

whether it is the wish of the committee that I read the statement or whether I should just file it and present myself for possible questions?

Mr. MOSS. I leave that entirely to your choice, whichever means you feel will most effectively indicate the views you have.

Mr. JENNINGS. I would like to then take up the matter of management fees.

I have restricted myself mainly here to legal problems involved in connection with the mutual fund structure. I will first deal with the problem of the proposed amendments to section 15 of the act relating to management fees.

The mutual fund structure is quite unique in that unlike most American corporations and financial institutions which employ their own staff to manage their affairs, the mutual fund typically receives its investment advice and management services from a separate organization which is owned and controlled by the sponsors of the fund or their successors. The fund usually has a board of directors who negotiate the advisory contract with the investment adviser. Traditionally, the fee in an investment advisory contract was one-half of 1 percent of the average assets of the fund during the year. In the early years of a fund, such a fee may in fact be inadequate. As the fund grows, however, the fee becomes more and more attractive. For example, if a fund has average assets of \$100 million at one-half of 1 percent, the fee would amount to \$500,000. If the average assets grow to \$600 million, the fee computed at the same rate rises to \$3 million. And if the fund climbs to a billion dollars of assets, the fee of \$5 million becomes enormous. It may be an oversimplification to say that "it costs no more in research effort to buy 100 shares of stock than 100 shares", as Judge Moore suggested in *Brown v. Bullock*, 294 Fed. 2d 415 (2d Cir. 1961), but surely this is an area where the economies of scale clearly would be expected to operate.

The Investment Company Act recognizes the inherent conflict of interest between the investment adviser and the fund by requiring (a) that at least 40 percent of the board of directors be "independent" of the adviser, that is not affiliated with it; and (b) that these unaffiliated directors annually approve the contract. Thus, the act supports the illusion that the unaffiliated directors will negotiate the advisory contract on behalf of the fund shareholders. It is also customary to have the advisory contract ratified or approved by a majority of the shareholders. In reality, however, when the shareholders are asked to ratify the contract, they cannot negotiate for the fund. They are limited to rejecting or accepting the contract formulated by the fund directors. Furthermore, with the proxy machinery supposedly in the hands of management, there is no difficulty in obtaining shareholder approval of the advisory contract.

Mr. KEITH. I have a question. You changed your testimony and I wonder the reason for it. You said on page 2 with reference to *Brown v. Bullock* "Surely this is an area where the economies of scale clearly operate."

I think you changed that in your oral statement.

Mr. JENNINGS. What I really mean is that it should be cheaper proportionately to operate a \$1 billion fund than a \$100 million fund. Whether the economies of scale are passed on is another question.