SMU | Dedman School of Law

SMU Law Review

Volume 24 | Issue 3 Article 7

January 1970

From Mattress and Cashbox to Speculative Securities: The Investor and His Mutual Fund

Raymond L. Dahlberg

COMMENTS

FROM MATTRESS AND CASHBOX TO SPECULATIVE SECURITIES: THE INVESTOR AND HIS MUTUAL FUND

by Raymond L. Dahlberg

The mutual fund, a distinct member of the elite class of "institutional investor,"[1] has, in the last thirty years, propagated itself headlong into an economic age which has notably been termed the "paraproprietal" society.[2] The past three decades have witnessed a 450 million dollar business develop into a 52 billion dollar industry.[3] One half of this increase has been attributed to an appreciation in market value, and the balance has resulted from the sale of new shares.[4] This phenomenal growth in investors can probably best be imputed to two major factors: (1) The concept of diversification of risk, and (2) the advent of "professional management" claimed to be highly proficient in investment techniques.[5] Both of these money-making maxims would remain inaccessible to virtually every small investor were it not for the mutual fund.[6] However, the mounting interest in this growth

[1] Institutional investors include banks, pension funds, insurance companies, savings and loan associations, college and university endowment funds, foundations, and investment companies (including mutual funds). D. BAUM & N. STILES, THE SILENT PARTNERS 29 (1965). The four factors characteristic of an institutional investor are: (1) concentration of large holdings in a relatively small number of hands, (2) full-time professionalism, (3) holdings of large blocks of stock issues, and (4) fiduciary responsibility. DUKE UNIVERSITY SCHOOL OF LAW CONFERENCE ON SECURITIES REGULATION 136-37 (R. Mundheim ed. 1965) [hereinafter cited as CONFERENCE].

[2] "Paraproprietal" is the neologism developed to describe the twentieth century system of American property ownership which has resulted from the institutional investor being interpositioned between the corporation and the public investor. In this sense the system is said to be "beyond property." P. HARBRECHT, S.J. & A. BERLE, JR., TOWARD THE PARAPROPRIETAL SOCIETY 8 (1960).

[3] *Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess., pt. 1, at 125 (1967). Another source puts the net assets of mutual funds in 1941 at $401 million. SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 3, at 95 (1964) [hereinafter cited as SPECIAL STUDY]. The $52 billion asset value is as of Dec. 31, 1969. INVESTMENT DEALERS DIGEST, Mar. 24, 1970, pt. II (Mutual Fund Directory), at 176. Mutual funds are not the only institutional investor that has experienced such growth. Corporate pension funds are well out in front of the rest of the pack, having a percentage growth between 1954 and 1968 of exactly twice that of mutual funds. 115 CONG. REC. E1327 (daily ed. Feb. 24, 1969).

[4] SPECIAL STUDY pt. 3, at 95.

[5] Diversification is a guiding principle in the mutual fund business, and that principle is fostered by the statutory provisions of the Investment Company Act of 1940 whch regulates the mutual fund industry and other investment companies. *See* Investment Company Act of 1940, 54 Stat. 789, *as amended*, 15 U.S.C. §§ 8(b), 13(a), 80a (1964). The investor's desire for portfolio diversification was found to be the second most important incentive prompting investment in mutual fund shares. SPECIAL STUDY pt. 4, at 141. As for professional management, a leading scholarly authority in the mutual fund area, Robert H. Mundheim, has stated: "The public investor who decides to invest in the equity market through an institution—be it an investment company, or insurance company or a bank—does so, in part, because he believes that the institution provides expert management. He is willing to pay something in order to be relieved of the responsibility of making individual investment decisions." CONFERENCE 132. Professional management was found to be the most important factor that caused investors to select mutual funds. SPECIAL STUDY pt. 4, at 285. *See also Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess., pt. 1, at 188 (1967). Diversification and professional management are the two most important ingredients of the growing "salesmanship" aspect of the mutual funds. *See* SPECIAL STUDY pt. 4, at 293.

[6] Leon T. Kendall, an economist for the New York Stock Exchange and a panel member on

has by no means manifested itself solely in the enthusiasm of the American investing public.[7] In recent years the most active issue both judicially and politically has been the mutual fund management fee.[8] But the inquisition has not neglected other areas of importance.[9] This monumental concern, touching virtually all phases of the industry, has centered primarily upon the inadequacy of the regulatory framework within which mutual funds operate. That framework has not been materially altered since its enactment almost thirty years ago,[10] and this statutory stagnancy, plus the concern for growth, has generated a host of problems which, under the current regulatory scheme, are assertedly incapable of adequate solution.[11]

---

a 1965 securities conference, rather elaborately summarized the growing sophistication of the American investor.

> The easiest way to look at this is to try to develop in your mind's eye a hierarchy of zones of financial sophistication. At the bottom of the ladder you start with something like the mattress or cashbox, then U.S. Savings bonds, then commercial bank savings accounts or mutual bank savings accounts. Here draw a fundamental line which has to be crossed requiring greater sophistication. Then start up again to savings and loan accounts, credit union accounts and balanced mutual fund holdings. The next line to be crossed . . . brings us to the zone of high sophistication. Here you find blue chip stocks, growth stock oriented mutual funds, speculative stocks, real estate and direct business investments, and the buying and selling of corporations. The American people are moving up this ladder. This explains why people have moved into savings and loans and mutual fund investments. . . . I agree with . . . [another panel member] that investors should not jump from mattress and cashbox to speculative securities, but, on the other hand, the mutual fund investor is a likely prospect for direct stock investment and the blue chip stock investor may well move up to speculative stocks.

CONFERENCE 165-66.

[7] In 1966, in a report to Congress, the Securities and Exchange Commission stated its position that "the Investment Company Act of 1940 has substantially eliminated the serious abuses at which it was aimed, but the tremendous growth of the industry and the accompanying changes have created a need for additional protection for mutual fund shareholders in areas which were either unanticipated or of secondary importance in 1940." SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess., letter of transmittal, vii (1966) [hereinafter cited as PUBLIC POLICY STATEMENT].

[8] For a recent, thorough analysis dealing with the problem of mutual fund management fees, see *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAW. 732, 894-956 (1969). In addition, see Gopman, *The Management Fee Problem and the Investment Company Act of 1940*, 7 AM. BUS. L.J. 153 (1969); Modesitt, *The Mutual Fund—A Corporate Anomaly*, 14 U.C.L.A.L. REV. 1252 (1967); *University of Pennsylvania Law School Conference on Mutual Funds*, 115 U. PA. L. REV. 726-67 (1967); Wymeersch, *Some Aspects of Management Fees of Mutual Funds*, 17 BUFFALO L. REV. 747 (1968); Comment, *Securities Regulation—Management Fees, Conspiracy or Compensation*, 36 U. MO.-KAN. CITY L. REV. 348 (1968).

[9] *See The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAW. 732 (1969), which discusses such problems as mutual fund selling practices, sales loads, and the influx of insurance companies and banks into the mutual fund arena. In addition, see Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 U. PA. L. REV. 1058 (1967); Werner, *Protecting the Mutual Fund Investor: The SEC Reports on the SEC*, 68 COLUM. L. REV. 1 (1968) (critical analysis of the 1966 PUBLIC POLICY STATEMENT and the role of the SEC in protecting the mutual fund investor); Comment, *Rights and Obligations in the Mutual Fund: A Source of Law*, 20 VAND. L. REV. 1120 (1967) (the source of law to be applied in the development of a federal common law regulating mutual funds); Note, *The Regulation of Dual Funds*, 54 VA. L. REV. 1396 (1968) (development of the American dual fund under the influence of the SEC). In addition, three studies of the mutual fund industry have been conducted since 1958. WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. No. 2274, 87th Cong., 2d Sess. (1962) (this study investigated the performance and market impact of mutual funds and analyzed the relationship between the funds and their investment advisors and principal underwriters); SPECIAL STUDY pt. 4, ch. XI (examined primarily aspects of the sale of mutual fund shares); PUBLIC POLICY STATEMENT (investigated the management advisory system, portfolio transactions, the sale of mutual fund shares, investment performance, and the impact of the growth of mutual funds on the securities markets).

[10] PUBLIC POLICY STATEMENT 1; North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME LAW. 677, 685 (1969).

[11] This appears to be the conclusion of the authors of an extensive analysis of the industry.

The past two years have contributed significantly to the augmenting legal meshes of an industry already beseiged by a body of authorities intent on expanding judicial or legislative regulation. The dimensions of the existing problems were substantially widened in 1969 as the securities market exacted from mutual funds its retribution for several years of financial bliss and prosperity.[12] Though the losses themselves are detrimental to mutual funds, their repercussions may go far beyond a drop in new sales or an increase in share redemptions. The legal implications could be devastating to the industry and its professional management, for, prior to the '69 crash, the accusing finger of "speculation" had in several instances been directed at mutual funds.[13] This Comment will explore the investor-

The Mutual Fund Industry: A Legal Survey, 44 NOTRE DAME LAW. 732, 967 (1969). *See also* Eisenberg & Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility under the Investment Company Act of 1940*, 20 RUTGERS L. REV. 181, 267 (1966); note 7 *supra*. In 1941 at least one commentator had grave doubts that the Investment Company Act of 1940 would adequately curtail the industry abuses which prompted its enactment. Thomas, *The Investment Company Act of 1940*, 9 GEO. WASH. L. REV. 918, 945-46 (1941).

[12] Many financial reports recorded the fall of the funds during 1969. Of special interest, see Glenn, *Most Funds Post Losses But Still Beat the Dow*, Barron's, Nov. 3, 1969, at 31, col. 2; *Funds Cautious as DJIA Eluded "1,000,"* Commercial & Financial Chronicle [hereinafter abbreviated to Com. & Fin. Chr.], Feb. 20, 1969, at 797, col. 1; Glenn, *Some Swingers Found the Going Rough Last Year*, Barron's, Feb. 3, 1969, at 27, col. 2.

One mutual fund which registered a 116% increase in its net asset value in 1967 sustained a 36% shrinkage after seven months of the 1969 market. See statistics for the O'Neil Fund in *Performance Funds: Under a Cloud*, FORBES, Aug. 15, 1969, at 80. Other declines, though not so drastic, are legion as 1969 "performance" was measured in terms of a fund's ability to keep its losses below those of its mutual competitors. Glenn, *Some Swingers Found the Going Rough Last Year*, Barron's, Feb. 3, 1969, at 27, col. 2.

[13] The catchword over the last few years has been "performance," not only emphasized by mutual fund management, but by investors themselves. One of the findings of the SPECIAL STUDY was "the high investor expectations regarding the prospective performance of both the stock market in general and of mutual funds relative to the market." SPECIAL STUDY pt. 4, at 320-21. This increasing awareness of mutual fund performance by investors demonstrates forcefully the industry's own infatuation with the concept. The great prominence given to performance can be ascribed to the funds' competitive desires to outperform each other and all other areas of the securities market. Owens, *Mutual Funds and the "Letter Stock" Problem*, Com. & Fin. Chr., July 31, 1969, at 22, col. 1; Biel, *Investment Problems and Prospects*, Com. & Fin. Chr., June 12, 1969, at 1, col. 1; *What Price Performance?*, BURROUGHS CLEARING HOUSE, Mar. 1968, at 32. The rewards for achieving superior performance represent an increasing accumulation of the public's investment dollar, as investors gravitate toward those funds that answer their demands for a maximization of total return. In the words of a vice-president of one small mutual fund: "Performance, then, is an integral part of our business. It is basic to our existence, our continuing growth and our ultimate survival." *University of Pennsylvania Law School Conference on Mutual Funds*, 115 U. PA. L. REV. 669, 690 (1967) (statement of Robert W. Doran, vice-president of Ivest Fund); *see The Sixties: Performance is no Longer a Dirty Word*, FORBES, Jan. 1, 1970, at 223.

At the First Annual Institutional Investors Conference in 1968 Manuel Cohen, then Chairman of the SEC, equated performance with speculation and seriously questioned if the American investing public was willing to substitute conservative investing with the newfangled performance concept involving high risk approaches. *What Price Performance?*, BURROUGHS CLEARING HOUSE, Mar. 1968, at 32. At the same conference David L. Babson, president of an investment advisory firm and director of a mutual fund, noted that a heavy concentration of assets and a high portfolio turnover was "at best, trading performance and at worst, outright gambling with other people's money," and he concluded that the securities markets were being converted into a "gigantic crap game." *Id.* More recently, a representative of the SEC labeled the emphasis on performance "great and unprecedented," and expressed personal misgivings concerning the "speculative activity of some of the funds in order to meet their performance objective." Owens, *Mutual Funds and the "Letter Stock" Problem*, Com. & Fin. Chr., July 31, 1969, at 22, col. 1. For the most part these accusations have been leveled at the "go-go" funds, which consist primarily of the growth-oriented stock funds. *Id.*; *Funds that Subtract Safety To Add Growth*, BUSINESS MANAGEMENT, July 1969, at 37; Biel, *Investment Problems and Prospects*, Com. & Fin. Chr., June 12, 1969, at 1, col. 1; *Sober Appraisal—Every Speculative Binge, says Ralph Rotnem, Brings a Morning After*, Barron's, Mar. 31, 1969, at 3, col. 1; Shapiro, *Trading in Tulips*, Barron's, Aug. 26, 1968, at 1, col. 1; Babson, *Performance—The Latest Name for Speculation?*, FIN. ANALYSTS J., Sept.-Oct.,

protections afforded by federal regulation of the investment company complex under circumstances in which professional money-managers of open-end mutual funds are engaging in "speculation"[14] without the knowledge or consent of investors.

I. Statutory Disclosure of Investment Policies

The Investment Company Act of 1940[15] was the congressional housecleaning of an industry that had been plagued by gross mismanagement and spectacular failures generated primarily by its own servants.[16] For the protection of the investor, the statutory provisions employed the concept of disclosure as a potent administrative weapon to curtail certain abuses.[17] Thus, the Act requires each investment company to set out in its registration statement the classification and subclassification within which the registrant proposes to operate;[18] and, in addition, to declare its policy as to borrowing money, issuing senior securities, underwriting securities, investing in real estate or commodities, concentrating investments in a particular industry or group of industries, making loans, and portfolio turnover.[19] The registrant must adhere to these policies unless a change is authorized by a majority vote of the outstanding voting securities.[20] More important, however, is the requirement that the registration statement contain "a

1967, at 129; *Relative Performance-Nonsense*, Fin. Analysts J., July-Aug., 1966, at 101. For an "inside" look at the performance cult, see A. Smith, The Money Game 177 (1969).

Of course, the industry has defended the performance mania. One professional money-manager has stated: "There is widespread acceptance of the objective of 'appreciation' or 'maximizing total return' as opposed to 'avoiding risk' or simply 'maintaining principal.' Performance investing has some real durability and is not just a blib [*sic*] rationalization for speculation." Stern, *Dilemma Facing the Investment Manager*, Com. & Fin. Chr., Aug. 7, 1969, at 1, col. 1. *See* Forbes, Sept. 1, 1969, at 56.

[14] "Speculation" is an extremely elusive concept and not susceptible to an easy definition. In the classic case of Harvard College v. Amory, 26 Mass. (9 Pick.) 446 (1830), the Massachusetts court freed the American fiduciary from the ancient Victorian shackles of ultra-conservatism imposed upon him by his English brethren. In so doing, the court concluded that there existed no truly safe investments, because no matter how capital was employed, there was risk. This conclusion ultimately suggests that every investment is speculative. It seems that a definition of speculation must vary with time and circumstances. However, for purposes of this Comment, a definition in terms of risk seems appropriate.

[15] 54 Stat. 789, *as amended*, 15 U.S.C. § 80a (1964) [hereinafter referred to as the 1940 Act, or the Act, and in footnotes cited to sections of that Act only].

[16] Examples of the abuses are to be found in Tolins, *The Investment Company Act of 1940*, 26 Cornell L.Q. 77 (1940); Comment, *The Regulation of Management Investment Trusts for the Protection of Investors*, 46 Yale L.J. 1211 (1937); Note, *Statutory Regulation of Investment Trusts*, 44 Harv. L. Rev. 117 (1930); Note, *Regulation of Investment Companies*, 88 U. Pa. L. Rev. 584 (1940). In addition, specific abuses which existed in the industry prior to the 1940 Act are documented throughout the SEC, Report on Investment Trusts and Investment Companies, which was submitted to Congress in various parts over a three-year period. Chapter VII of part III of the Report, which deals with abuses in the organization and operation of investment trusts and companies, was printed in H.R. Doc. No. 136, 77th Cong., 1st Sess. (1941). *See also* H.R. Rep. No. 2639, 76th Cong., 3d Sess. 5 (1940); S. Rep. No. 1775, 76th Cong., 3d Sess. 2 (1940).

[17] *See* Motley, *Federal Regulation of Investment Companies Since 1940*, 63 Harv. L. Rev. 1134, 1140 (1950); Note, *The Investment Company Act of 1940*, 41 Colum. L. Rev. 269, 285-88 (1941).

[18] Under § 4 of the Act, registered investment companies are divided into three classes: face-amount certificate companies, unit investment trusts, and management investment companies. Furthermore, under § 5, management investment companies are classified as (a) open- or closed-end companies, and (b) diversified or non-diversified companies.

[19] Section 8(b)(1).

[20] Section 13(a).

recital of the policy of the registrant in respect of matters, not enumerated in section 8(b)(1), which the registrant deems matters of fundamental policy and elects to treat as such."[21] This "fundamental policy" provision is similarly subject to the majority stockholder vote requirement to effectuate a change,[22] and at first glance it may appear to offer some redress for an aggrieved investor who has witnessed the diminution of his fortune in the hands of a mutual fund management bent on speculation. Unfortunately, one judicial decision and some legislative history suggest otherwise.

Judicial Activity. In *Green v. Brown*,[23] the only case thus far decided under section 13 of the Act, a stockholder brought a derivative action against the directors of a closed-end, non-diversified investment company for changing a "fundamental policy" of the company without stockholder approval. The instruction forms which the SEC had sent to Narragansett Capital Corporation for preparation of its registration statement provided that the section of such statement entitled "Item 2. Fundamental Policies of the Registrant" was to contain the policies that the company deemed fundamental and elected to treat as such under section 8(b)(2) of the Act. The instructions also specified that under Item 3 of the same section the registrant was to specify certain investment policies which were not described as "fundamental" under Item 2. Therefore, under Item 3 in its registration statement, the company listed several investment policies which could not be changed without the majority approval of the stockholders. One of these policies provided that the company would at no time invest more than twenty per cent of its combined capital and surplus in the securities of any one issuer, except those of the United States Government. The company did so invest, and a stockholder alleged a violation of section 13(a)(3).[24]

The court noted that section 13(a)(3) of the Act only prohibited de-

[21] Section 8(b)(2).

[22] Section 13(a)(3).

[23] 276 F. Supp. 753 (S.D.N.Y.), *remanded*, 398 F.2d 1006 (2d Cir. 1968).

[24] The defendant directors contended, and the court found, that the stockholders had subsequently ratified the investments which purportedly violated the company's "fundamental investment policy" concerning the twenty per cent limitation. In this respect, it is interesting to note that a proxy statement sent to the stockholders for the purpose of approving a change in the twenty per cent limitation policy for the future, referred to the limitation as a "fundamental investment policy" of the company. *Id.* at 756 n.3. It appears the stockholder here was contending that the deviation from the twenty per cent limitation was a violation of § 13(a)(3) because that limitation appeared in the company's *prospectus* as a "fundamental policy." The stockholder's authority for this proposition was Lutz v. Boas, 39 Del. Ch. 585, 171 A.2d 381 (Ch. 1961), where a Delaware court held that a change in the company's investment policy of "normal turnover," as stated in its prospectus, was a violation of the Act. The court in *Green* refuted this by stating that "under the Act, the only relevant policies are those contained in the registration statement. The prospectus is immaterial." 276 F. Supp. at 756 n.4. It is quite clear that under § 13(a) of the Act a violation does not occur unless the company deviates from the recitals of policy contained in its registration statement. The nexus between these two items of disclosure is the SEC. Under § 45(a) of the Act, the information in the registration statement "shall be made available to the public, unless and except in so far as the Commission, by rules and regulations . . . finds that public disclosure is neither necessary nor appropriate in the public interest or for the protection of investors." Of course, a mutual fund prospectus must be delivered to the potential investor when or before the shares are sold. Securities Act of 1933, 15 U.S.C. §§ 77(b)(10), 77(e), & 77(j) (1965). Notwithstanding this requirement, some prospective investors never see the prospectus. SPECIAL STUDY pt. 4, at 339.

viations from "fundamental policies" elected to be treated as such under section 8(b)(2), and that Narragansett did not treat its twenty per cent limitation as a "fundamental policy" under that section, even though the registration statement required majority stockholder approval for a change of that policy. The court concluded that Narragansett had not violated the Act by deviating from the stated twenty per cent limitation, although the court observed that "[o]ne would think that no policy could be more 'fundamental' in an investment company than its policy pertaining to investments."[25] Nevertheless, section 13(a)(3) was held to apply only to those policies which the registrant "elected" to "deem" fundamental, and the court refused to ignore the statutory words completely and thereby find what it believed to be the more favorable result. The only alternative offered was that "[i]f it be thought undesirable to permit an investment company to 'write its own ticket,' so to speak . . . the remedy lies with Congress, not with the courts."[26] The statutory construction of the language of sections 13(a)(3) and 8(b)(2) of the Act by this federal district court seems difficult to refute. However, the United States Court of Appeals for the Second Circuit, as it remanded the case on appeal, implied that the difficulty might be a minor one.[27]

Prior to the filing of the appeal, an aspect of the case had changed, possibly rendering the action moot; the stockholder himself asserted a violation of the Act which the district court had not considered; and the Securities and Exchange Commission participated as amicus and suggested a possible defense of good faith reliance on commission forms.[28] Thus, the Second Circuit felt constrained to remand the case to allow the district court to consider the new issues and have the benefit of the Commission's viewpoint. However, in its opinion, the court intimates disapproval of the lower court's interpretation of sections 13(a)(3) and 8(b)(2). In justifying consideration of an issue first raised on appeal, the court of appeals felt the issues concerned in the case "are of great significance in construing an act designed to protect thousands of investors."[29] The court then gave the Commission's argument that "Congress intended the term 'fundamental,' as used in sections 8(b)(2) and 13(a)(3), to apply to any investment policy which a registrant 'elects' to make subject to shareholder approval."[30] Thereafter, the court states, "[t]he district court has construed two sections of the Act in a way that is at least questionable, without the benefit of the Commission's views."[31] Following the decision in *Green v. Brown* by the Second Circuit, the SEC proposed a revision in its forms so that any investment policy which a registrant decides shall not be changed without

[25] 276 F. Supp. at 756.
[26] *Id.*
[27] Green v. Brown, 398 F.2d 1006 (2d Cir. 1968).
[28] Section 38(c) of the Act provides: "No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule, regulation, or order of the Commission, notwithstanding that such rule, regulation, or order may . . . be determined by judicial or other authority to be invalid for any reason."
[29] 398 F.2d at 1009.
[30] *Id.*
[31] *Id.* at 1010.

shareholder approval shall be considered a "fundamental" policy within the meaning of sections 8(b)(2) and 13(a)(3).[32] Even if it be conceded that the Commission has some authority to define what "fundamental" means,[33] it is doubtful that the Second Circuit's opinion in *Green*, or the Commission's proposed revision, does anything to substantially protect the investor. Rather, it simply forces the investment company to pour its management investment policies into a new container. A company will continue to possess the ability to "write its own ticket" as it avoids electing to treat certain policies as "fundamental" by refusing to make them subject to change solely by approval of the majority of the shareholders.

The unfavorable treatment of the district court's interpretation of sections 8(b)(2) and 13(a)(3) in *Green*, plus the Commission's willingness to use its regulatory powers to further protections for the investing public, point in the direction of a broader interpretation of section 8(b)(2), with an accompanying constriction of the registrant's power to perform its "ticket writing" under the protective wing of the statutory language. Such an expansion, though highly desirable, is completely unwarranted. If the strong language of section 8(b)(2) does not clearly show congressional intent to give an investment company the right to "elect" whether or not a certain policy will be conclusively presumed to be "fundamental," then perhaps the legislative history will elucidate that intent.

Legislative History. Courts have properly encountered little difficulty in expanding the provisions of the Act because of the declaration of policy in section 1. "It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors."[34] And one of the conditions specifically enumerated concerns investors who deal in securities of an investment company "without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, *policies*, and financial responsibility of such companies and their manage-

[32] SEC Investment Co. Act Release No. 4939 (Dec. 20, 1968).

[33] Under § 8(a) the Commission has the authority to designate what information shall be contained in the registration statement "as necessary or appropriate in the public interest or for the protection of investors." However, such prescriptive authority is limited in scope to encompass only that information relating to a recital of the registrant's policies as listed under § 8(b)(1), and a recital of fundamental policies under § 8(b)(2). Hence, the Commission could require less information than is listed in these two sections, but not more, because its discretion is bounded by "such of the following information and documents set forth under [§§ 8(b)(1), (2), (3), and (4)]." Section 8(b). In addition, the Commission has the authority to define "accounting, technical, and trade terms, used in the Act." Section 38(a). However, a "fundamental policy" can not be considered an accounting, technical, or trade term. Even if it be conceded that the SEC can properly determine what is or is not a "fundamental policy," the *election* to treat that policy as such is expressly given to the registrant under § 8(b)(2).

[34] The language of this section has been used as an important guideline in interpreting the Act by both the district court and the court of appeals in Brown v. Bullock, 194 F. Supp. 207 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961). *See also* Levitt v. Johnson, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); Aldred Inv. Trust v. SEC, 151 F.2d 254 (1st Cir. 1945), *cert. denied*, 326 U.S. 795 (1946).

ment."[35] Thus, by combining these policy statements, a favorable argument can be made for expanding the scope of section 8(b)(2). However, such an argument fails to consider the particular section and its relationship to the history surrounding the entire Act, and the atmosphere that accompanied the congressional action.[36]

The original bill dealing with the regulation of investment companies was introduced in both Houses of Congress on March 14, 1940.[37] According to one of the representatives of the industry at the House and Senate hearings, "[t]he original bill followed in many respects the pattern of recent federal legislation. . . . That there were precedents or analogies in other federal legislation for provisions of the bill which were objectionable to members of the industry, constituted but cold comfort for investment company executives. While most recognized that some measure of regulation was necessary for the protection of investors and was essentially to the best interests of the industry, or was in any event inevitable, the bill as originally introduced could not be accepted."[38] The ultimate result was that the Commission and the industry, in a joint effort, redrafted the bill upon principles of regulation which could be accepted by the industry.[39] The redrafted bill became the 1940 Act.

Much has been made of the spirit of "co-operativeness" which accompanied the enactment of the redrafted legislation.[40] The unanimity between the Commission and the industry has been used by some as reason to adopt a restrictive interpretation of the Act.[41] In turn, the rebuttal has been premised on the theory that the Act represents simply an extension of the regulatory concepts underlying the 1933 and 1934 federal securities laws, and hence the 1940 legislation should be given a liberal construction in

---

[35] Section 1(b)(1). Other conditions include: the operation of investment companies solely for a special class of security holders, § 1(b)(2); inequitable provisions in securities, § 1(b)(3); pyramiding of investment companies and their operaton by irresponsible persons, § 1(b)(4); the use of misleading accounting practices, § 1(b)(5); reorganization or transfer of control without the consent of the shareholders, § 1(b)(6); the speculative character of junior securities, § 1(b)(7); and when a company operates without adequate assets or reserves, § 1(b)(8).

[36] Articles dealing with a history of the Act include, Jaretzki, *The Investment Company Act of 1940*, 26 WASH. U.L.Q. 303 (1941); North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME LAW. 677 (1969); Thomas, *The Investment Company Act of 1940*, 9 GEO. WASH. L. REV. 918 (1941). *See also* Brown v. Bullock, 194 F. Supp. 207 (S.D.N.Y. 1961).

[37] Wagner-Lea Bill, S. 3580, H.R. 8935, 76th Cong., 3d Sess. (1940).

[38] Jaretzki, *supra* note 36, at 308-09.

[39] *Id.* at 308-11. *See also* S. REP. No. 1775, 76th Cong., 3d Sess. 1 (1940).

[40] Alfred Jaretzki, Jr., who represented the closed-end investment companies at the congressional hearings, commented: "The passage of such comprehensive legislation with virtually no debate is probably without precedent. The constructive attitude of the industry and the wholehearted cooperation between the Commission and the industry was indeed a significant event." Jaretzki, *supra* note 36, at 311 [footnotes omitted]. Senator Downey, a member of the Subcommittee on Securities and Exchange of the Senate Committee on Banking and Currency, in response to learning of the actual agreement between the Commission and the representatives of the industry on the redrafted bill, remarked: "[T]hat is a most amazing thing in this chaotic world right now," and thereafter he queried: "How was this miracle brought about?" *Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess., pt. 1, at 1130 (1940), as cited in North, note 36 *supra*, at 684. *See also* Note, *The Investment Company Act of 1940*, 41 COLUM. L. REV. 269, 295 (1941); Note, *The Investment Company Act of 1940*, 50 YALE L.J. 440, 442 (1941).

[41] Brouk v. Managed Funds, Inc., 286 F.2d 901 (8th Cir. 1961), was influenced by the "compromise" legislation in holding the Act did not confer a private right of action. *Id.* at 912. For a rebuttal, see Brown v. Bullock, 194 F. Supp. 207, 240, 246, 247 (S.D.N.Y. 1961).

order to accomplish its purpose of protecting the public investor.[42] Indeed, one commentator has recently suggested that the latter approach has ultimately found success in the federal courts.[43] Whatever the merits of each side of this controversy, the Commission secured the much needed regulation, and the industry succeeded in watering down substantially the regulatory provisions of the original Wagner-Lea proposal—especially those provisions of section 8 which contain some of the important registration requirements.

The original bill, in keeping with the "pattern of recent federal legislation," required much more information from the registrant than does the present Act, including the characteristics and relative amounts of securities which the registrant had acquired or intended to acquire. In addition, it gave the SEC the power to require additional information from the registrant. But most important, it provided that the *Commission* was to determine what was or was not a "fundamental policy."[44] Clearly, the present Act gives that election to the investment company. The following passage, written shortly after the Act was adopted, demonstrates succinctly the SEC's regulatory powers under both the original proposal and the Act.

> While it was never seriously proposed to outlaw investment companies entirely, the original bill . . . surpassed even the Holding Company Act in grants of discretionary power to the Commission. Whether it would have been politically possible to pass the bill in its original form is questionable. At any rate, the present Act is a drastic modification, rewritten entirely by the Commission and the industry. . . . Where the original draft left the Commission with power by rule and regulation to implement the broad policies of the bill, the present Act generally sets certain maxima of regulation, leaving in the Commission a discretionary power only to *exempt and minimize.*[45]

The alterations performed on the original proposals of section 8 demonstrate clearly the intent and policy to circumscribe the authority of the Commission to require information. The use of the terms "elect" and "deem," combined with this limited discretionary power to "exempt and minimize" rather forcefully confirm the district court's conclusion in *Green v. Brown* that the language of section 8(b)(2), "permits, even invites, the registrant, to withhold the fatal label 'fundamental' from any policy, no matter how important it may be."[46]

The statutory language of section 8(b)(2) and the legislative intent in modifying that section can be considered highly unfortunate. But the

---

[42] *See* North, *supra* note 36, at 684; note 39 *supra.*

[43] North, *supra* note 36, at 684 n.17.

[44] Wagner-Lea Bill, S. 3580, H.R. 8935, 76th Cong., 3d Sess. § 8 (1940). For a discussion of the original bill see Thomas, *supra* note 36, at 927-28. The original bill was objected to because of the large amount of discretionary power given to the SEC. "In general, the industry objected to restrictive or regulatory legislation in respect to matters which were not peculiar to investment companies. In the bill as originally introduced a very large measure of discretion was vested in the Securities and Exchange Commission to formulate standards, to impose restrictions, and to regulate conduct." Jaretzki, *supra* note 36, at 311.

[45] Note, *The Investment Company Act of 1940*, 50 YALE L.J. 440, 442-43 (1941) (emphasis added).

[46] 276 F. Supp. 753, 756 (S.D.N.Y. 1968).

public protection policy underlying the very foundations of the Act does not seem of sufficient import to warrant the protection of the investor by the judiciary in a manner which Congress expressly refused to sanction. As far as section 8 of the Act is concerned, an investor remains at the mercy of a mutual fund's discretion. His federal remedies for a deviation from an investment policy that is not christened "fundamental" appear virtually non-existent.[47]

While section 8 offers little aid to the mutual fund investor who holds speculative securities indirectly through a "growth" fund, section 36 of the Act, which establishes management's liability for "gross misconduct" and "gross abuse of trust,"[48] proffers a more hopeful avenue of redress. However, before encountering the perplexities of section 36, one nagging problem demands resolution. The manner in which the courts have handled the outburst of litigation in recent years concerning the advisory fee contracts has prompted one commentator to attack the rationale underlying the directors' liability in section 36.[49] The attack is premised on the asserted theory that the terms of the trust define the duty to be discharged. In other words, for the mutual fund investor the terms of the prospectus directly designate and thereby limit the responsibilities of the directors.

> He, himself [the investor], chose the adviser who would do the managing, *selected the fund for its stated policy and the risk level apparent in its portfolio.* . . . By having made the choice, he divested himself of control of his money and mandated the use of it in the hope of return through a fund investment account. Until he elects to terminate the account through redemption, control of these operational aspects of the fund is in others than himself. With that control go mandated functions and responsibilities, squarely within his legitimate expectations.[50]

Thus, the prospective investor by sifting through the prospectuses commits a total act of decision to purchase or not to purchase any particular fund's offering. Once having made his choice, he is in no position to complain about any matter disclosed and accepted by him through the prospectus. In this respect it is asserted that his selection reflects "an informed act of mature will."[51] In reality, however, he is merely culling blind bargains.

II. Disclosure of Investment Objectives and Policies

Any attempt to evaluate the effectiveness of the disclosure of management objectives and policies of a mutual fund through statutory analysis or traditional modes of legal research seems grossly inadequate. Abstract concepts are simply ineffective toward a meaningful evaluation of the

[47] An analysis of the random sample selection of prospectuses in section II *infra* revealed that only seven of the total forty-eight prospectuses received expressly stated that the fund's investment objective and policies were "fundamental" and could only be changed by shareholder approval.

[48] *See* note 69 *infra.*

[49] Lobell, *Rights and Responsibilities in the Mutual Fund*, 70 YALE L.J. 1258 (1961).

[50] *Id.* at 1269 (emphasis added).

[51] *Id.* at 1268.

factors influencing the decision-making process of the investing public. It may indeed be legally significant that a prospective investor through "an informed act of mature will" accepts or rejects the terms of the trust which guide mutual fund management in pursuit of their so-called fiduciary obligations. However, the investor's selection of those terms which generate the legal relationship rests upon a hypothesis of doubtful validity. But no amount of functional analysis embodied in legalistic concepts can ever attempt to show the terms upon which mutual fund shareholders entrust their economic power to the professional money-managers. Toward this end the best laboratory is the investor's real world, and the best research tool is the mutual fund prospectus.

An analysis of a random sample selection of mutual fund prospectuses[52] revealed that, as required by the SEC,[53] the prospectuses are similarly organized as to the manner in which the presentation is made to the investor. A short paragraph of description of "the fund" is followed by a statement of its investment objective, investment policies, and a detailed listing of investment restrictions. Thereafter, the prospectus discloses information relating to officers and directors, the investment adviser, purchase and redemption of shares, shareholders' rights and privileges, and usually concludes with a list of investments owned, and certified financial statements as of the end of the company's last fiscal year. The prospectuses covered a broad range of the various types of funds, including income and balanced funds along with several hedge funds. The prospectuses were analyzed solely on the basis of investment objectives. In this regard, primary emphasis was placed on the so-called "growth" funds.[54]

Over eighty per cent of the total prospectuses received listed the sole or primary investment objective of the fund as one of capital growth or capital appreciation.[55] This percentage includes those funds whose objective was stated to be either long-term growth or long-term appreciation. It can probably be said with a fair degree of accuracy that a "growth" fund is designed to realize gain through appreciation in the market value of its portfolio investments, and, unlike an "income" fund, does not invest with

---

[52] A 10% random sample of all mutual funds registered as of June 30, 1969, was selected from the INVESTMENT DEALERS DIGEST, Oct. 14, 1969, pt. II (Mutual Fund Directory). Those funds in initial registration at June 30, 1969, were not included in the universe. In addition to the random sample, all funds listed by the *Digest* as having in excess of 250,000 shareholders as of June 30, 1969, were also included in the analysis. The total sample included forty-seven listings and inquiries produced prospectuses for forty-eight funds. This discrepancy resulted from receiving several mutual fund prospectuses from a single issuer. For example, an inquiry to Keystone Funds, Inc. produced four separate prospectuses, each representing a different Keystone series. In addition to the forty-eight prospectuses received, three funds did not reply and two had ceased selling shares to the public. While quarterly, semi-annual, or annual reports were received with the prospectuses, no attempt was made to evaluate or analyze them.

[53] *See* SEC Investment Company Act Release No. 1932 (Dec. 15, 1953).

[54] No attempt was made to limit the random sample solely to "growth" funds. The prevalence of this type of fund within the industry was of considerable significance.

[55] This percentage includes capital growth funds listing "growth of future income" as an objective. This income growth objective, while considerably different from a *current* income objective, was considered indistinguishable from a pure "growth" purpose in view of the fact that "growth" investments are justified on the basis of future growth of earnings. Shapiro, *Trading in Tulips*, Barron's, Aug. 26, 1968, at 1, col. 1.

a view toward the production of current dividend or interest income.[56] While the objective of a growth fund is communicated to the investor with some degree of clarity, little or no information is offered as to how it is to be accomplished. A "growth" objective does not disclose the type of investments that will be employed by management to achieve that end. An investor would probably expect investments to be made in securities that management expects to appreciate in market value. However, a "growth" security has a distinct meaning only in relation to the subjective interpretation of the investing public. Any definitive meaning given to a growth or appreciation investment by professional money managers or market analysts can not be ascribed to the relatively unsophisticated investor.[57] To the small investor a growth fund can mean anything from a blue chip stock fund to an investment company dealing solely in highly speculative securities. And in this context, the prefacing of the growth objective with a "long-term" appendage does little to dissipate the shroud of indefiniteness, as the tax-minded investor considers a six-month holding period quite adequate to fulfill a "long-term" commitment. Of course, such an analysis of a fund's single statement of investment objective may seem unwarranted in that disclosure of an objective is not intended to communicate anything more than the ultimate purpose for which the fund is investing. In this sense the statement of objective achieves its design.

More important in the disclosure process are the fund's investment policies, for they more than anything else are intended to establish the terms upon which the investor delivers his money to a scheme of professional management. However, unlike the fund's statement of objective, the investment policies do not seem to serve their purpose.

Of the thirty-nine prospectuses having a growth objective as defined above, four stated that management's investment policy would be guided not with a view toward speculation, but with due regard toward conservation or safety of principal. Of the remaining thirty-five, nine prospectuses made an affirmative statement to the effect that an investment in that particular fund might entail risks greater than an investment in a fund not having a growth objective. Two of these nine were hedge funds in which investments were clearly labeled "speculative." The remaining seven were strikingly similar to the other growth funds in both objectives and policies, and nothing was discernible as to what prompted these seven growth funds to mention the greater degree of risk when the great majority of their cohorts omitted such a statement.[58]

[56] The Investment Company Institute would agree with this definition except it characterizes "growth" as being over a long term. Note, *The Regulation of Dual Funds*, 54 VA. L. REV. 1396, 1397 n.5 (1968). As to the implication of the meaning of "long term," see text following note 57 *infra*.

[57] The SPECIAL STUDY found a generally low level of knowledge among most mutual fund investors concerning their funds. It reported that it was quite clear that most mutual fund investors did not possess the ability to deal with relevant investment issues, and it characterized the investors as generally "unsophisticated." *Id.* pt. 4, at 145, 348.

[58] Almost all of the prospectuses contained a statement to the effect that the fund's objective might not be attained because of the inherent risk in any investment. While the phraseology of the investment objectives, policies, and restrictions of the growth funds' prospectuses were strikingly similar, the prospectus writers experienced a total lapse of creativity when it came to wording

The remaining twenty-six growth funds comprise more than fifty-five per cent of all mutual fund prospectuses received. Each of these funds stated in general terms that management's policy would be to invest in securities that in management's view would be likely to achieve the growth objective. In addition, all stated that investments would be primarily in common stocks, and all but six listed preferred stocks and bonds as additional permissible investments.[59] All but two of these twenty-six growth funds either failed to give a definite portfolio turnover rate, or provided an anticipated rate along with a qualification that it would be affected by economic or market conditions in situations where management was investing or reinvesting in the best interests of the stockholders. The obvious intent was to avoid restricting the fund to a portfolio turnover rate.[60] Almost all of the funds listed their portfolio turnover rates for the three fiscal years immediately preceding the date of the prospectus. In the great majority of the twenty-six growth funds the last fiscal year reported was 1968. The portfolio turnover rates for this year ranged from a low of 9.6 per cent to a high of 231 per cent, and over one-half of these funds had turnover rates for the 1968 fiscal year in excess of 50 per cent.[61] What these rates are intended to demonstrate is entirely unclear. Excessive rates point to a substantial amount of short-term trading which in turn may be indicative of speculation. However, a 50 per cent rate (or any rate for that matter) does not necessarily denote an absence of churning of securities, for such a rate could result if three-fourths of the fund's portfolio remained stable and one-fourth was replaced twice during the year. In this context, all but three of these twenty-six growth funds either stated that the fund would engage in short-term trading, or, though not the intention of the fund to engage in such trading, the right to do so was expressly reserved in circumstances in which management deemed short-term trading advisable.

The remainder of the investment policies of the prospectuses varied, but in general such policies dealt with matters concerning the permissible percentages of diversification in any one industry, factors to be considered

these disclaimer clauses. Such phrasing as, "of course, there is no assurance that the Fund's objective can be achieved since all investments are subject to risk," or some minor variation thereof was rampant. In addition, what little value these disclaimer clauses contained was usually eradicated by prefatory or conclusory remarks concerning the advantages of diversification of investments or the full-time dedication of management to the attainment of the fund's objective.

[59] Those that omitted any reference to preferred stocks and bonds usually did not surrender anything, as management reserved the right to assume a "defensive" position when required by economic circumstances.

[60] A number of the funds stated that the portfolio turnover rate for that particular fund may be higher than a rate experienced by a fund having similar investment objectives. This appears to be a direct consequence of Lutz v. Boas, 39 Del. Ch. 585, 171 A.2d 381 (Ch. 1961). There a mutual fund had a portfolio turnover rate of 44% for 1957, 97% for 1958, and 47.4% for 1959. The average turnover for various funds for the same three years was 25%. In its prospectus the fund stated that its investment policy was one of "capital growth" and "normal turnover." The court held the excessive turnover for the three years 1957-59 was contrary to the stated investment policy of the fund because "[t]he 'normal turnover,' in its context, fairly implied a comparison with mutual funds generally and not with some isolated Fund also having a high turnover." *Id.* at 393.

[61] The portfolio turnover rate over the past ten years for the mutual fund industry has been steadily increasing. *See* PUBLIC POLICY STATEMENT 304 n.67; 114 CONG. REC. H6736 (daily ed. July 16, 1968).

by management in choosing growth stocks, and in some instances the fund's policy with respect to investment in restricted securities. The investment restrictions of all the prospectuses follow the pattern laid down by the 1940 Act.[62] In only one instance did the funds show any initiative to deviate from the statutory pattern. Of the twenty-six growth funds analyzed above, nine restricted permissible investments to securities of companies which had been in continued operation for more than three years at the time the investment was made. This statement alone can not be considered a disclosure of management's intent not to invest in speculative securities. The restriction would not be violated if the fund invested in speculative issues of companies having at least a three-year history of continuous operation. High risk investments are not limited to new-born firms.[63] Concerning this restriction, ten funds made the limitation applicable only if the investment would exceed three or five per cent of the fund's total net assets, and eight of the prospectuses contained no such restriction.

Other information that could possibly be useful to the investor in discovering the fund's policies is the list of investments that the fund holds as of the date of its certified financial statements. Concerning these investments, one commentator has remarked: "While many funds may state their investment objectives in similar language, the actual degree of risk taken to achieve the objective may vary considerably and be discernible only by inspection of the portfolio—*i.e.*, the nature of the stocks held and the relative amount of cash or cash equivalents or bonds retained in the portfolio."[64] This suggestion that the listing of securities and the relative defensive position will inform the investor of management policies or the degree of risk not otherwise disclosed is utterly preposterous. First, the suggestion does not consider the possibility of the fund's "window-dressing" its portfolio at the end of the fiscal year, or before each quarterly report. Secondly, the mutual fund shareholder is a relatively unsophisticated investor.[65] It can not be expected that he will be familiar with any more than a few of the companies in such a listing, and it can not be seriously contended that he has the duty to familiarize himself with those unknowns by delving into the issuer's history. If such were the case, the investor would be performing the very tasks that he legitimately expects professional management to undertake, and to that end be economically rewarded at his expense. Finally, it is indeed a unique form of disclosure which requires investors to glean hidden management policies and degrees of risk from complex detailed comparisons of various listings of mutual fund investments or non-investments.

Generally, the over-all investment objectives and policies of the twenty-

[62] *See* notes 18 & 19 *supra*, and accompanying text.

[63] *See* Shapiro, *Trading in Tulips*, Barron's, Aug. 26, 1968, at 1, col. 1, where the author details five examples of the speculative "growth" stocks. In all five cases the companies had been in continuous operation for at least three years.

[64] Lobell, *Rights and Responsibilities in the Mutual Fund*, 70 YALE L.J. 1258, 1268 n.38 (1961).

[65] *See* note 57 *supra*.

six growth funds analyzed represent a composite of vague generalities communicating virtually nothing of any value to aid the investor in his decision-making process. A prospective shareholder would be hard-pressed to discover the kind of securities a fund's management would purportedly invest in given a growth fund with a policy of diversification among and concentration within equity securities, no definite statement as to portfolio turnover or short-term trading, no emphasis placed on conservation of capital or prudent investment, no statement whatever as to the type or degree of risk involved in that particular fund,[66] and in some cases a limited investment restriction pertaining to issues of companies with less than three years of continuous operation. It is quite obvious that mutual fund management is not going to tie its hands with respect to the fund's investment policies. Nor, perhaps, should it do so. It has been quite persuasively argued that the 1940 Act intended no such restrictions.[67] Neither should any be attempted by further regulation, for if any benefit is to be derived by the investing public from the advantages professional management can offer, it would destroy a great deal of the mutual fund's attractiveness to circumscribe such benefits through regulation.[68]

Acceptance of this argument, however, demonstrates even more forcefully the conclusion to which the growth funds concertedly aim. As to management policies concerning investment decisions, the investor in no way establishes, except within broad generalities, the "terms of the trust" from which professional management derives its duties and obligations. The prospectus grants mutual fund management broad discretionary power in the exercise of its responsibilities, and the price of such discretion should not be nominal. When a growth fund management speculates with other people's money, the investor, never having consented to such action, should not be precluded from challenging management with "gross misconduct or gross abuse of trust."

III. Gross Misconduct and Gross Abuse of Trust: The Past

The Securities and Exchange Commission has the power under section 36 of the Act to initiate proceedings for the temporary or permanent removal of an investment company's management for "gross misconduct or

[66] Better articulation of the fund's degree of risk would substantially aid the investor. One fund announced: "The Fund is designed primarily for persons who can afford to assume a significant degree of risk." Prospectus, Drexel Hedge Fund, Inc., May 16, 1969, at 1. Better yet, were those funds that characterize the degree of risk in comparative terms. "The Fund's policy . . . means that the assets of the Fund will generally be subject to greater potential fluctuation and risk than would be involved if the Fund did not follow such a policy." Prospectus, Incentive Fund, Inc., Jan. 5, 1970, at 5. "Such a policy . . . involves . . . the assumption of a higher degree of risk than in a 'balanced' fund, or in a 'managed' fund . . . ." Prospectus, Loomis-Sales Capital Development Fund, Inc., May 1, 1969, at 3.

It seems that these "comparative risk" statements would be more suitable for purposes of disclosure, and the SEC under its administrative authority would have little difficulty in requiring such statements to be included in a fund's prospectus. *See* §§ 8(b)(4) & 38(a) of the 1940 Act.

[67] Motley, Jackson, & Barnard, *Federal Regulation of Investment Companies Since 1940*, 63 Harv. L. Rev. 1134, 1141, 1156 (1950); Thomas, *supra* note 36, at 928; Note, *The Investment Company Act of 1940*, 50 Yale L.J. 440, 456-57 (1941).

[68] For example, mutual fund management needs some flexibility in order to shift strategies with the market.

gross abuse of trust."[69] That this section confers a private right of action against such management seems so well established as to be beyond question.[70] However, the present enigma for both courts and commentators alike has been their inability to develop a definitive statement of these elusive concepts. Standing alone, the phrases would seem to import a rather low level of care and fiduciary obligation akin to the concepts of gross negligence or bad faith. Fortunately for the investor, delineation of the boundaries of management's duties has not been limited to so cursory an examination.

Legislative History. The imposition of fiduciary responsibilities on investment company management was considered an integral part of the regulatory structure of the Act. The industry itself recognized the need for such responsibilities,[71] but it balked at the original proposal. Section 17(e) of the Wagner-Lea Bill provided: "Any gross misconduct or gross abuse of trust in respect of a registered investment company, on the part of any person registered under section 9 as an affiliated person of or principal underwriter for such company, shall be unlawful."[72] The Commission's objective was obviously to impose fiduciary responsibility upon investment company management, and make it a criminal offense to violate that responsibility. Representatives of the industry, however, wanted no part of a federal penal offense which they contended was too "indefinite," and "indefinable."[73]

[69] Section 36 provides in full:

> The Commission is authorized to bring an action in the proper district court of the United States or United States court of any Territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after the enactment of this title and within five years of the commencement of the action, of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts:
>
> (1) as officer, director, member of an advisory board, investment adviser, or depositor; or
>
> (2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.
>
> If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate.

[70] Just a few years ago the existence of a private right of action under the 1940 Act was seriously questioned in Brouk v. Managed Funds, Inc., 286 F.2d 901 (8th Cir. 1961), *vacated as moot per curiam*, 369 U.S. 424 (1962). However, the Eighth Circuit in Greater Iowa Corp. v. McLendon, 378 F.2d 783 (8th Cir. 1967), overruled *Brouk* by implication. *See* notes 92-93 *infra*, and accompanying text. For cases supporting the private right of action, see Schwartz v. Eaton, 264 F.2d 195 (2d Cir. 1959); Entel v. Allen, 270 F. Supp. 60 (S.D.N.Y. 1967); Brown v. Bullock, 194 F. Supp. 207 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961); Taussig v. Wellington Fund, Inc., 187 F. Supp. 179 (D. Del. 1960); Cogan v. Johnston, 162 F. Supp. 907 (S.D.N.Y. 1958). For an argument establishing the propriety of an implied right of action under the Act by means of analogous decisions in the related areas of securities regulation, see Brown v. Bullock, 194 F. Supp. 207, 224-34 (S.D.N.Y. 1961); Eisenberg & Phillips, *Mutual Fund Litigation—New Frontiers for the Investment Company Act*, 62 COLUM. L. REV. 73 (1962).

[71] Greene, *Fiduciary Standards of Conduct under the Investment Company Act of 1940*, 28 GEO. WASH. L. REV. 266, 267 (1959).

[72] S. 3580, 76th Cong., 3d Sess. § 17(e) (1940), as cited in Brown v. Bullock, 194 F. Supp. 207, 240 (S.D.N.Y. 1961).

[73] *Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 380, 1056 (1940), as cited in Greene, note 71 *supra*, at 270 n.13. Mr. Alfred Jaretzki, Jr., representing the closed-end investment companies at the 1940 Hearings, stated to the House committee:

When viewed with hindsight, their objections certainly seem justified in light of the judicial uncertainty as to the meaning of "gross abuse of trust." During the Senate hearings on the original bill, David Schenker, Chief Counsel to the *SEC Investment Trust Study*,[74] articulated the Commission's position that the "trust" provision was not by any means intended to impose upon investment company directors "a trustee obligation," primarily because trustees "in some instances may be liable for negligence."[75] Thus, the SEC clearly never advocated that investment company management should be held to the strict liability of a trustee. However, Mr. Schenker's testimony on the original bill makes it equally clear that the Commission was advocating a relatively broad standard of conduct concerning the duties of management.[76]

The ultimate provisions of section 36, like so many other portions of the compromise Act, were the result of a redrafting by the SEC and the industry representatives.[77] The only definite intent to emerge from the legislative history indicates that the "trust" provision does not mean the strict liability of a trustee. The "gross misconduct" provision apparently did not receive even the limited attention given to the "trust" provision, and no affirmative statement of either seems to have been attempted by the SEC, the industry, or the legislators. Of course, the alterations made in the compromise provision could support an argument that "gross misconduct or gross abuse of trust" was intended to apply a stricter standard than that which was encompassed in the original proposal.[78] In this context a criminal offense for breaching these duties obviously focused primarily on the more serious violations, and deletion of the criminal element operated to broaden the applicable standards. However, it is more likely that the framers of the Act were reluctant to delimit the substantive boundaries of management's obligation, preferring to leave this task to the more suited and easily adaptable judiciary, whose common everyday business abounds in statutory interpretation.

Judicial Activity. In *Aldred Investment Trust v. SEC*,[79] the first case

> The original bill contained a provision making unlawful gross misconduct and gross abuse of trust on the part of officers and directors of investment companies and consequently making such conduct subject to the penalties of the act. The group that I represent objected to this provision on the ground that it subjected persons to criminal liability for violation of an indefinite standard which was impossible of determination.

Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 124 (1940), as cited in Brown v. Bullock, 194 F. Supp. 207, 241 (S.D.N.Y. 1961). *See also* Jaretzki, *supra* note 36, at 344.

[74] *See* note 16 *supra*.

[75] *Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 262 (1940), as cited in Brown v. Bullock, 194 F. Supp. at 241.

[76] *Id.*

[77] The House committee did, however, make clear the character of the final legislation. "In the opinion of the Committee, the Securities and Exchange Commission and the industry itself, this legislation is needed to protect small investors from breaches of trust upon the part of unscrupulous managements and to provide such investors with a regulated institution for the investment of their savings." H.R. REP. No. 2639, 76th Cong., 3d Sess. 10 (1940); *See* S. REP. No. 1775, 76th Cong., 3d Sess. 11-12 (1940).

[78] *See* note 75 *supra*.

[79] 151 F.2d 254 (1st Cir. 1945), *cert. denied*, 326 U.S. 795 (1946).

brought under section 36, the court of appeals gave a very broad interpretation to "gross abuse of trust" in affirming a district court's determination that section 36 had been violated by all but one of the individual defendant trustees. The trust was registered under the Act as a closed-end, non-diversified management investment company. The principle abuse was the trust's purchase of the controlling interest in Suffolk Downs race track. The investment constituted thirty per cent of the trust's assets, and was made at a time when the trust could not pay interest on $5,900,000 of debentures outstanding in the hands of public investors, and the assets of the trust were substantially below this amount. Because the track investment of thirty per cent of the trust's assets involved a departure from the company's investment policy, approval of a new policy was obtained at a shareholders' meeting without any discussion of the track investment. Inquiries by the bondholders were circumvented by the trustees in the hope that profits from the upcoming racing season would satisfy the investors and mollify any complainants. First, the court of appeals noted that, "[b]y reason of its essential character of liquidity the investment company is peculiarly subject to abuse. . . . 1(b) of the Act, 15 U.S.C.A. 80a-1(b), in effect codifies the fiduciary obligations placed upon officers and directors of investment companies."[80] In affirming the district court's finding that the principal stockholder and his associates were guilty of a gross abuse of trust, the court stated:

> The findings of the District Court, amply supported by the evidence, reveal a course of conduct that was motivated by self-interest and personal advantage and the calculated denial of fiduciary obligations. . . . In effect the appellants have been using their control of other people's money to enrich themselves through the perquisites of such control. In our opinion the court below properly found them guilty of 'gross abuse of trust' within the meaning of § 36 of the Act.[81]

The court's view that section 1(b) codifies fiduciary obligations of the officers and directors, and its reliance on the classic language of Mr. Justice Douglas in *Pepper v. Litton*,[82] manifests a conclusion that section 36 covers a broad range of fiduciary obligation. The court in *Aldred* did not offer a substantive statement of the actual standard to be imposed under section 36. Its observance that investment companies were "peculiarly subject to abuse," might suggest a standard somewhat similar in scope to that im-

[80] *Id.* at 260. The court quoted portions of § 1(b) in order to list several of these obligations. *See* note 35 *supra.*

[81] 151 F.2d at 260.

[82] 308 U.S. 295 (1939). The court cited the following statement of Mr. Justice Douglas:

> He who is in such a fiduciary position cannot serve himself first and his *cestuis* second . . . . He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestuis*. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation.

151 F.2d at 260.

posed on the management of other financial institutions. No matter what the ultimate standard the court in *Aldred* thought applicable, its interpretation of section 36 gave impetus to a federal common law for investment companies.

In *Brown v. Bullock*[83] a court of appeals upheld a district court's finding that a private right of action was available to a shareholder of an investment company under sections 15 and 37 of the Act. Although the court of appeals did not comment on the alleged violation of section 36, the district court's opinion[84] dealt quite extensively with this section and, therefore, is particularly illuminating. The complaint in *Brown* alleged that the management company's advisory fees were excessive; that the advisory contracts were not the result of arms-length bargaining, but rather were adopted by management in arbitrary action replete with collusion and gross negligence; and that the advisory fees were not proportionate to the value of the services performed, and the defendant directors knew or should have known this fact. The district court found section 36 to be a "reservoir" of substantive federal duties, and it enunciated the view, implicit in *Aldred*, that the section was designed to create a federal common law applicable to investment company management. A detailed investigation of the legislative history of section 36 led the court to make the following observation:

> It was not practicable to incorporate specific deterrents for every potential abuse without seriously impeding the operation of the industry. Therefore, with respect to the more subtle abuses—such as those that might arise from a director's representation of conflicting interests or from his lack of independence resulting in the subordination of the stockholders' interest to that of the management—section 36 was a reservoir of fiduciary obligations imposed upon affiliated persons to prevent gross misconduct or gross abuse of trust not otherwise specifically dealt with in the Act.[85]

The court firmly rejected an argument that section 36 was incorporated simply for the purpose of enforcing state-created duties, and it emphasized that to deny the existence of a federal duty would clearly frustrate the intent of Congress. In the end the court viewed section 36 as a residuary clause capable of dealing with abuses not readily foreseeable by the framers and hence not specifically enumerated in the Act. In the court's opinion, "the judicial implementation of the provisions for truly independent directors and for remedies against gross misconduct and gross abuse of trust are critically necessary to prevent a recurrence of the evils and malpractices that victimized the investing public prior to the passage of the Act."[86]

The decisions in *Aldred* and *Brown* represent cornerstones in this underdeveloped area of federal common law. However, it is relatively little comfort to investors merely to have established that section 36 of the Act

[83] 294 F.2d 415 (2d Cir. 1961).
[84] Brown v. Bullock, 194 F. Supp. 207 (S.D.N.Y. 1961).
[85] *Id.* at 238-39 n.1.
[86] *Id.* at 240 n.1.

creates certain fiduciary obligations which can be privately enforced by the federal judiciary. It is much more important to question the relative standard of such obligations. In answering this the courts have been less articulate and oftentimes quite confused. In both *Aldred* and *Brown* there were implications to the effect that the standard may be similar to that imposed by corporate law on commercial and savings banks.[87] This proposition has been forcefully endorsed by several commentors,[88] but not by any other courts.

In *SEC v. Midwest Technical Development Corp.*[89] the Commission charged that the directors were "trafficking" in fund portfolio securities in violation of section 17 of the Act (prohibiting transactions of certain affiliated persons and underwriters). The Commission also asserted a violation of section 36. The court found a violation of section 17(d), but declined to apply section 36, stating that, "[a]n adjudication of gross abuse of trust must be based upon evidence that a director is so untrustworthy that he should not be permitted to act in that capacity for any other company."[90] While the court found certain patterns and practices to the defendants' dealing in portfolio stocks, the failure of the defendant directors to appreciate the conflict of interest and their unintentional failure to obtain Commission approval were mere technicalities not justifying the application of such drastic measures as section 36. The court in *Midwest* may have believed that the standard under section 36 should vary depending upon whether the SEC or a stockholder is alleging a violation of a "gross abuse of trust." It is clear that the SEC's remedy is the removal of the director,[91] but it is as equally unclear as to what a shareholder may recover. In any event, the court in *Midwest* does not expressly enunciate this principle, and its application under section 36 seems questionable.

In *Brouk v. Managed Funds, Inc.*[92] shareholders of the Fund sought to hold directors of the Fund liable for a breach of duty owed them under various provisions of the Act. The practices contended to be in violation of such duties included excessive trading in portfolio securities, and general management of the Fund in the interest of the controlling group at the expense of the shareholders' interest. The Eighth Circuit dismissed the complaint on the basis that the 1940 Act did not create duties owed by the directors which were enforceable by a federal court in a private right of action. In dictum the court stated that the controlling corporate law required that directors only exercise due care, and they are not liable as insurers. Because the stockholders sought to hold the directors to the strict

---

[87] As to *Aldred*, see note 80 *supra*, and accompanying text. In *Brown* the court stated: "Section 36 imposes upon investment company directors, officers, investment advisers and principal underwriters fiduciary obligations appropriate to their respective trustee and managerial responsibilities in the handling of other people's money." 194 F. Supp. at 238 n.1.

[88] Eisenberg & Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940*, 20 RUTGERS L. REV. 181, 203 (1966); *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAW. 732, 940 (1969).

[89] CCH FED. SEC. L. REP. ¶ 91252 (D. Minn. 1963).

[90] *Id.* at 94146.

[91] *See* note 69 *supra*.

[92] 286 F.2d 901 (8th Cir. 1961), *vacated as moot per curiam*, 369 U.S. 424 (1962).

liability of an insurer, the court found they had violated no duty. The decision in *Brouk* concerning the private right of action has been impliedly overruled in the Eighth Circuit.[93] However, the Supreme Court's endorsement of private civil remedies under federal regulatory statutes[94] does not imply that *Brouk* is wrong by tying itself to corporate law as an appropriate source of director's liability in investment companies. The Eighth Circuit will re-evaluate the *Brouk* dictum when the question is more fully considered in a private right of action. However, the decision stands as an indication of a court's first impulse to look to corporate common law as the appropriate source for the derivation of directorial liability under section 36 of the Act. While this approach is probably favored by the industry,[95] it has been severely criticized as being too restrictive of the fiduciary obligations of investment company management.[96]

Acampora v. Birkland[97] illustrates succinctly the ultimate confusion which has entered the area. A shareholder sought recovery of certain management fees paid during a period when the management advisory contract was contended to be void. The court allowed recovery for a limited amount of fees. Even though a violation of section 36 was not alleged, the court on its own initiative offered some thoughts on directors' liability. "[L]ack of prudence on the part of the directors would not subject them to liability. . . . Admittedly, the standard is that of gross negligence or . . . bad faith."[98] However, in the same breath the court says: "These non-affiliated directors have a demanding mission and that is the protection of the assets of Fund and the shareholders. Their position in relation to the adviser is adversary in character, and if they are to properly fulfill their mission they are obligated to scrutinize the acts and doings of the adviser with great care."[99] The concepts of "gross negligence" and "great care" seem highly incompatible. But the court in *Acampora*, in touching upon the duties of the non-affiliated directors, may have struck a chord that has thus far remained silent in the judicial interpretation of section 36.

Not only have judicial authorities given various interpretations to section 36, but in general they have failed to distinguish between a duty of care and a duty arising from a conflict of interest. Within the structural framework of the mutual fund organization, it would seem that the independent directors would be more vulnerable to an alleged violation of the duty of care, and that the affiliated directors and management adviser would be

---

[93] Greater Iowa Corp. v. McLendon, 378 F.2d 783 (8th Cir. 1967).

[94] *See* J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

[95] Jaretzki, *Duties and Responsibilities of Directors of Mutual Funds*, 29 LAW & CONTEMP. PROB. 777 (1964).

[96] Comment, *Rights and Obligations in the Mutual Fund: A Source of Law*, 20 VAND. L. REV. 1120 (1967).

[97] 220 F. Supp. 527 (D. Colo. 1963).

[98] *Id.* at 550.

[99] *Id.* The distinction between non-affiliated (or independent) and affiliated directors can be found in § 10(a) which provides: "[N]o registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are investment advisers of, affiliated persons of an investment adviser of, or officers or employees of, such registered company."

more susceptible to the conflict of interest attack.[100] While it is recognized that in any given factual situation violations of both duties may arise, the distinction between affiliated and non-affiliated directors is intended to emphasize the separability that has been attributed to the duty of care and the duty of loyalty.[101] While the two fields seem to overlap in certain instances, it has generally been recognized that they proceed from entirely different principles. In this context, the framers of the 1940 Act may have recognized this diversity when they wrote into section 36 both a "misconduct" and a "trust" provision, for the duty of care has not historically been considered a "fiduciary" obligation.[102] While this differentiation may have some merit on its face, it is difficult to determine whether the courts have paid tribute to it.[103] In any event, it is not intended to explore the applicable standard in relation to the conflict of interest problem. Observance of investment policies resulting in a fund's entry into speculation under circumstances where the fund has not disclosed to the investor the amount of risk or the fund's intention to so speculate could, of course, create serious conflicts of interest arising from greater management fees or higher brokerage costs. However, the present inquiry is limited to a search for the standard of care applicable to directors and management advisers, and whether or not speculation with other people's money can be said to violate that standard.

IV. The Standard of Care and Speculation

Several commentators have rather forcefully argued that the standard applicable under "gross abuse of trust" should be similar to that applied to commercial and savings banks.[104] The analogy is supported primarily by a comparison between the nature of the institutions with respect to the type of investments made, the persons they are designed to serve, and the high liquidity of their assets. Further, it is argued that the special regulatory statutes under which the national and state savings institutions operate, show governmental concern for the adequate protection of an investing public which is financially unsophisticated.[105] For the mutual fund shareholder, it is alleged that this governmental concern is demonstrated in section 36 and the general declarations of policy in section 1 of the Act. The argument possesses a great deal of appeal, but it appears that its advocates have discussed its application only under circumstances involving a breach of the fiduciary duty of loyalty, and, more specifically only in con-

[100] It should be remembered that § 36 applies not only to directors of investment companies, but also to management advisers. *See* note 69 *supra*.

[101] H. Ballantine, Corporations §§ 62, 66, at 156, 167 (1946).

[102] *Id.*

[103] In *Brown* the court speaks of "fiduciary obligations" encompassing both the "misconduct" and the "trust" provisions of § 36. *See* note 85 *supra*, and accompanying text. Also, in *Acampora* the court seems to embrace two completely different standards even though the decision is not based specifically upon § 36. *See* notes 97-99 *supra*, and accompanying text.

[104] Eisenberg & Lehr, *supra* note 88, at 189; *The Mutual Fund Industry: A Legal Survey*, 44 Notre Dame Law. 732, 940 (1969). *See also* Comment, *Rights and Obligations in the Mutual Fund: A Source of Law*, 20 Vand. L. Rev. 1120 (1967).

[105] Eisenberg & Lehr, *supra* note 88, at 191-92.

nection with management advisory fees. Within this limited context the argument is given added impetus by the rising standard of directorial loyalty over the past several decades,[106] and even more recently under the federal securities acts.[107] However, since this increase is not generally applicable to the duty of care, and because the banking analogy, though relevant, has not been specifically applied to this duty, it seems that a basic analysis is required to formulate a possible standard. Before undertaking this task it must be emphasized that, for the provisions of section 36 to apply, something more than simple misconduct or abuse of trust is required. In the words of one authority, characterizing only the "trust" provision, the standard under section 36 is limited as follows: "Although it is clear that directors are held to account for negligence, the phrase "gross abuse of trust" clearly indicates that the standard was not meant to include inadvertent conduct or minor lapses; the phrase conveys a meaning of serious, wilful misconduct or disloyalty, recklessness, or gross negligence with respect to an investment company."[108]

The business judgment rule applicable generally to directors of corporate entities proceeds from the obligation of corporate directors to perform their various functions with due care and diligence.[109] Courts are usually quite reluctant to interfere with the correctness of directorial actions, and, hence, directors are vested with a large degree of discretion concerning their business transactions.[110] However, the application of the business judgment rule assumes the exercise of reasonable care and diligence, and therefore the focus is on the duty of care.[111] The standard is usually formulated in terms of that care and diligence which a reasonably prudent director would exercise under similar circumstances.[112] From this general rule there has developed the principle that directors of banks, trust companies, and other institutions which engage in the handling and investment of other people's money, are held to a higher standard of care than are directors of ordinary business corporations. However, it is unlikely that the standards are really any higher, but rather simply that the circumstances are extremely different.[113]

It does seem appropriate that the banking analogy should have its place in the derivation of the proper standard of care applicable to directors of

[106] Cary, *Corporate Standards and Legal Rules*, 50 CAL. L. REV. 408 (1962).
[107] *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).
[108] Eisenberg & Lehr, *supra* note 88, at 226.
[109] H. BALLANTINE, CORPORATIONS § 62, at 156 (1946).
[110] *Id.* § 63a, at 160-61.
[111] *Id.*
[112] *Id.*; N. LATTIN, CORPORATIONS § 10, at 242 (1959).
[113] Professor Ballantine states:

> Directors of savings banks, trust companies, life insurance companies and companies which solicit the handling and investment of the funds of others, are by some courts declared responsible for a higher degree of wisdom, prudence and good judgment than directors in ordinary business corporations. It is doubtful, however, whether more is actually required than giving reasonable attention to the business, making proper inquiries upon the matter in hand, and exercising an honest judgment upon the information available, unless improvidence goes to the point of wilful or negligent waste.

H. BALLANTINE, CORPORATIONS § 63a, at 161 (1946) [footnotes omitted]. *See, e.g.*, Litwin v. Allen, 25 N.Y.S.2d 667 (1940).

the mutual funds. However, the internal operational similarities between the two types of institutions should not create a higher standard of care for the mutual fund director solely because, as is so often contended, directors in the banking industry are declared responsible for a higher degree of wisdom, prudence, and good judgment. By placing emphasis on this higher standard alleged to exist within the banking industry and thereby analogizing through similarity of circumstances to the operational aspects of the mutual fund, the standard created for mutual fund directors is inappropriately circumscribed because the reasoning process emphasizes the standard itself and not the circumstances to which the general standard should be applied. To equate a mutual fund to a bank or trust company and thereby derive a standard applicable to mutual fund management ignores the fundamental difference between the two institutions; a difference which, because it is correctly a "circumstance," should engender a greater burden on the mutual fund director.

As has been stressed earlier, the overwhelming attractiveness of the mutual fund is the prominence it places on professional management.[114] Unlike any other financial institution, it offers to the public only one service—professional investment management. And the emphasis given to this service by the industry has led the investor to elevate the concept to the point where it fosters his highest expectations.[115] Because of its importance to both management and investor alike, the presence of professionalism should operate as the most important of "circumstances" encompassing management's duty of care. Directorial responsibility in the growth mutual fund should rest upon that care and diligence which a reasonably prudent director would exercise in the professional handling and investment of money given to the company for the purposes of obtaining growth of capital under the investment policies and restrictions which the investor has consented to. However, assuming the existence of speculative practices and equating the standard to be consistent with professionalism does not, without more, establish directorial liability. There remains the problem of the "prudent man."

Is investment in speculative securities the exercising of the care and diligence of a reasonably prudent director under the circumstances set forth above? Several professionals would have us think so,[116] but not all would agree.[117] In order to evaluate more carefully the contrasting views, a close look at the kind of investments that this professionalism fosters is necessary. One Wall Street strategist with over twenty-five years experience in analyzing stocks recently compared the 1968 mania for growth stocks to the 17th century tulip craze which swept Holland.[118] The follow-

[114] *See* note 5 *supra*, and accompanying text.

[115] Although diversification of risk is also an important factor in the mutual fund industry, it seems that even it can be considered merely a single facet of the concept of professionalism.

[116] *See* note 13 *supra. See also The Money Men: You Call it Speculation; I Call it Investment*, FORBES, Sept. 1, 1969, at 56. During an interview with Fred Carr, manager of a "go-go" fund, the interviewer concluded: "In fact, much that Carr says seems calculated to make speculation sound respectable." *Id.* at 58.

[117] *See* note 13 *supra.*

[118] Shapiro, *Trading in Tulips*, Barron's, Aug. 26, 1968, at 1, col. 1.

ing illustrates one of the many growth stocks highly acclaimed by private and institutional investors during the summer of 1968.

> The common stock of National Patent Development Corp., selling at $185, is another present-day tulip. On December 31, 1967, there were 730,882 shares outstanding. To this must be added 263,864 shares which have been issued since December 31, 1967, or may be issued through exercise of warrants and options. The grand total: 994,748 shares. This entire issue, at the current market of $185 per share, is being given a value in excess of $175,000,000. What does the tulip-buyer get for his $175,000,000? The chief asset of National Patent is a licensing agreement it has received to produce or market a plastic (hydrophylic acrylic) polymer. The licensing agreement was signed with the Academy of Science of Czechoslovakia, which owns the patent. The plastic substance, which has a property to absorb liquids, is deemed to have commercial possibilities, particularly in contact lenses.
>
> Bausch & Lomb has signed a sub-licensing agreement with National Patent under which Bausch & Lomb will investigate, develop, manufacture and market contact lenses on a 50-50 profit-sharing arrangement. The contract can be terminated by Bausch & Lomb at any time with a minimal penalty payment. After months of investigation, no contact lenses have yet been marketed. National Patent has signed sub-licensing agreements with other companies for other uses of Hydron (the name which National Patent has given to the plastic material). So far, no sales of materials fabricated of Hydron have been made in commercial quantities. The company has lost money every year since its inception in 1959; the greatest loss, $758,193, was incurred in 1967. The accumulated historical deficit is $1,762,333.
>
> Speculators who put a $175,000,000 value on National Patent have been mesmerized by the 'unusual' properties which Hydron is reputed to possess. . . .
>
> Individuals or institutions who have put their money into National Patent should expect that some day the company might turn a profit. How large a profit should be achieved in order to justify a market price of $185 per share? Surely, it is not too much to ask for earnings which would establish a 17 price-earnings multiple, since it is possible to buy the world's greatest corporations for just such a P-E. To attain such a multiple, National Patent Development would need to earn approximately $11,000,000, equal to $11 per share ($11 multiplied by 17 would result in 187, or approximately the present market price).
>
> And what are the chances that National Patent will ever earn $11,000,000 in a single year? Bausch & Lomb, a leading maker of ophthalmic products and scientific instruments, with a global organization, infinitely greater technological resources and far bigger assets, in 1967 recorded the largest income in its history; yet earnings came to less than $6,000,000. In most of the years during the past decade, its net ranged between $2,000,000 and $3,000,000. Why these modest earnings? Because the markets which Bausch & Lomb serves do not yield really great profits. The clear inference is that National Patent can be expected, at best, to enjoy earnings which are only a fraction of Bausch & Lomb's. To expect otherwise is to chase a tulip seller across the streets of Amsterdam.[119]

The author notes that this kind of speculation has become very popular. Whereas twenty-five years ago speculators were looked upon with suspicion, today "as the number of such speculators has swelled and as their ranks have been joined by mutual funds . . . and other sophisticated investors,

[119] *Id.* at 3, col. 1.

their behavior in the marketplace has been accepted and emulated."[120]

This acceptance and emulation seems to be the core of the problem. The underlying justification for the kind of investing exemplified above is based on a change in the prudent-man standard. Thus, for professional money-managers, the adoption of investment techniques once considered speculative is justified as "reasonable" solely on the basis of mass acceptance. It is true that the standard of the reasonable man has for some time been dependent upon the usual and ordinary conduct of others in the applicable community.[121] While the use of a community standard might appear to create a rule based on the judgment of a majority of the community, it has never been considered the sole criterion in developing the concept of the reasonable man. Authorities recognize that a deviation from the ordinary will not of itself violate the reasonable-man standard.[122] However, in a confrontation between the old and the new, the law is inclined to give preference to traditional custom. Even assuming that the entire investment community were to employ new investment techniques, such a change would not encompass an alteration in the relevant standard. An entire industry has been known to be unreasonable,[123] and in this regard the prevailing community standard is not always a reliable one. "What usually is done may be evidence of what ought to be done, but what ought to be done is fixed by a standard of prudence, whether it usually is complied with or not."[124] In the mutual fund industry the new standard is by no means a universal one. Those in opposition to the modern investment approach point to the old school with its emphasis on conservation of principal and less drastic methods of investing for capital growth.[125] Under the guise of professionalism the modern approach to the preservation of capital is to double it,[126] without regard for the risk assumed.

It is reasonable to speak of new financial institutions and business customs, changing commercial methods and practices, altered monetary usages and investment combinations. It is reasonable to speak of the relative values of the things that can be found for sale in the financial world. And it is reasonable to speak of the insufficiency of maintaining the value of investment capital over a long period of years without protecting the purchasing power of the dollar. But is it reasonable that the economic and social circumstances which have tended to alter the American property system should dictate the abandonment of a principle of cautious responsibility? In light of the traditional standard of investing and the experiences of the 1920's, it would seem that the role of conservative investing has its place in an industry that acclaims professionalism, and that the standard should

[120] *Id.*

[121] W. PROSSER, TORTS § 33, at 168-70 (1964).

[122] *Id.* at 171.

[123] The T.J. Hooper, 60 F.2d 737 (2d Cir. 1932), *cert. denied sub nom.* Eastern Transp. Co. v. Northern Barge Corp., 287 U.S. 662 (1933) (radio sets for tugs).

[124] Texas & Pac. R.R. v. Behymer, 189 U.S. 468, 470 (1903); *accord*, Wabash R.R. v. McDaniels, 107 U.S. 454 (1882).

[125] *See, e.g.*, Biel, *Investment Problems and Prospects*, Com. & Fin. Chr., June 12, 1969, at 1, col. 1.

[126] A. SMITH, THE MONEY GAME 180 (1969).

not become so easily abrogated over a relatively short era of financial prosperity. The market itself has lectured the mutual funds once before on the hazards of speculation.[127] To forget that lecture is to invest in "irrationality," for "those who cannot remember the past are doomed to repeat it."[128]

V. Conclusion

The mutual fund industry perhaps more than any other institutional investor demonstrates succinctly the burgeoning institutionalization of private property ownership on the American economic scene. Aside from the desirability of further institutionalization, the majority of problems countenanced are the progeny of such growth, if only because their subtle presence in 1940 escaped recognition by legislators bent on the eradication of more prominent abuses. If this thirty-year-old legislation was designed to cope with the thorns of speculation, a lack of precision in so doing can only be attributed to the framers' utmost faith in the diligence of both the federal and state judiciary and the SEC. Certainly, the explicit statutory utterances of section 8 and the accompanying legislative history effectuate a complete frustration of that diligence, even within the laudable purposes and policies which gave birth to the Act. However, within the present boundaries of section 36 there lies a seething potential for judicial implementation. Contemplating the section as a skeleton of legal principles, the judiciary can develop the broad policy of investor protection in much the same spirit that has prompted judicial action under the federal securities acts.

However, even such a development of investor protection is only half an answer. Certainly, better articulated investment objectives and policies are the ultimate goal. But what of the realities of enforcement? Money damages are an extremely high cost to pay for such benefits where multimillion dollar losses are possible. For the future, the SEC can require disclosure of the risk inherent in a mutual fund investment, and perhaps even disclosure of gains and losses on a more frequent and specific basis.[129] But this is of no help to the present investor. For him, section 36 provides the best means of enforcement—the removal of professional management. While removal has been considered a drastic measure,[130] such severity may be in order. If the declarations of policy in section 1 of the Act are to represent something more than mere verbiage, then it seems only appropriate that the federal judiciary should enlighten the professional investment community on the congressional condemnation of selling an investing public a bill of goods containing hidden charges for institutional speculation.

[127] Comment, *The Regulation of Management Investment Trusts for the Protection of Investors*, 46 Yale L.J. 1211, 1214, 1225-26 (1937). *See also* Tolins, *The Investment Company Act of 1940*, 26 Cornell L.Q. 77, 81-82 (1940); Comment, *Federal Legislation: Investment Company Act of 1940*, 29 Geo. L.J. 614 (1941); Note, *The Investment Company Act of 1940*, 41 Colum. L. Rev. 269, 270-71 (1941).

[128] Quotation is attributed to George Santayana, an American philosopher. Torrance, *Legal Background, Trends, and Recent Developments in the Investment of Trust Funds*, 17 Law & Contemp. Prob. 128, 160 (1962).

[129] *See* note 66 *supra*.

[130] *See* notes 90-91 *supra*, and accompanying text.