Internalization might not benefit the shareholders of newly created funds. These investors sometimes benefit from the external system because an adviser to such a fund often is willing to invest his time and energy to build the fund and therefore may spend more to run the fund then he receives from it in advisory income in the first years. He does so in the hope that as the fund grows it will provide an advisory income that will be adequate enough to compensate for the deficits incurred when the fund was small and to provide an opportunity for capital gain. Since the prospect of the entrepreneurial profits that can be earned under the external system once a fund reaches a certain size is a principal incentive for the formation of new funds, there is some reason to believe that forced internalization might inhibit the formation of new funds.

Consideration should also be given to the fact that many mutual fund management companies are now publicly held. Since most of those companies derive substantially all of their income from their profitable advisory relationships with the investment compaines that they serve, compulsory internalization would have a greater impact than our recommendation on the interests of the many thousands of public investors who hold stock in mutual fund management companies.

It should be pointed out, however, that management company shareholders are a much smaller and a more sophisticated group than mutual fund shareholders.[1] The prospectuses covering public offerings of shares in mutual fund management companies have made it very clear that under the Investment Company Act the relationship between an investment adviser and its investment company client is always terminable at the investment company's election.

The Commission believes that it is important to achieve a fair balance of all the interests affected and that every effort should be made to find an approach which would deal effectively with problems of mutual fund investors in a manner that would have the least possible adverse effect on the mutual fund management business. We think that section 8 of H.R. 9510 and 9511 embodies such an approach.

The Public Utility Holding Company Act of 1935 prohibits registered holding companies from supplying goods or services to the operating companies in their systems. It permits holding company subsidiaries or "mutual service companies", to furnish such services, but only under contracts to be "performed * * * at cost fairly and equitably allocated * * *." It should be noted in this connection that there are today large, successful funds and fund complexes which are operated either by their own staffs or by service subsidiaries owned by the funds themselves.

While there are similarities between the role of the service company in the utility business of the pre-Holding Company Act era and the role of the management company in the mutual fund business of today, the two situations are not precisely parallel. In the mutual fund case, the advisory business is generally the central function and main source of profit of the management company, which usually has no substantial stock interest in the funds which it advises. To compel internalization by law would be to wipe out the value of management company securities, substantial quantities of which are held by public investors.

In the utility situation, on the other hand, the service function was only a part of the holding companies' business. Their principal assets were the securities of the operating companies, and their principal source of income was generally the return on those securities. Their dissolution resulted in the distribution to the holding company shareholders of operating company securities, which very often had a market value higher than that of the surrendered holding company securities.

Moreover, while the conflicts of interest engendered by external management in the mutual fund industry directly affect the interests of four million mutual fund shareholders, the conflicts of interest endemic to the public utility holding company structures of the pre-1935 era inflicted direct injury on almost every consumer of gas or electricity in the United States. The artificially inflated costs of production that the service company device inflicted on the operating companies affected the customers as well as the security holders of those companies. State and local regulatory bodies were unable to protect consumers because they

[1] At the end of 1966 the publicly held management companies had about 67,000 shareholder accounts, less than 1% of the approximately 7,000,000 shareholder accounts that the mutual funds had at that same time.