fund directors), Section 15 (required approval of advisor-underwriter contracts), and Section 32(a) (relating to approval of financial statements by independent accountants).

One of the often used key terms of the 1940 Act is "affiliated person." For instance, Section 10 imposes percentage limitations on the number of directors who may be "affiliated persons", of the investment advisor or underwriter, while under Section 15(c) investment advisory contracts must be approved by a majority of directors who are not parties to the contract or "affiliated persons" of a party, unless the fund shareholders ratify the contract. Section 2(a)(3) defines "affiliated person" to include one who owns or controls more than 5% of the voting stock of another, one who is an officer, director, or partner or employee of the other person, or one who is "directly or indirectly controlling, controlled by, or under common control with" the other person. Under Section 2(a)(9) ownership of 25% of the voting securities of a company raises a presumption of control. The "control" definition is unfortunately limited by raising another presumption that "a natural person shall be presumed not to be a controlled person."

This cluster of terms, although seemingly inclusive, is in fact inadequate and inhibiting. Certain loopholes permit relationships, strongly savoring of serious interest conflicts, to flourish uncorrected. For instance, a director is not an "affiliated person" even though he owns 4.99% of the stock of the investment advisor. Thus, his vote on the advisory contract counts as one of the all-important unaffiliated director votes, although certainly he is hardly disinterested. Again, the son of the controlled share holder of the principal underwriter or advisor is not an "affiliated person," although he too is scarcely a disinterested director when voting on the contract between the fund and his father's firm. Even if it could be argued that such persons are "controlled" by the advisor or underwriter, this contention is defeated since the fact of "control", under existing law (Section 2(a)(9)), must be affirmatively proven because a natural person is presumed not to be "controlled." As a final instance, the attorney on retainer of the advisor or underwriter is not an "affiliated person" under present law; establishing that he is a "controlled" person encounters the difficulties just noted.

Since the critical term in the existing law—"affiliated persons"—does not come close to covering all persons who have a significant economic or other interest in a fund's advisor-underwriter, it is clear that decisions which must be made by unaffiliated directors are being made by interested directors. Indeed, since the advisor normally is in a position to secure the election of all the directors of the fund, it would be fatuous to suppose that one holding such control will knowingly place on the fund's board persons who will be other than kindly disposed to the advisor's interests. This is not to suggest that unaffiliated directors breach their duty. It is to declare emphatically that many such unaffiliated directors are in a posture of unavoidable conflict of interests, even though they do their best to resolve those conflicts as decent and honorable men. But the very existence of such conflicts deflects the main thrust of the Act: that a certain percentage of directors will be the disinterested, dispassionate protectors of the interests of the fund shareholders especially when the critical question of the advisory contract is to be voted upon. One need not suppose that an unaffiliated director is necessarily subservient to the advisor. However, his delicate position of subtle dependence will dispose him to resolve doubts in favor of the advisor, to stress in his own mind the quality of services actually rendered rather than investigate the possibilities of improvement, to silence nagging doubts that the compensation formula may be producing excessive compensation as fund assets grow, to soften the probing question or forego the extra hours of independent inquiry into comparative statistics and information, or to ignore suspicions as to the propriety of sales practices under the fund underwriter's auspices. Congress in 1940 no doubt believed that unaffiliated directors would pursue such efforts on behalf of the fund and doubtlessly in some measure these expectations have been fulfilled. But the fact of mere partial fulfillment is disquieting, and the failure has occurred in crucial areas of fund operation. For example, almost none of the externally managed funds took steps to reduce compensation under the classic one-half of 1% of net assets formula, until pressure was generated by the Wharton School Report and, more tangibly, the numerous shareholder derivative suits challenging operation of the formula.

It could reasonably be supposed that truly disinterested fund directors would have anticipated the undue swelling of compensation under a rigid formula and