

and I think their suggestions are appropriate if the requirement is not to be completely devoid of meaning; but I am very dubious that this change will carry us very far toward solving the problem. As long as the organization of the fund, and the choice of directors, is in the hands of the individuals associated with external investment adviser, it will be difficult to transform the directors into a group capable of bargaining effectively on management fee rates. A move in that direction may be desirable, but its inherent limits should be obvious.

(4) A fourth possibility is an extension of disclosure requirements. This is the traditional emphasis of the securities legislation, and a valuable one, but I think its capabilities have been seriously over-rated. It even shows some potential for becoming a reflex substitute for more effective, but also more controversial, actions. This avenue is limited in the mutual fund area by the importance of salesmanship—and the salesman's pitch is beyond effective control. It is also limited by the possibility of over-saturation of disclosure to a point where its value to the buyer declines absolutely. Furthermore, the most important kind of disclosure, a clear indication of the price and quality of alternatives, is extremely difficult to present briefly and equitably. Thus, while more and especially better disclosure is unobjectionable, I have doubts as to its serviceability as the central element in establishing reasonable management fees.

(5) Finally, we may establish a standard of reasonableness of fee rates, stipulating the relevant criteria (including performance)² in general terms, and leaving the detailed elaboration of these norms to the administrative and judicial process. This is essentially the SEC proposal. It is, if anything, unduly conservative, accepting the industry's structure in its existing form, and surrounding the application of the standard of reasonableness with statutes of limitations on suits and other protections of the fund and its directors that seem a bit excessive. Nevertheless, I would favor this proposal as a minimum in an area where something should be done and where more drastic actions designed to increase competition are not likely to be very effective.

III. THE SALES CHARGE

The case for limiting the size of the charge that can be levied in the sales of mutual fund shares rests on the fact that the market for fund shares is competitive only in a limited and somewhat perverse way. Competition is restricted, first, by the Act's section 22(d) provision for resale price maintenance. This is a significant restraint on price competition, and one that is desired by the industry. A second limitation on competition stems from the uninformed nature of the small investor market that has been heavily tapped by the fund industry. As noted earlier, this has tended to encourage salesmanship and to reduce further any possible price competition at the retail level. The price competition that still remains involves mainly a bidding by issuers of fund shares for dealers to carry and push their wares. Given this direction of competition, market penetration is increased by *elevating* the sales charge (or the dealer's percentage of the charge) at the expense of the ultimate purchasers of shares. This is perverse or upside-down price competition.

This peculiar type of competition results from the fact that, since a large fraction of fund shares purchasers are uninformed on the complexities of stocks and investor options, they have to be "sold" their shares, they don't just buy them. They do not have a base of comparative knowledge that would permit them to evaluate a salesman's pitch. The Prospectus that they are given is tedious and lacking in comparative information that would render these details meaningful. Thus, from the standpoint of the fund, selling shares is mainly a question of getting salesmen to push them; that is, increasing the dealers' take from the gross sale price. The truth of these contentions is demonstrated by the fact that, in the *Study of Mutual Funds* it was found that sales of fund shares were much

² Although a performance basis for establishing management fee rates has considerable appeal, it is not easy to convert a complex variable like performance into a usable general standard. The variety of possible formulas (number of years considered relevant, adjustment for differences in fund objectives, etc.) would make an informed evaluation of management fee rates by investors even less feasible than at present. And if the formulas were so arranged as to provide at least *some* compensation even for atrocious performance, as is likely, performance standards are likely to work out as a "heads I win, tails you lose" proposition (as the SEC has suggested). In the light of these considerations, I suspect that a general application of a performance standard would turn out to be a source of further abuse.