

101. 2 A. SCOTT, TRUSTS § 186 (2d ed. 1956).
102. N. LATTIN, CORPORATIONS 177 (1959).
103. 1 W. FLETCHER, CORPORATE FORMS ANNOTATED § 537 (3d ed. rev. vol. 1957).
104. Securities Act of 1933, 15 U.S.C. §§ 77(b)(10), 77(e)(b), 77(j) (1964). Requirements as to the content of prospectuses are contained in Investment Company Act, 15 U.S.C. § 80a(8) (1964).
105. 1 A. SCOTT, TRUSTS §§ 67-69 (2d ed. 1956).

is true of a corporation board of directors. They too are empowered and limited to act within the stated corporate purpose. Since, however, the corporate purpose is usually stated in relatively broad terms, the board is generally permitted a wider latitude of activity than is the trustee. Thus, the spectre of ultra vires acts and resulting liability is less constrictive in the corporation than is its counterpart in the trust. Concomitantly, the beneficiary in a trust has the power to enforce outer limits on his trustees' actions with more particularity and hence has more effective control than has the shareholder over his board of directors.

What is more important for purposes of beneficiary control of the trustee is that the trustee's fiduciary duties run directly to the beneficiary, since the trust is merely a relationship and not a separate legal entity. Compare this with the business corporation board of directors whose duty runs to the corporation on whose behalf the shareholders may bring an action. While the nature of a corporation as a separate legal entity strongly encourages this alignment of duty, note that it tends to create in the corporate form a gap between directors and shareholders the result of which is to undermine shareholder confidence in their rights and powers against the directors. In the trust, on the other hand, the alignment of duties, and knowledge of this alignment, bolster the confidence of the beneficiary in his powers of supervision and control. The result can only be greater concern by trustees conscientiously to fulfill their equitable duties than one finds in the business corporation.

Finally, the trust is distinguishable from the business corporation because implicit in the trust relationship is an intense duty of loyalty directly to the beneficiary. "The most fundamental duty owed by the trustee to the beneficiaries of the trust is the duty of loyalty . . . . [The fiduciary element] is peculiarly intense in the case of a trust. It is the duty of the trustee to administer the trust solely in the interest of the beneficiaries."[106] This duty is breached when, without express permission from the beneficiaries or authorization from the trust, the trustee purchases trust property for himself even though the sale was made in good faith and for fair consideration.[107] The same duty is breached where the trustee has a personal interest in the buyer of trust property such as a corporation in which the trustee is a significant stockholder.[108] It is also breached where the trustee uses the trust property for his own purposes.[109] The corporate director's

106. *Id.* § 170.
107. *Id.* § 170.1.
108. *Id.* § 170.10.
109. *Id.* § 170.17.

fiduciary duty, on the other hand, not only does not run directly to the shareholder, but neither is it so intense. The issue of a director purchasing corporate property is generally decided in favor of the director where the transaction is found to be reasonable.[110] The same is true of a director's separate business purchasing corporate property. It has even been said that "Directors or officers of a corporation are not, by reason of the fiduciary relationship they bear toward the corporation, necessarily precluded from entering into an independent business in competition with it, but, in doing so, they must act in good faith."[111] Clearly then, the director's duty of loyalty is somewhat less demanding than that of the trustee.

B. *Similarities of Trust and Mutual Fund*

The comparison of trust law is relevant to the mutual fund because many of the functional characteristics of a trust are essentially similar to those found in the mutual fund. Central to this similarity is the three part form that the trust sometimes takes in order to fulfill its function. Often the settlor will select a trustee not for his ability to perform the managerial functions required by the trust but for his trustworthiness. In these instances, the selected trustee will hire managers under contract and will periodically review their performance to ensure competent management. At these times, the active relationship between the investor and investment adviser in the mutual fund is more nearly like that between the beneficiary and actual management in the private express trust than it is like that between shareholder and management in the business corporation. For example, the investor, in both the private express trust and the mutual fund, enters into an agreement which specifies the limitations upon the use to which his investment may be put by stating in relatively explicit terms the purpose for which he intends his money to be used. In contrast, the corporate shareholder imposes no such defined limitations on the use of his investment. Further, in both trust and mutual fund, the investor is the one to be primarily benefitted. The trust, a relationship to accomplish the intentions of the settlor, demonstrates this by its customary operation and by the legal relationships contained therein. The mutual fund suggests this by basically functioning as an investment institution and by passing through all of its "net gains"[112] to the shareholders. Finally, in both the mutual fund and trust the investor commits his funds in the belief that the policies that he

110. N. LATTIN, CORPORATIONS 257-60 (1959).

111. Lincoln Stores, Inc. v. Grant, 309 Mass. 417, 423, 34 N.E.2d 704, 707 (1941).

112. Note that the tax law requires the mutual fund to pass its net gains through if it is to avoid taxation of them at the corporate level. *See* text accompanying note 43 *supra*.

has adopted or stated will be carried out faithfully without need for constant supervision. Hence the word "trust" and the claimed advantage of mutual funds in relieving the investor from the burdens of ownership. Thus, a brief look at the fund from a functional viewpoint shows that it is materially similar to the corporation in all ways except for the investor-management relationship, and that for purposes of the investor-management relationship the fund is materially similar to a private express trust. It does not then seem unreasonable to look first to corporate law for a base from which to reason and develop mutual fund law for all purposes but investor-management duties, and for those duties to look first to trust law. Factual analysis of the three institutions suggests such a dual orientation; and in addition, a need for a remedy to the problem of investor insulation supports the conclusion. By imposing the duty of loyalty found in the trust on the fund board of directors and by causing them to be clearly and directly answerable to the investors for any breach of this duty, the board becomes a policeman whose concern for the welfare of the investor is maximized. Thus, the investor who is attracted to the mutual fund because of his relative naivete in the financial marketplace will be more likely to receive the watchful protection that he particularly needs while at the same time the directors are fairly encouraged to fulfill their obligations vigorously.[113]

Application of this relatively simple dually-oriented system of law is subject to at least two limitations. The first is that which arises through recognition of the fact that this system is only a logical starting point for the development of mutual fund law. It is entirely possible that the trust standard of fiduciary obligation may impose such a burden on the directors as to prohibit the effective operation of the fund. Thus when scrutinizing a fund characteristic, which is more nearly typical of a corporation than of a trust, the concept of corporateness should properly relax the rigidity of the fiduciary duty to the extent necessary for effective operation. While such modifications should be made only to satisfy a clear need, there is no reason to limit unduly the flexibility of the proposed system. A second limitation on the dictates of the common law are statutes, primarily federal, which impose various requirements on the structure and operation of the funds. A detailed discussion of their effect follows. In the last analysis, however, there remains the core thesis that the best source of mutual fund common law is a combination of corporate and trust law.

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113. Dr. Vannever Bush wrote a pamphlet entitled *The Role of the Independent Trustee of a Mutual Fund* published by the Putnam Management Company, Inc. which comments on the independent director's role with respect to management.

V. Statutory Regulation

Mutual funds have been subjected to significant federal statutory regulations since 1940 when the Investment Company Act[114] was passed to protect "the national public interest and the interest of investors . . . ."[115] Based on the interstate commerce clause and congressional power to control the mails,[116] The Act performs its function of protecting investors through the use of four techniques: first, by making easily available to the prospective as well as present investor sufficient information for him to be able to make a reasoned decision as to the nature of the fund; second, by limiting the scope of activity of the fund where such activity is deemed to be too likely to be detrimental to the investor's best interests; third, by reposing in the investor all the power necessary to terminate those relationships of the fund with parties that have control or substantial influence over the disposition of the investor's interest; and finally, by structuring the fund in such a way as to minimize the potential dangers to the investor inherent in its operation. Thus the regulatory scheme is significant because it recognizes the need for higher standards of protection than corporate law would provide, and it defines the legal context in which the mutual fund must operate.[117] Hence, it forms the structure around which the proposed mutual fund common law must develop.

A. *Board of Directors*

The board of directors is the most vigorously regulated participant in the mutual fund. In order to inform the general public, the board is required, on behalf of the fund, to register a statement with the Securities and Exchange Commission, open to the public, that not only satisfies all disclosure requirements on the issue of new securities[118] by standard business corporations, but which, in addition,

114. The Act includes within its regulatory scope every company which is or holds itself out to be primarily engaged in the business of investing, reinvesting, or trading in securities. Through the exceptions to this general rule, the statute narrows its scope to those companies which issue their shares to the shareholders and which are not regulated by any other governmental body. Investment Company Act, 15 U.S.C. § 80a(3) (1964).

115. Investment Company Act, 15 U.S.C. § 80a(1)(b) (1964). The Investment Advisers Act, 15 U.S.C. § 80b(1), (21) (1964), was also passed in 1940. The effect of this statute on the subject matter of this paper is minimal; hence, the statute will not be treated.

116. *See* Investment Company Act, 15 U.S.C. § 80a(7)(a) (1964).

117. For an enlightening discussion of desirable modes of solution for investment fund problems and the suggestions of the then trade group of the industry, see J. Fowler, American Investment Trusts 228-39 (1928).

118. For these requirements see Securities Act of 1933, 15 U.S.C. § 77j (1964); Securities Exchange Act of 1934, 15 U.S.C. § 78(1) (1964).

describes the scope of the intended activity of the fund, states its fundamental policy,[119] and gives full descriptive information on affiliated persons, officers and directors.[120] As is the case with a business corporation, prospectuses containing registration information must be transferred to the prospective investor on or before sale of any securities to him. The fund is also required to furnish its investors with semi-annual reports containing a balance sheet, a statement of assets, a statement of income, and a statement of purchases and sales.[121] This provision seems to be a compromise between corporate law which requires annual reporting and trust law which requires reporting on demand but at reasonable times. In its efforts to prevent the fund from undertaking unduly hazardous activities, the statute forbids the fund to acquire any securities which are underwritten by any of its officers, directors, employees or advisers.[122] Neither may the fund purchase portfolio shares on margin, sell short, nor participate in a trading account.[123] Further, without shareholder approval the fund cannot swap its shares for securities in other funds.[124] The fund is allowed, however, to sell its shares through an underwriter or by itself but only at the prospectus price; to restrict the tradeability of its shares but only in conformance with its registration statement; and to receive only cash or securities for its shares.[125] Finally, the fund may issue senior securities provided it takes the substantial measures which are prescribed by statute to protect their safety and the value of the common shares.[126] Limits of this type are not generally found in either corporate or trust law. Rather, the less precise limit of public policy forms the bounds of corporate or trust activity.

The statute limits the composition of the board of directors to men who have no record of malpractice in the securities industry.[127]

119. Among the information to be provided is the type of fund (open-end, etc.); whether it plans to borrow money, issue senior securities, underwrite other securities, concentrate investments in particular industries, deal in real estate or commodities, loan money to others, have a high or low turnover rate. Investment Company Act, 15 U.S.C. § 80a(8)(b)(1) (1964).

120. *Id.* § 80a(8)(b)(3).

121. *Id.* § 80a(29)(d). Annual reports must contain a statement by independent accountants.

122. *Id.* § 80a(10)(f). It may purchase such securities if the fund itself is the principal underwriter.

123. *Id.* § 80a(12).

124. *Id.* § 80a(11). It may convert from one class or series into another class or series of securities issued by the same company as specified by the instrument subject to which the securities to be converted were issued.

125. *Id.* § 80a(22).

126. *Id.* § 80a(18).

127. *Id.* § 80a(9)(a). This section prohibits from serving as an officer, director, adviser or principal underwriter one who has been convicted of a felony or misdemeanor within the previous ten years which arose out of securities activities, or one

It also prevents more than sixty per cent from being members of any one group such as the investment adviser, fund officers or fund employees,[128] and thus insures the presence of an independent minority on the board. As a further safeguard, a majority of the directors not affiliated with the principal underwriter must approve the contract between it and the fund; and a majority of the directors not affiliated with the adviser must approve its contract with the fund.[129] The statute also gives the board as a whole the duty to renew adviser and underwriter contracts, and the power to terminate adviser contracts without penalty.[130] Lastly, it prevents the directors from limiting their liability for certain acts in the articles of incorporation of the fund.[131] In its attempts to vest a power of control in the investor, the statute requires the investors to elect the board of directors,[132] to approve new adviser contracts[133] and to approve changes in fundamental policy.[134] They are also given the power to renew adviser and underwriter contracts and to terminate adviser contracts without penalty.[135]

In these last two areas of regulation the statute seems to suggest that corporate standards do not provide enough investor protection. The mutual fund board must have an indpendent contingent; key contracts must be approved by independents; the board must be at liberty to terminate the adviser's employment contract at any time without penalty; and investors must approve new advisers and new policies for the fund. Each of these requirements tends toward trust fund standards by providing protection over and above what the shareholder would receive in the corporation where the board need not be independent from management, and where shareholders may disapprove of new management and policy only by refusing to reelect incumbent directors or by selling their shares. Appropriately enough, this same relationship between statutory requirements and corporate-trust law is also reflected in the statute's regulation of the investment adviser.

B. *Adviser*

The statute attempts to insure that the shareholders are informed

who for bad conduct is enjoined by court order from engaging in security company activity.

128. *Id.* § 80a(10)(g). If the fund meets certain requirements all of its directors but one may be affiliated with the adviser in accordance with § 80a(10)(d).

129. *Id.* § 80a(15)(c).

130. *Id.* § 80a(15)(a). Shareholders also have these powers.

131. *Id.* § 80a(17)(h).

132. *Id.* § 80a(16)(a).

133. *Id.* § 80a(15)(a).

134. *Id.* § 80a(13).

135. *Id.* § 80a(15)(a).

as to the compensation paid the investment adviser by requiring that the adviser be employed only pursuant to a written contract which describes all compensation to be paid to it.[136] When a new investor becomes a shareholder he will be informed as to the amount of this compensation through the prospectus that he must be shown,[137] and when a new employment contract is signed, the shareholders will be made aware of the level of compensation when they vote, as they must, on whether to accept the contract.[138] The statute also seeks to place control over the adviser, at least through the veto, in the shareholders or the body more nearly responsive to them, the board of directors. It requires that the employment contract shall not be in effect for more than two years except by annual shareholder or director approval, that it may be terminated by the shareholders or directors at any time without penalty and that it automatically terminates if assigned.[139] In addition, the board may not renew the contract without the concurrence of a majority of the independent directors of the fund.[140] The activities of the adviser are also limited by statute. Where the adviser is the principal underwriter of an issue, the fund it advises may not acquire any of that issue.[141] Also, it may not vary from the fundamental policy of the fund without express shareholder approval.[142] The structural requirements imposed by statute prevent those whose record in the securities field is not good from serving as adviser.[143] Perhaps the most telling structural requirement is that which prevents more than sixty per cent of the board from consisting of representatives of the investment adviser or its affiliate,[144] but permits all but one member of the board to be from the adviser if the fund meets certain stringent requirements.[145] Thus where the safety requirements are met, the fund may have more freedom in the composition of its board, and the "corporation-law plus" standard need not be employed.

As an over-all system of regulation the Investment Company Act provides a sound skeleton. By recognizing the importance of the investor-adviser relationship and by trying to create closer ties between the two, it wisely reinforces the basic corporate web of share-

136. *Id.* § 80a(15)(a)(1).
137. *Id.* § 80a(8)(b)(1).
138. *Id.* § 80a(15)(a).
139. *Id.* § 80a(15)(a)(2)-(4).
140. *Id.* § 80a(15)(c).
141. *Id.* § 80a(10)(f).
142. *Id.* § 80a(13).
143. *See* note 127 *supra.*
144. Investment Company Act, 15 U.S.C. § 80a(10).
145. *Id.* § 80a(10)(d). Such a result is permissible if eight safeguards are met. The apparent purpose of the safeguards is to limit the possible misallocation of expenses as between fund and adviser.

holder protection to take into account the additional insulation between shareholder and management and the additional need for close, loyal ties between the two parties in the fund. As such, the statute strives to create a relation between the two parties[146] not unlike that found in a trust which reflects the functional relation intended by the investor. Add to this statutory skeleton of regulation the behavioral standards of the trust and fill in the remaining areas with the legal ramifications of the corporate form, and a relatively complete source of mutual fund law begins to take shape.

VI. Judicial Activity

Cases dealing with director liability in the mutual fund situation reflect uncertainty and confusion in the search for common law principles to supplement specific statutory dictates. It is submitted that the central reason for this unsatisfactory state of affairs is the inflexible use of corporate law as the sole source of regulatory common law. This approach is readily understandable, since the use by most mutual funds of the corporate form requires the application of corporate legal doctrine to them. However, this fact does not mean that mutual funds cannot justifiably be required to meet standards of dealing more stringent than those applicable to businesses of other sorts employing the corporate form. The law has long required higher standards of some businesses than of others, no matter what form of business association is employed. Consider, for example, the business of insurance. The dealings of insurers with their policy holders have long been given a special scrutiny by the courts, the relation of insured and insurer being characterized as one *uberrimae fidei.* That the analogy is appropriate is indicated by the high probability that more and more insurers will soon enter the variable annuity market, offering annuity contracts whose benefits are closely akin to those claimed by the mutual funds.

If one accepts the two principal arguments submitted thus far in this note—that the functional nature of the mutual fund is such that dealings between the fund and its shareholders require special scrutiny; and that the development of special rules designed for mutual funds can appropriately be undertaken by the courts, since they have done so in other areas, notably in the field of trusts—then two further questions inevitably present themselves: (1) What sources of legal doctrine provide the best guide to the formulation of "mutual fund common law"? (2) What should the rules of this mutual fnnd common law be?

It is the first of these questions which is the concern of this note.

146. For an analysis of the statutory alloeation of functions and duties see Lobell, *Rights and Responsibilities in the Mutual Fund,* 70 Yale L.J. 1258, at 1275-88 (1961).

It is submitted that the best foundation for a cohesive body of judicially developed rules for the regulation of mutual funds can be laid by constructing it of materials drawn from two sources: the law of trusts, and the policies which the Congress enunciated by implication in enacting the Investment Company Act. It is further submitted that this development is appropriate because the Congress indicated by the statute a desire that mutual fund shareholders be given greater protection than that afforded investors generally, and by doing so placed the fund shareholder in a position more nearly analogous to that of a trust beneficiary. Finally, it is submitted that the leading case concerning the scope of directors' duties under the Investment Company Act, *Brown v. Bullock*,[147] demonstrates that such an approach is both feasible and fair.

In *Brown*, shareholders of Dividend Shares, Inc., brought suit derivatively and representatively against the directors of the company. They alleged that their fund was being charged higher fees by its adviser than was another fund managed by the same advisers; that defendant directors, members of a board that was controlled by the adviser, had sent out proxy statements which falsely described their adviser arrangement as "similar" to that between the adviser and his other clients; and that this conduct violated a director's duties under the Investment Company Act[148] as well as under the common law. The complaint withstood defendant's motion to dismiss, the court holding that under the Investment Company Act the complaint adequately alleged a willful conversion and failure by the board, which was completely controlled by the adviser, to give a "meaningful" approval of the management contract; and that these claims were enforceable by private parties in federal court. The court reasoned that since the act empowers the board of directors to renew the adviser's contract annually, and to terminate the contract at will,[149] it impliedly imposed on the directors a duty to scrutinize the actions of the adviser in order that it might know when non-renewal, re-negotiation or termination is advisable. Additionally, the court recognized, but did not rely on,[150] the common law obligation of corporate fiduciaries not

147. 194 F. Supp. 207 (S.D.N.Y. 1961), *aff'd*, 294 F.2d 415 (2d. Cir. 1961). The district court opinion is the more illuminating one. The best and most recent discussion of case law under the Investment Company Act is Eisenberg & Lehr, *An Aspect of Emerging "Federal Corporation Law": Directorial Responsibility under the Investment Company Act of 1940*, 20 RUTGERS L. REV. 181 (1966).

148. Investment Company Act, 15 U.S.C. § 80a(36) (1964). This section forbids wilful conversion. Investment Company Act, 15 U.S.C. § 80a(15) (1964), requires the board to renew the adviser's contract annually if it is to continue for more than two years.

149. *Id.* 15 U.S.C. § 80a(15).

150. *See* Lobell, *supra* note 146, at 1281-82, which roundly criticizes the *Brown* case for not discussing the uniqueness of the mutual fund and for assuming that the corporate mold should dictate the proper regulatory law.

to misapply willfully the corporation's funds. However, by relying on the Investment Company Act to define interstitial duties, the *Brown* court utilized a more logical approach to the solution of the source of law problem than is used by the strict corporate law courts.

Further expansion of this technique to include implications from other sections of the statute could well provide a workable seed for the development of a full system of mutual fund common law. Were this to be done the most controversial provision would, no doubt, be that section of the Act which empowers the SEC to enjoin any director from acting in the capacity of a director where the Commission has shown him to be guilty of a gross abuse of trust.[151] By using the "gross abuse of trust" standard in such a way as to define both the quantitative and qualitative dimensions of whatever duties were not otherwise provided for in the statute the courts could develop a full system of mutual fund common law. However, even assuming that there is found to be a private right of action under this section, there still remains the problem of a lack of guiding law on the books. Given the need for predictability in the area, the utility of going first to the dual oriented corporate-trust system of regulatory common law becomes particularly attractive. Since too, insofar as director's duties are concerned, trust law will probably impose higher standards than would a sophisticated system of mutual fund law, reliance on such a developed system seems not only useful but safe.

The case of *Brouk v. Managed Funds, Inc.*[152] is in clear disagreement with *Brown* on the issue of whether the Investment Company Act can be used as an authoritative source from which to infer duties and under which private rights of action may be prosecuted. In this case shareholders of Managed Funds filed a derivative suit against the fund adviser, the fund directors, the fund underwriter (the three of which were under common control) and the brokerage firms that handled most of the fund business. The plaintiffs charged that the fund was being managed in the interest of the controlling group rather than in the interest of the investors, evidenced by excessive trading in portfolio securities, questionable allocation of brokerage business and money paid to members of the controlling group for which no service was performed. Complainants alleged, as they did in *Brown*, that these practices breached a duty owed them under various sections of the Investment Company Act.[153] The defendants'

151. Investment Company Act, 15 U.S.C. § 80a(35) (1964). Eisenberg & Lehr, *supra* note 147, develops this idea more fully.

152. 286 F.2d 901 (8th Cir. 1961).

153. Investment Company Act, 15 U.S.C. § 80a(1) (1964), which states the general purposes of the Act; *Id.* § 80a(13), which requires changes in investment policy to be approved by the shareholders; *Id.* § 80a(15), which requires advisers' contracts to be renewed annually by the board of directors; *Id.* § 80a(34), which prohibits misrepresentation.

motion to dismiss was granted by the court of appeals on the ground that the act creates no duties owed by directors which are cognizable in federal court through a private cause of action. The court, in failing to allow the suit, factually distinguished analogous cases decided under the other securities acts which had found such a right of action under either a contract[154] or tort[155] theory. Further, the court was apparently deterred from allowing such a claim under the sections imposing criminal penalties for violations of the act[156] because of the requirement of willfulness. Finally, the court found that the ". . . wording of the Act shows that it was the legislative intent to refrain from entering the field of director responsibility."[157] On the common law claim, since the controlling corporate law did not make directors insurers, the court found the questioned actions to violate no duty owed by the directors under either law. Thus the *Brouk* court not only ties itself to the erroneous presumption that corporate law is the only appropriate regulatory common law, but it cuts itself off from a more enlightened source of such law, the implications of the Investment Company Act. This court apparently believes that the mutual fund should be held to corporate common law standards whenever possible, even though the legislature appeared to demonstrate its recognition of the need for higher standards in the mutual fund field by enacting the Investment Company Act. It is submitted that this is an undesirable approach to the problem.

Not long after the *Brouk* decision, *Lutz v. Boas*[158] was decided by the Delaware Chancery Court. The case arose out of the same facts as *Brouk*, but was based on Delaware corporation law. Chancellor Seitz found the directors liable for breach of their fidueiary duty under state common law[159] because the directors "gave almost automatic approval to the management agreement; they did not examine the registration statements carefully; they did not discuss securities at their meetings or discuss any of the other facts which would have been pertinent to a reasonable discharge of their duties; . . . the directors did not know who selected securities for purchase or sale; they did not inform themselves about the rate of turnover and how

154. This theory is predicated on the provision of the statute that invalidates contracts entered into in violation of the Act. 286 F.2d at 908.

155. This theory relies on the tort theory that a breach of a statutory duty normally gives rise to a right of action on behalf of the injured person for whose protection the statute was enacted. 286 F.2d at 907-08. *See also* J. I. Case Co. v. Borak, 377 U.S. 426 (1964), *noted in* 18 VAND. L. REV. 275 (1964).

156. Investment Company Act, 15 U.S.C. § 80a(36) (1964). *Id.* § 80a(48).

157. Brouk v. Managed Funds, Inc., 286 F.2d 901, 916 (8th Cir. 1961).

158. 171 A.2d 381 (Del. Ch. 1961).

159. The liability was imposed on independent directors for their negligence as well as active directors for their positive wrongs. The court took the opportunity to roundly criticize these independent directors for not carrying out their functions responsibility. *Id.* at 395.

the brokerage business was being distributed."[160] Had these directors "discharged their responsibilities as to general supervision they would have discovered these violations of Funds' investment policy."[161] Thus, failure of the directors to perform duties of general supervision constitutes a breach of the corporate fiduciary duty in Delaware.

Even after an enforceable duty has been found to exist, it has proved difficult to define the scope of that duty. In *Acampora v. Birkland*[162] a shareholder of Financial Industrial Fund brought a derivative action against the fund's directors and its combination adviser-underwriter. The plaintiff sought restoration of certain management fees paid during a period when the management contract was allegedly void because various sections of the Investment Company Act had been violated.[163] The court allowed recovery for amounts represented by improper allocation of officers' salaries, office furniture and equipment, and certain fees on the ground that the allocation of these assets was in direct violation of the terms of the adviser's contract. However, of more significance (although dictum only) is the court's statement of the director's duty inferred, apparently, from the Investment Company Act. On one hand the court says that the standard is "gross negligence or, . . . at least, bad faith."[164] But on the other it says:

> These non-affiliated directors have a demanding mission and that is the protection of the assets of Fund and the shareholders. Their position in relation to Management [the adviser] is adversary in character, and if they are to properly fulfill their mission they are obligated to scrutinize the acts and doings of the adviser with great care.[165]

The legal effect of acting in the gap between "scrutinize . . . with great care" and "gross negligence" is open to speculation. Suffice it to say that there is some uncertainty as to the exact scope of the directors' duty. Here too, the court avoids the difficulties in selecting an authoritative source for its determination that a duty exists and simply cites no authority to support any of its discussion of the issue, although the language used seems to reflect the policy of the Investment Company Act.

Finally, in *Saxe v. Brady*[166] shareholders brought a derivative action against the fund directors, its adviser and its adviser's parent, alleging that the adviser's fee of 1/2 of 1 per cent is ". . . unreasonable, exces-

160. *Id.* at 395-96.
161. *Id.* at 396.
162. 220 F. Supp. 527 (D. Colo. 1963).
163. Investment Company Act, 15 U.S.C. § 80a(15)(a) (1964), requiring amendments to adviser's contracts and new contracts to be approved by the shareholders; and *Id.* § 80a(10)(a), which requires 40% of the board to be independent.
164. Acampora v. Birkland, 220 F. Supp. 527, 550 (D. Colo. 1963).
165. *Id.*
166. 184 A.2d 602 (Del. Ch. 1962).

sive and an illegal waste and spoilation of the Fund's assets." They contended that payment of the fees and annual renewal of the contract constituted a breach of the directors' fiduciary duty. Although Chancellor Seitz found the adviser's fee not to be unreasonable under common law standards, he cautioned that "an independent board would [not] wait until the fees paid under the management contract warranted a finding of waste before attempting to negotiate a better deal."[167] Hence although the facts in this case do not justify a finding of corporate waste, there is some point at which the directors are obliged to see that the management fee is adjusted according to the effort necessary to do an adequate job. Thus, although the courts are not satisfied with the scope of the existing duties as defined by corporate law, they are reluctant to define a new scope, perhaps of old duties, which would fit the needs of the mutual fund.

In the final analysis, both the determination of the existence of a duty and the definition of the scope of that duty with respect to directors has been plagued by uncertainty in state and federal courts. Of the current approaches, the one that seems most likely to succeed in the development of a mutual fund common law is that suggested in *Brown*, which requires that duties be implied through the provisions of the Investment Company Act and that private rights of action be allowed thereunder.[168] Even here, recognition of trust law as a proper indicator of fiduciary obligations would give mutual fund common law a maturity beyond its years. The typical approach of the courts in assuming that corporate law should be used has not proved satisfactory even to the courts and it is submitted that trust law should be more actively used.[169]

VII. Recent Developments

Recent developments both within and related to mutual funds also reflect dissatisfaction with the way that the funds are currently fulfilling their responsibilities to the investing public. The *Wharton*

167. *Id.* at 616.

168. *See* text accompanying note 147 *supra.*

169. In the *Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess., pt. I, at 262-63 (1940), *supra* note 34, it was said that the statute did not "impose a trustee obligation on these managers . . . [because] . . . maybe that obligation is much too strict." Instead they proposed to make the manager guilty of a crime for gross abuse of trust. To what extent this testimony ought to control the duty imposed on directors which is decided upon as a result of reasoned independent analysis is left to the reader. It is submitted that sound independent analysis is, perhaps, a more rational foundation on which to base one's choice of law than is 25-year-old testimony before a Senate subcommittee. In any event, the reason for the drafter's rejection of a trust standard is that it would have impracticably harsh results. That may still be true. If so, it still does not negate the persuasive force of the comparisons between mutual fund, trust and corporation. It may however alter what conclusions may wisely be drawn therefrom.

Report, the *Special Study of Securities Markets*, and the *SEC Report* criticize particular aspects of fund operation which today are the targets of the most active reform. One such target of both criticism and reform is the sales practices of mutual funds. Concern has been expressed that the fund salesmen are poorly trained,[170] and exert an undue influence on the investment decision.[171] The response to this problem has been varied. First, the SEC has required personnel of firms dealing in mutual fund shares which are not regulated by any other organization to submit to examinations to determine their eligibility for work as security salesmen, analysts, supervisors or advisers.[172] A second response has been the increased number of no-load funds. One example is the One William Street Fund, which shortly after the publication of the *Special Study* switched to become a no-load fund by eliminating its eight per cent sales charge.[173] Other funds have taken less drastic measures and reduced their sales charge to rates comparable to those paid for shares listed on the New York Stock Exchange.[174] Most recently the SEC advocated abolition through amendment of the Investment Company Act of front end load contractual plans and establishment of a five per cent ceiling on sales commissions.[175] Thus, in the field of sales practices, following a recognition of need, steps have been taken to minimize the potential for danger in the operation of the mutual fund.

The level of investment adviser's fees has also been criticized in the cases[176] and in the government reports.[177] Here too there has been response from the government and the private sector. The SEC has proposed that the adviser's cost figures be included in the annual solicitation of proxies to approve the advisory contract as well as in the prospectus. These figures would include the expenses incurred

170. "The primary problem involves the fund-share shalesmen—most of them part-timers—whose abilitics, training and tactics have been the subject of much criticism." N.Y. Times, Jan. 6, 1964, at 108, col. 3.

171. *See generally* SPECIAL STUDY pt. 4, at 102-212.

172. About 23,000 employees of 954 firms are expected to pass qualifying exams under the proposed rule—19,000 are employees of 55 mutual fund organizations. An exam given by state, NASD, NYSE or Amex authorities would exempt an individual from the SEC examination. In addition, persons associated with one firm since July 1, 1963, and who haven't been involved in state, federal or industry regulatory violation are exempt. N.Y. Times, Sept. 9, 1965, at 56, col. 2.

173. 72 FORTUNE 86 (1965).

174. On a $2000 transaction a normal mutual fund salcs charge would be about $170, while a NYSE commission would be about $27. Wall St. J., April 5, 1966, at 13, col. 2.

175. SEC REPORT 22. For detailed discnssion on operation of contractual plans and sales commissions see note 66 *supra*.

176. *See* text accompanying note 167 *supra*.

177. The *SEC Report* noted that among 57 externally managed funds of more than $100 million net asset value, adviser fces were double those found in banks and funds with internalized advisers. SEC REPORT 11.

by the advisers in providing their service, the amount paid as a fee to the advisers from the fund, and the before and after tax income of the adviser service.[178] The purpose, clearly, is to provide the investors with sufficient information to vote intelligently for or against approval of the adviser's contract. Even more recently the SEC recommended that the Investment Company Act be amended to require that fees paid to affiliated persons such as advisers be reasonable and that their standard of reasonableness be enforceable by either the Commission or an aggrieved investor.[179] Reaction in the private sector has taken the form in some funds of linking the amount of the fee to the performance of the fund. When the fund outperforms the Dow-Jones industrial average percentage increments are added to the base rate.[180] Thus, in the sensitive area of adviser's fees, the interested parties are recognizing their substantial obligation to charge and to approve reasonable fees and are promoting a relationship of trust between the fund and its investor.

Perhaps the most significant proposal for the improvement of mutual fund regulation to be made since the Investment Company Act itself was that made by the SEC in its recent report.[181] It requested that sections 35 and 36 of the Act be amended to delete the word "gross" from the phrase requiring that an individual be "guilty . . . of gross misconduct or gross abuse of trust" in order for the SEC to enjoin him from acting as an affiliate of a fund. It also requested the right to enjoin an affiliate from breaching a fiduciary duty and to seek any additional relief necessary for protection of the investors. Basically, the SEC has asked Congress to establish by statute the rights and remedies that the courts using the *Brown v. Bullock*[182] approach are beginning to establish without a specific congressional mandate.

VIII. CONCLUSIONS

The proposals of this note, the thrust of statutory regulation, the trend of the case law and the direction of recent developments are all consistent. In a practical sense, the suggestions here attempt to provide a reasonable source of law for the men of the industry and for the courts in search of an authoritative system of behavioral standards. If, for example, a mutual fund has enjoyed such vigorous growth that the percentage fee now charged by the advisers has lost its relevance to the actual cost of management, the disgruntled shareholder or the apprehensive director would seek information on potential law suits. They would first turn, no doubt, to the Investment

178. N.Y. Times, March 19, 1964, at 46, col. 3.
179. SEC REPORT 13.
180. *Supra* note 156.
181. SEC REPORT 31.
182. *See* text accompanying note 147 *supra*.

Company Act to determine whether the statute specifically imposed any duties that might be violated. Finding none, the interested party would, under the proposals of this paper, then turn to duties created by implication under the Investment Company Act or duties created by trust law.[183] Having determined that such duties arguably exist, the party, to establish the scope of these duties, would then look to trust standards in the absence of controlling case law under the statute. Utilizing the principles of trust law under the theories set forth in this note, the shareholder might then build his brief, or the director govern his actions, on the basis of such law to the extent that it provides reasonable solutions. Suit could then be brought in conformity with the procedural requirements of standard corporation law. This technique, derived from rational analysis of the participants, emphasizes the best aspects of both predictability and fairness, and as such is worthy and capable of bracing the newly developing mutual fund law until such time as it has the strength to stand on its own. Once this point is reached, there will no longer be a need to borrow halfway relevant law from other sources or to run the risk of misdirection implicit in the utilization of law in an area for which it was not promulgated. But, until that time, it is senseless not to apply all the relevant learning possible to problems analogous to those about which substantial law already has been developed. It has been the purpose of this note to demonstrate the utility of this device for the mutual fund.

JAMES M. ANDERSON

183. Recent entrance of a new type of mutual fund and the resulting concern for behavioral guidelines illustrates again the utility of trust fund standards. During the last week of March 1967 the SEC approved five "dual purpose" investment funds for entry into the public market for the first time. In simple form they require two investors, one of whom is interested solely in capital gains, the other of whom is interested solely in income. Each purchases its respective class of security in the "dual purpose" fund. For the first fifteen years the owner of the income securities receives all income earned by both his contribution and the contribution of the capital gains investor, and the latter receives all capital gains generated by the reinvestment of both his and the income investor's contributions. After fifteen years the securities mature and the income investor receives his original investment back while the capital gains investor receives his appreciated investment. At least one fund guarantees a seven per cent annual return to its income investors.

The primary reason why the SEC required more than a year to approve this new concept in mutual funds was its concern over how a fund could serve two masters, that is, both income and capital gains. What guidelines would the fund use to channel its investments in such a way as to act in the best interests of both income and capital gains securities holders? The question was never fully answered. It is submitted that the method of analysis proposed by this paper provides the best answer. The courts, encouraged by the SEC and enlightened litigants, could look to trust fund law to determine the guidelines for similar situations therein provided. For instance, trust law has dealt with this same problem when a trustee is charged with responsibility for both life estate income beneficiaries and remaindermen. The same conflict between income and growth investments exists here and here also can be found a body of thoughtful consideration on the problem.