

however, the courts have held that because of the Act's requirements for approval of advisory contracts by shareholders and unaffiliated directors, the courts will not inquire into the fairness of advisory fees unless the plaintiffs can prove that fees are so excessive as to constitute a waste of the fund's assets. Proof of waste as we have noted, requires a showing that the fees are not only excessive, but "excessively excessive."

Thus, the Act's requirements of shareholder and unaffiliated director approval, which Congress intended as a protection for shareholders, has actually insulated the fees from judicial scrutiny. The purpose of the Bill is not to change existing law but to enforce it effectively by removing the unwarranted and unintended fetters to judicial scrutiny of the fairness of management compensation in the mutual fund industry.

It may be true, as the industry emphasized, that in applying the corporate waste doctrine to advisory fees, the courts have acted no differently than they might have with respect to self-dealing transactions involving ordinary commercial corporations. But as the industry also emphasized, the structure of the mutual fund industry is unique and its managers usually are not compensated like managers of ordinary commercial corporations. For this reason, the application of the waste doctrine is singularly inappropriate. It strips mutual fund shareholders of the only protection available to them against the overreaching that results where uninhibited conflicts of interests prevail.

If, like ordinary corporations, mutual funds were managed by their own officers, subject to the supervision of their own directors, then the stockholders would have the protection of the unbiased business judgment of the directors as well as meaningful disclosure of and conventional limitations on executive compensation. On the other hand, if mutual funds obtained management services from unaffiliated management organizations, then as sometimes occurs in the case of hotels and some other operations, then fund shareholders would have the protection of arms-length bargaining between the management company and their own directors assisted by officers having no personal interest in the transactions and owing loyalty only to the fund.

The problem with the externally-managed mutual funds in that neither of these protections exists. There is no arms-length bargaining as to fees and even the unaffiliated directors have no opportunity to exercise real business judgment, which implies the selection among available alternatives of that course of action which seems best for the business. In this situation independent review by a court, applying the standard of reasonableness which usually prevails where fiduciaries are in a position to fix their own compensation, is required to protect the interests of fund shareholders.

9. THE CHARGE OF "RATE REGULATION" IS WHOLLY UNJUSTIFIED

There has been a persistent effort on the part of industry spokesmen to characterize the Commission's recommendation, that investment advisory fees should be reasonable, as rate regulation, and then to say that this is not appropriate because mutual funds are not public utilities.¹ While the very argument is a semantic one, conjuring labels rather than providing analysis, we recognize that investment companies are not public utilities and for that and other reasons we do not suggest rate regulation. But it must also be recognized that insofar as supplying investment advice to the funds they control mutual fund advisers have an effective monopoly. For this reason we propose that the well-established standard, that fiduciary compensation must be reasonable, be applied to investment advisory fees and that where there is a question whether that standard has been lived up to, the determination be made, as it traditionally has been, by courts of equity. The courts, under the proposed standard of reasonableness, would not fix a schedule of rates for the industry, or for a particular fund; they would rather decide whether a particular fee submitted to them was within the range of reasonableness under all the circumstances. This, as Judge Friendly has noted, is a traditional function of the courts and is not unduly difficult to administer.

If the industry is satisfied, as it asserts, that the independent directors and other controls have kept fees at reasonable levels, they have nothing to fear from court review. The statutory proposal, which in a number of respects is less

¹ ICI Testimony, 206, 220; Testimony of the Investment Bankers Association, R. 248-251.