

the fact that neither the bill, nor the SEC's report, would effect any change in the unique structure of the externally managed mutual fund. Accepting that structure as it has developed over the years, the bill would only employ moderate and protective safeguards against abuses, both demonstrated and potential.

2. Reasonableness of fees—Existing law

The sequence of litigation challenging the advisory fee charged many mutual funds by their advisor-underwriters is well known. Few of these decisions went to final judgment, although many were settled with some downward revisions of the fees. Litigation under state law standards is demonstrably inadequate to the risk of insuring fair and reasonable fees in the industry. These decisions, coupled with the facts found by the Wharton and SEC Reports demonstrate the need for congressional intervention. This, I believe, is shown by the state law standards employed by the courts in testing the levels of the fees.

(a) *Judicial Views*.—Absent shareholder ratification, courts diverge on the validity of a transaction between a corporation and a director, officer or controlling person; but the probable majority view is that the transaction stands if it is found to be fair (upon judicial scrutiny) and was approved by a majority of directors having no direct or indirect interest in the transaction. If shareholders ratify the transaction, despite some variance among the courts, this factor is given substantial weight. The Delaware courts view ratification as shifting the burden of proof to the objector to show that the transaction is unfair. In the litigated mutual fund cases, where shareholder ratification typically is involved, this burden is to "convince the court that no person of ordinary, sound business judgment would be expected to entertain the view that the consideration was a fair exchange for the value which was given." Even if "waste" of corporate assets is alleged, judicial security is limited, for "if * * * ordinary businessmen might differ on the sufficiency of the terms" of the contract, fee, etc., "then the court *must* validate the transaction." *Saxe v. Brady*, 40 Del. Ch. 474, 486, 184 A. 2d 606, 616 (Ch. 1962). Although not an impossible burden, it is manifestly a heavy one. Most importantly, it will almost invariably be the applicable standard since overwhelming shareholder ratification of contracts with investment advisors may be had for the asking.

Under state law standards, probably persons of "ordinary, sound business judgment" will not deem the compensation unreasonable so long as the fee is not too far from the classic level ($\frac{1}{2}$ of 1% of average net assets with some scale-down at high levels) long prevailing in the industry for externally managed funds. Even if this standard were a satisfactory one in theory, *Saxe v. Brady* demonstrated the difficulty of applying it to a concrete situation because of the unavailability of comparative data to measure the reasonableness of the fee paid by a particular fund. For instance, absent such information, a court cannot rationally assess the quality of services furnished by the advisory organization, or its level of profits, or the reasonableness of expenses incurred. Finally, several able judges have visibly winced at the restrictions of this rule which has required them to sustain fee schedules which seemed to them excessive, but not so much so as to point to fraud or over-reaching, or otherwise to a violation of the applicable standards. See *Saxe v. Brady*, 40 Del. Ch. 474, 497-98, 184 A. 2d 602, 616-17 (Ch. 1962); *Acampora v. Birkland*, 220 F. Supp. 527 (D. Colo. 1963). It is clear, then, that the prevailing state-law judicial tests are inadequate to deal with the problem of excessive fee levels. And the fact that they are excessive is indicated by the number of cases which were settled with advisory fee reductions. To put the matter into context, it must be remembered that this entire fee is borne pro rata by the shareholders of the fund since the amount, whatever it may be, is skimmed off the gross revenue of the fund before distributions are made.

(b) *State Statutes*.—A development not noted by the SEC Report but important for the future is the advent of statutes specifically validating transactions, otherwise doubtful or involving conflict of interests. Several states, most importantly Delaware, have statutes which uphold transactions between a corporation and a director or officer, or between interlocked corporations, if full disclosure is made to the director and the transaction is approved by a majority of the disinterested directors "in good faith"; or if the shareholders ratify the transaction after full disclosure; or, in any event, if the transaction is fair to the corporation as of the time it is made. Delaware Gen. Corp. Law § 144(a).² If any one of these conditions is met, the transaction is substantially immunized from attack.

² The reference is to the newly enacted Delaware General Corporation Law, signed by the Governor on July 3, 1967.