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The Use of Mutual Fund Assets to Pay Marketing Costs

JOHN P. FREEMAN*

INTRODUCTION

Managements of few companies would find it difficult to obtain or defend approval of an annual allocation of .2 percent of net assets to a marketing program expected to increase sales and benefit shareholders. In the mutual fund industry the picture is different. In that industry, pressure exerted by the Securities and Exchange Commission traditionally has prevented overt adoption of the normal practice of charging corporate assets to pay marketing costs. However, many funds are engaging in the practice indirectly,¹ and, despite its traditional opposition, the SEC occasionally has allowed certain funds to pay marketing costs.²

This article analyzes both sides of the ongoing debate between the SEC and the fund industry whether it is proper, under the Investment Company Act of 1940,³ to use mutual fund assets as a source of payment for fund marketing costs. In addition, this article discusses a significant legal problem that has been glossed over by both the SEC and the fund industry—the continuing nondisclosure by the industry of the indirect use of assets for marketing costs. To aid understanding of the issues considered in this article, the following sections present an introductory discussion of the contours of the mutual fund industry and the history of the debate between it and the SEC.

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During the summers of 1974 and 1975 the author worked with the Securities and Exchange Commission on matters related to mutual fund marketing. The views expressed herein do not necessarily reflect the views of the Commission or the Commission's staff. The author wishes to express his thanks to Wilkins Byrd for his very fine research assistance. This article bears a date of February 1, 1978.

1. Indirect use of fund assets to pay marketing costs arises when a portion of a fund's advisory fee is used to pay for marketing expenses. Such allocation of advisory fees is said to be common. See note 18 infra. The SEC historically has acquiesced in such action on the theory that marketing expenses are being paid out of advisors' profits. See note 126 infra and accompanying text.

2. SEC action authorizing certain schemes whereby fund shareholders would bear marketing costs is discussed in notes 30, 32, 36 & 37 infra and accompanying text.

The mutual fund industry consists of approximately 1200 companies having roughly 7.5 million shareholders and total assets of approximately $50 billion. Mutual funds differ markedly from regular business corporations in the ways they are regulated and managed. Regulation is both intensive and far-reaching. As one former SEC Chairman has observed: "No issuer of securities is subject to more detailed regulation than mutual funds." The chief piece of regulatory legislation for the fund industry is the Investment Company Act of 1940, although fund operations are also affected by the other federal securities laws, blue sky laws, state corporate laws, and common law fiduciary duty principles.

A mutual fund consists of a pool of assets in the form of securities. Fund shareholders have pro-rata claims on the portfolio securities. In buying fund shares, an investor purchases three things: professional investment management, diversification of investment risk and a redeemable security. This latter feature means that unlike most securities, which are traded in secondary markets, fund shares are redeemed by the funds themselves for their net asset value at the time of redemption, less any redemption fee. The redemption feature is significant because unless a fund has a successful marketing program to attract new investors, it eventually will be redeemed out of existence.

Unlike a regular business corporation whose affairs are "internally managed" by its officers and board of directors, the assets of most mutual funds are externally managed by an investment adviser who is hired by a single fund or by members of an affiliated group of funds. Such an affiliated group is called a fund "complex." Approximately one-half of the industry's assets are con-

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5. This is the number of shareholders owning stock in mutual funds that belong to the Investment Company Institute, the fund industry's trade association. The assets of members of the Institute represent about 90% of the fund industry's assets. See Statement of the Investment Company Institute, SEC File No. 4-186, at 1 (Nov. 1976).
8. For evidence of a judicial willingness to apply common law fiduciary duty principles in 1940 Act cases, see Rosenfeld v. Black, 445 F.2d 1337 (2d Cir. 1971), cert. denied, 409 U.S. 802 (1972).
9. For a recent discussion that presents basic background information concerning the fund industry and the way it is regulated, see Krupsky, The Role of Investment Company Directors, 32 BUS. LAW. 1733 (1977). A much more extensive but less current analysis of the industry is found in The Mutual Fund Industry: A Legal Survey, 44 NOTRE DAME LAW. 732 (1969) [henceforth cited as Survey].
centrated in ten large fund complexes. Besides rendering investment advice to a mutual fund, the adviser often furnishes the fund with a broad array of administrative and clerical services, even to the point of providing the fund's office space. The adviser is compensated for services rendered by a management fee which normally is calculated as a percentage of the fund's average net assets. The most common annual fee is .5 percent of fund average net assets up to a certain specified level, with provision for a sliding-scale reduction of the percentage as assets increase.

The marketing of fund assets to new investors is ordinarily handled by the fund's "principal underwriter," which is usually the adviser or an affiliate of the adviser. In rare cases, the fund itself acts as underwriter of its shares. Shares generally are sold to the public in one of two ways: (1) the underwriter selects dealers who then sell to the public and collect a sales charge (the "load"); or (2) the shares are sold directly to the public at no sales charge. Funds following the latter practice, called "no-load" funds, account for approximately twenty percent of the industry's assets. The load rarely accrues to the fund. Rather, the load is purely compensation for marketing effort, and typically is split between the principal

10. SEC DIVISION OF INVESTMENT MANAGEMENT REGULATION, MUTUAL FUND DISTRIBUTION AND SECTION 22(D) OF THE INVESTMENT COMPANY ACT OF 1940 17 n.3 (1974) [hereinafter cited as DISTRIBUTION REPORT]. Indeed, it has been noted that a complex, rather than an individual fund, is the "relevant unit" in the investment company industry today. Statement of the Vanguard Group of Investment Companies, SEC File No. 4-168, at 10 (Nov. 22, 1976). Besides sharing a common investment adviser, the member funds of a complex normally share the same corporate management and the same principal underwriter. Id. Practical aspects of fund complex operations are discussed in Bogle, THE MUTUAL FUND COMPLEX, 3 REV. SEC. REG. 911 (1970). An in-depth legal analysis is presented in Glazer, A STUDY OF MUTUAL FUND COMPLEXES, 119 U. PA. L. REV. 205 (1970).

11. See Survey, supra note 9, at 885-86, 891. Among the many services that may be supplied to the fund by its adviser are accounting, auditing and legal services, payment of registration and filing fees, payment for stationery, supplies, printing costs and executives' salaries. For a checklist of services that may be provided to a fund by its adviser, see SEC Form N-1R, Item 1.22, reprinted in 4 FED. SEC. L. REP. (CCH) ¶ 51,963 at 39,847.

12. WEISENBERGER INVESTMENT COMPANIES SERVICE, INVESTMENT COMPANIES 1977 14. See also note 42 infra and accompanying text (discussing money market fund management fees).


15. An extensive study of the mutual fund industry published 12 years ago did note that several funds charged low sales loads and kept the loads. See REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess. 52 n.124, 207 n.26 (1966) [hereinafter cited as PUBLIC POLICY REPORT]. The only fund mentioned by name in the report as charging and keeping a load was Growth Industry Shares, Inc. Id. at 52 n.124. That fund is now a no-load fund. See Prospectus of Growth Industry Shares, Inc., April 29, 1977.
underwriter, the retail dealer, and sales personnel of the dealer. 16

Externalized management is the chief operating characteristic which distinguishes the fund industry. Ordinarily, the external investment adviser organizes the fund or complex and, through the fund's board and by control of the proxy mechanism, controls the fund. Former SEC Chairman Manuel Cohen pointed this out eleven years ago in the course of hearings on proposed mutual fund legislation. Referring to testimony by fund investment advisers he said:

They also made the point that the investment adviser creates the fund, and operates it, in effect, as a business. Many of them stated that "it is our fund, we run it, we manage it, we control it," and I don't think there is anything wrong in them saying it. They were just admitting what is a fact of life.

The investment adviser does control the fund. 17

The fact of external adviser control paired with the fact that adviser compensation pursuant to board-approved contracts normally is based on a percentage of total net assets leads to an understanding of the SEC's reluctance to authorize use of fund assets to subsidize sales of fund shares. The benefit to the adviser, the dominant party, is easy to see; much less clear is the nature and extent of any benefits flowing to fund shareholders from increased sales.

If the conflict of interest problem is obvious, so is another facet of the problem: a substantial amount of money is involved. If the SEC permitted direct use of fund assets to pay marketing costs, fund expenses conceivably could rise by the seemingly miniscule .2 percent mentioned in the first sentence of this article. An annual charge of .2 percent applied against the fund industry's asset base of $50 billion yields an annual drain on fund investors' capital of $100 million.

This discussion would be incomplete if it failed to reiterate a vital fact noted in the introduction: the assets of mutual funds currently are being used to pay for fund marketing costs. 18 Indeed, for the

16. Some funds sell their shares to the public by means of their own “captive” sales forces. One fund complex has a captive sales force numbering 3,100 sales personnel. See Statement of Hamer H. Budge, SEC File No. 4-186, at 1 (1976).


[We] want to reemphasize that in the conventional mutual fund complex today, the aggregate management or advisory fees generated by the funds as a group provide substantially all of the resources expended for the distribution of each fund.
many no-load funds, the absence of a sales charge makes it absolutely essential that a portion of the management fee be used to pay indirectly for marketing costs. For the load funds, fund assets likewise are used to pay indirectly for distribution, by use of management fee revenue to offset losses incurred in distribution activities. The direct allocation of assets by load or no-load funds to pay marketing costs rarely occurs. Whether it is proper under the 1940 Act or rule 14a-9 under the Securities Exchange Act of 1934 to mask appropriations for marketing ventures as part of the management fee payment presents a nice legal question considered later in this article. For present purposes it is enough to note that the practice of using fund assets to pay marketing costs exists and apparently is widespread.

**LEGAL HISTORY OF THE PROBLEM**

The SEC's activism in investment company marketing matters is well documented. Many areas have received close scrutiny, occasionally to the point of absurdity, such as the Commission's decision to dictate the type size and style required in legends in fund tombstone ads. In contrast, the Commission's participation in the con-
trovery explored here has been reluctant and tentative. Surprisingly, the legal implications of the practice escaped close study by the Commission until quite recently.

Until the publication of its landmark 1966 report, entitled Public Policy Implications of Investment Company Growth, the SEC paid only scant attention to the precise problem confronted in this article. The report did not present detailed analysis of the problem, but it did note in passing that it is not uncommon for a fund's resources to be used to promote sales. It also pointed out that a mutual fund managed by E.W. Axe & Co., Inc., bore an effective charge of .13 percent against fund assets in the form of "continuing fee" payments for marketing costs. The fee was payable to Axe Securities Corp., an affiliate of the investment adviser. Although the report expressed no judgment as to the legality of the continuing fee practice, it did explore the closely analogous issue of the propriety of allocating brokerage commissions generated by fund portfolio transactions to stimulate sales. On this point the report echoed earlier Commission criticism of the use of mutual fund reciprocal business and customer-directed give-ups to generate sales rather than to reduce advisory fees paid by the funds.

In the early 1970's the outlines of the present controversy began to take form. In 1971 the Commission's Division of Investment Management granted a no-action request which, in effect, permitted an externally managed no-load fund to bear its own distribution expenses. In February of 1972 the Commission's position crystalized fur-

16, 1975). The amendment was made after it came to the Commission's attention that, among other things, the type-size requirement might discourage the use of small advertisements. The result would be to discriminate against distributors unable to afford large ads.


26. An earlier extensive analysis of mutual fund marketing practices conducted on behalf of the SEC presented only a brief analysis of "the extent to which, if at all, the advisory function of certain firms is subsidizing the underwriting function, or vice versa." See Wharton School of Finance and Commerce, A Study of Mutual Funds, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 31-32, 514-17 (1962).


28. See id. at 93-94.


ther when, in its *Statement on the Future Structure of the Securities Markets*, it opined that mutual fund selling costs should be borne by investors who purchase the fund shares, "and not, even in part, by the existing shareholders of the fund who often receive little or no benefit from the sale of new shares." In April of the same year, the Commission retreated from its *Future Structure* pronouncement when, by granting an application for exemptions from certain provisions of the 1940 Act, it allowed four *load* mutual funds in a complex to pay distribution expenses out of assets. The funds were internally managed, in the sense that, together with an affiliated closed-end fund, they owned all the stock of their investment adviser. One year later, however, the Commission's staff twice took very restrictive interpretative positions with respect to inquiries concerning the propriety of using investment company assets to compensate sales personnel. Both inquiries involved the normal situation of load funds controlled by their external advisers. One of the requests, filed on behalf of the Axe-Houghton funds, involved the distribution scheme which the Commission had noticed and failed to condemn seven years earlier in the *Public Policy Implications* study. In both cases the staff took the position that use of assets to compensate sales personnel would violate the 1940 Act. In 1975, the Commission's Division of Investment Management departed two more times from its hard line approach. In May the staff granted a no-action request permitting three affiliated inter-

34. "Internal management" has been described as
   a rather slippery phrase . . . . [I]t could mean that the fund's portfolio management and maybe all other services for the fund are performed by its own salaried employees. Or it could mean that if there is an external investment adviser, all services other than investment advice are performed by someone else.
   Jones, *Payment of Sales and Promotional Expenses by Mutual Funds*, *Mutual Funds Forum* 9, 18 (June 1977). An example of the first type of internalized management is that of the Broad Street Group discussed in the releases cited in note 32 supra. The investment companies in the Broad Street Group own their adviser and underwriter. An example of the second type of internalized management is the Vanguard Group, discussed in Jones, *Mutual Fund Distribution and the State of Policy*, *Mutual Funds Forum* 1, 2 (Oct. 1977). For cogent argument in favor of allowing funds to internalize all functions other than advisory services, see Proposed Vanguard Statement, supra note 18, at 41-42, 45.
nally managed funds to distribute their shares on a no-load basis. In August of 1975 the staff gave a qualified no-action letter to Armstrong Associates, Inc., an externally managed no-load fund that intended to use a portion of its management fee to pay continuing sales compensation to broker-dealers.

Thus, despite the stern language used in its Future Structure statement, by 1976 the Commission or its staff had considered and not objected to plans involving the use of fund assets to pay for distribution advanced by two different externally managed no-load funds, a complex containing four internally managed load funds, and a group of internally managed no-load funds. However, for the most common type of fund, the externally managed load fund, the teaching of the Future Structure statement was held applicable and controlling.

For purposes of this discussion, it is also pertinent to note that in 1974, the Commission's Division of Investment Management completed a comprehensive report on mutual fund distribution. Although the report made clear that distribution of fund shares was becoming a money-losing proposition for the fund industry, it stated no conclusion about proper sources of payments for marketing costs. Indeed, the propriety of using fund assets to pay for distribution was side-stepped entirely in the text of the report, although a footnote indicated that the issue was under review by the staff.

In 1976, concern over the propriety of using fund assets to pay for distribution intensified substantially. The catalyst for change was a no-action letter given to Mutual Liquid Assets, Inc. by the Commission's Division of Investment Management. On May 14, 1976, Mutual Liquid Assets filed a registration statement seeking to commence operations as a no-load money market fund. The man-

36. SEC Staff No-Action Letter to Pegasus Fund, Inc. (May 21, 1975). The factual setting for the Pegasus no-action request was unique in that the funds had been abused by their former management, and at the time the request was granted a majority of the funds' directors and the special counsel of the funds were court-appointed. This was pointed out in the no-action letter. The factual background concerning the request is described in extensive correspondence included in the public file with the no-action letter.
37. SEC No-Action Letter to Armstrong Associates, Inc. (Aug. 19, 1975) (copy on file with the Loyola Law Journal). The qualifications were that: (1) full disclosure of the plan be made in proxy statements and the fund's prospectus; (2) the advisory fee not be raised; (3) the board, including a majority of the disinterested directors, approve the plan; and (4) the ability of the adviser to fulfill its obligations not be adversely affected by the continuing compensation arrangements.
38. See DISTRIBUTION REPORT, supra note 10.
39. Id. at 20, 30-31.
40. Id. at 10 n.1.
agement fee was set at .5 percent of net assets, the fee customarily charged by investment advisers for other money market funds. In its no-action request the fund announced its intention to "reallocate" one-half of the advisory fee (.25 percent) to dealers selling the fund. This reallocation procedure, like the one involved in the Armstrong Associates no-action letter, constitutes an innovative approach to no-load fund promotion, which traditionally has been built around advertising and direct mail solicitation.

In its request for a no-action letter, Mutual Liquid Assets stated its intention to make prospectus disclosure of the practice to fund shareholders at the time they invested and periodically thereafter. The request also pointed out that, from a cost standpoint, the effect of the proposed practice on fund shareholders would not differ from customary money market fund practice: "We understand that in many instances a substantial percentage of the management fee is allocated to advertising and promotional expenses."

In essence, the Mutual Liquid Assets no-action request presented an opportunity to move the practice of using fund assets for marketing costs out of the closet. The staff's response indicated that if the management of Mutual Liquid Assets had nerve enough to fully and fairly disclose what they planned to do with fund shareholders' money, then the Division of Investment Management had nerve enough to let them. The no-action request was granted with two qualifications. First, the fund was informed that the question of use of fund assets for distribution was still under review by the staff and it was assumed that Mutual Liquid Assets would modify its practices if it was later determined by the staff that the practices did not comport with the 1940 Act. Second, the no-action response was premised on the assumption of full disclosure to the fund's directors of the "uncertain legal status" of the distribution payment scheme.

The staff's no-action letter quickly received the attention of the fund industry. In a letter "on a matter of extreme urgency" that was

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42. Id. at 86,731. The letter noted that an examination of 42 money market funds showed that 28 imposed a flat .5% charge, 4 imposed a fee of .5% with a sliding-scale fee reduction for higher asset levels, 8 imposed a fee of less than .5% and 2 levied a fee of more than .5%. In the fund industry as a whole, the use of sliding-scale reductions is more prevalent than in the money market segment. See text accompanying note 12 supra.


45. Id. at 86,730.
hand-carried to the SEC, the Investment Company Institute's senior vice president and general counsel complained that the staff had made "apparent changes in the ground rules" dealing with payment for fund marketing costs in the absence of a public expression by the Commission through promulgation of a rule or a release. The complaint was not that the no-action letter to Mutual Liquid Assets was inappropriate as a legal matter. Rather, it was that the staff's ad hoc determination was improper because it granted an unfair competitive advantage in the form of a "head start" to the no-action letter recipient. Of course, until publication of the Mutual Liquid Assets no-action letter, SEC action on the question had consisted of nothing but sporadic ad hoc rulings. Indeed, the basic question confronted in the Mutual Liquid Assets letter had been dealt with a year earlier in the staff response to the Armstrong Associates request. The only major difference between the two situations was that Armstrong Associates was an existing fund while Mutual Liquid Assets was a new one.

Industry criticism perhaps contributed to a later Commission directive that the staff not grant a request for acceleration of the Mutual Liquid Assets registration statement. It also may have been a factor in the Commission's decision to convene hearings announced in a release dated October 4, 1976, inquiring into the propriety of arrangements under which mutual funds would bear distribution costs. The stated purpose of the hearings was to assist the Commission in giving guidance to the mutual fund industry on the propriety of using fund assets to finance advertising, dealer compensation, and other distribution expenses. The release defined twenty issues to be probed at the hearings, and it pointedly stated that, "in view of the hearings," the Commission had instructed the staff to withdraw the Mutual Liquid Assets no-action letter. However, the Armstrong Associates no-action letter has still not been withdrawn.

Nearly one year later, long after the end of the 1976 hearings and more than three years after the footnote disclosure that the staff was reviewing whether fund shareholders should bear selling expenses, the Commission issued another release stating that its review of the matters considered at the 1976 hearings was incomplete and that,

46. Letter from David Silver to SEC (June 29, 1976), at 1.
47. Id. at 3.
49. Id.
[a]ccordingly, the Commission has no reason at this time to change its previous position that it is generally improper under the Investment Company Act of 1940 . . . for mutual funds to use their assets, directly or indirectly, to finance the distribution of their shares. Therefore, directors, officers and investment advisers which authorize mutual funds to bear the expenses of distribution will be doing so at their risk.50

Thus, at the present time, there is substantial disorder. According to the Mutual Liquid Assets no-action request and other documentary evidence, the use of fund assets to pay for distribution is widespread,51 even though, according to the SEC, the practice "is generally improper under the Investment Company Act." From the following analysis of various legal and policy arguments concerning the practice, both pro and con, it will be seen that there is a substantial amount of worthless rhetoric on either side of the question, with neither side packing a knockout punch. It will also be seen that a major issue has been ignored by the debaters.

THE DEBATE OVER USE OF ASSETS FOR MARKETING UNDER THE 1940 ACT

If fund directors are not to be permitted to exercise their business judgment in deciding whether to allocate assets to pay for distribution costs, then some provision of the 1940 Act must be found to stand in the way. The SEC has cited numerous provisions as militating against the practice.

Assignment of the Advisory Contract

One SEC argument is that the payment of a portion of a fund’s management fee to sales personnel constitutes an “assignment” of the adviser’s advisory contract under section 15(a),52 thereby requiring, among other things, new approval of the contract by shareholders each time there is a change in sales force personnel.53 The assign-

51. See, e.g., Statement on Behalf of Lionel D. Edie & Co., SEC File No. 4-186, at 5 (Nov. 29, 1976); Statement of Merrill Lynch Asset Management, supra note 43, at 10, 16; Statement on Behalf of the Oppenheimer Group, SEC File No. 4-186, at 7 (Nov. 30, 1976). See also note 18 supra.  
53. If the advisory contract is terminated by an assignment of it, shareholder approval of the new contract is required under § 15(a), 15 U.S.C. § 80a-15(a) (1970).
ment argument was made in a 1973 interpretive letter from the staff. It has not been advocated in public since, with good reason.

Sales Load Theories

1. Section 22(d)

Two slightly less gossamer staff arguments are premised on section 22(d) of the Act. Central to each argument is the proposition that the assessment of charges against assets for marketing costs constitutes the imposition of a sales load under section 2(a)(35) of the Act. According to one interpretation, the use of assets to pay for sales effort results in "hidden sales loads" violative of section 22(d). The second section 22(d) argument is that the practice is illegal since it causes loads to be borne by shareholders in an irrational and discriminatory manner, i.e., based on length of time of shareholder status, in contravention of the section 22(d) requirement that loads not be unfairly discriminatory.

Both of these arguments can be countered. The hidden sales load claim is disposed of if full disclosure of any asset charge for distribution is made in the fund’s prospectus and proxy statements, as in the Armstrong Associates and Mutual Liquid Assets plans. One plausible response to the irrational-discrimination argument is that, assuming marketing expenditures benefit shareholders (and this is the pivotal assumption), then it is rational for people who enjoy the benefits the longest to pay the most. A major weakness of both

57. Id. § 80a-2(a)(35).
58. See Letter from SEC Staff to Hoch Reid, supra note 28, at 4. The usage of disguised loads by investment company sponsors was a matter of concern at the time the 1940 Act was being considered. See SEC, COMPANIES SPONSORING INSTALLMENT INVESTMENT PLANS, H.R. Doc. No. 482, 76th Cong., 2d Sess., at 84-89 (1939); Hearings on H.R. 10065 before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 131-34 (1940).
59. Letter from SEC Staff to Hoch Reid, supra note 35, at 4.
60. The SEC's broad anti-unfair discrimination interpretation of § 22(d) is questioned in
22(d) arguments is that the assumption that distribution charges constitute sales loads under the Act is highly questionable. The statutory definition of "sales load" and its legislative history suggest the contrary. Moreover, it is noteworthy that section 10(d) of the Act refers separately to, and appears to distinguish between, a fund's charging a "sales load" and its incurring "sales or promotion expenses." If the drafters of the Act meant the latter to be co-extensive with the former, the separate treatment in section 10(d) is hard to explain. Section 10(d) has also been cited by the Investment Company Institute in support of its claim that sales and promotional expenses can be borne by funds. According to the Institute, that section, which expressly prohibits a certain type of no-load fund from charging sales loads and bearing "sales or promotion expenses," implicitly recognizes that such expenses may be borne by funds not covered by the section.

2. Rule 22c-1

The idea that asset payments for distribution are "sales loads" is also the foundation for another SEC argument based on the 1940 Act. This argument is that commitments by funds to pay a portion

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Freeman, supra note 23, at 101 n.317, 102-03 n.320, 111 n.340.


"Sales load" means the difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer (or in the case of a unit investment trust, by the depositor or trustee), less any portion of such difference deducted for trustee's or custodian's fees, insurance premiums, issue taxes, or administrative expenses or fees which are not properly chargeable to sales or promotional activities.

At least one reputable law firm formally has expressed its legal opinion that § 2(a)(35) regulates only charges "by the selling broker . . . at the time of purchase." Letter of Sullivan and Worcester to Boards of Directors of Investors Group of Companies (Nov. 5, 1976), at 3 (copy on file with the Loyola Law Journal).

62. See Hearings on S. 3580 Before a Subcomm. of the Senate Banking and Currency Comm., 76th Cong., 3d Sess., pt.2, at 799 (1940) [hereinafter cited as 1940 Senate Hearings], where the load was described by an SEC official as the difference between the "amount paid by the investor and the amount which the investment trust received." In an interpretive letter written by the staff in 1975, it was claimed that neither the Commission nor the staff has ever "taken the position that the payment of [sales and promotional expenses] from fund assets necessarily would constitute a sales load." Letter from SEC Staff to Steadman Security Corp., (May 22, 1975), reprinted in [1973-1976 Transfer Binder] MUT. FUNDS GUIDE (CCH) ¶ 10,201. But see Letter of SEC Staff to Hoch Reid, supra note 35, at 3-4. For recent staff waffling on the issue, see Jones, Payment of Sales and Promotional Expenses by Mutual Funds, MUTUAL FUNDS FORUM 9, 19 (June 1977) ("annual charges against assets for distribution might not be sales loads in a technical sense (that gets into a nice legal question")).


64. Compare id. § 80a-10(d)(3) with id. § 80a-10(d)(5).

of their assets to defray marketing costs lead to violations of rule 22c-1, which requires that fund shares be sold at net asset value. The theory is that the rule's requirement of certainty in the calculation of net asset value is violated where "[n]et asset value at the time of sale is reduced by an undetermined amount representing the [fund's] contingent liability to its underwriter in later years." One difficulty with this analysis is that it proves too much. Taken literally, it suggests that all no-load funds, and any load funds that have real contingent liabilities, are in violation of the 1940 Act. Another shortcoming is that the SEC's own rule defining "net asset value" notes the need to deduct "expenses" in computing net asset value, yet it makes no mention of the need to take so-called "contingent liabilities" into account. Another difficulty with the net asset value argument is the lack of substantive support for the staff's interpretation of rule 22c-1, either in the SEC release promulgating the rule, the sections under which the rule was adopted, or the legislative history of those sections.

3. Section 22(b)

The SEC is on somewhat firmer ground when it makes the argument that charges against assets to pay for distribution can lead to excessive sales loads in violation of section 22(b). Congress has indeed manifested an intent that "excessive" sales charges be pro-

67. Letter from SEC Staff to Hoch Reid, supra note 35, at 4.
70. Rule 22c-1 was adopted under subsections 22(a) and 22(c) of the 1940 Act, 15 U.S.C. §§ 80a-22(a), 22(c) (1970). Those sections vest the SEC and the NASD with broad rulemaking authority, but they do not contain any substantive prohibitions, and they relate only to the pricing of shares at the time of sale.
71. The chief wrong that §§ 22(a) and (c) were intended to redress was dilution of shareholders' investment value caused by the "two price system" that used to apply to sales of fund shares. See United States v. NASD, Inc., 422 U.S. 694, 707-10 (1975); Survey, supra note 9, at 790-92, 804-05.

Use of Fund Assets

hibited, and section 47(a) of the Act prohibits devices that accomplish indirectly that which cannot be done directly. Assuming, again, that asset charges for distribution are sales loads for purposes of the Act, then the 22(b) argument poses a real problem, particularly in light of an Illinois appellate court case, *Group Securities, Inc. v. Carpentier,* which upheld the Illinois Secretary of State's position that a load fund's payment of a continuing service fee to dealers violated the sales load ceiling of the state's securities act. However, the precedential value of the *Carpentier* case was recently eroded when the Illinois Secretary of State approved the Mutual Liquid Assets continuing fee scheme. Further, the 22(b) argument is weakened by the fact that no-loads have always at least indirectly charged assets for selling expenses, but this has never prevented them from advertising themselves as no-loads.

**Fund Industry Arguments under the 1940 Act**

1. **Section 12(b)**

An argument in favor of allowing assets to be used for marketing effort revolves around section 12(b) of the 1940 Act. The language of that section provides that a fund may serve as a distributor of shares it issues and, obviously, incur costs in conjunction with that activity unless and until the Commission prohibits such conduct by rule or regulation. No such prohibitory rules or regulations have ever been issued. Furthermore, in the course of House hearings prior to approval of the 1940 Act, section 12(b) was described as protecting mutual funds "against excessive sales, promotion expenses, and so forth." As with the Investment Company Institute's section 10(d) argument, it may be claimed that, by negative implication, reasonable selling costs may properly be charged against fund assets.

77. Moreover, in the case of the Broad Street Group, the SEC specifically authorized load funds to charge assets for distribution costs. See note 32 supra and accompanying text.
80. See note 65 supra and accompanying text.
2. Section 12(d)(3)

Another argument in favor of allowing assets to be used to pay for marketing costs is built around section 12(d)(3) of the 1940 Act. That provision makes it unlawful for a fund, inter alia, to own stock in an underwriter unless the underwriter's stock is owned entirely by one or more funds and unless the underwriter is "primarily engaged" in the business of underwriting or selling securities. This section thus implies that a fund's assets may be used to participate in the ownership of an underwriter which markets the fund's shares. It would seem that if it is legal for a fund to control marketing effort by controlling its underwriter via stock ownership, it likewise should be legal for a fund to be its own underwriter and pay marketing costs directly out of assets.  

THE REAL ISSUES: INDEPENDENCE, FULL DISCLOSURE AND DUE CARE

Background

None of the foregoing arguments premised on the 1940 Act is sufficiently compelling to terminate debate. Presumably, if the SEC staff truly believed that its arguments were dispositive, it never would have granted the Armstrong Associates and Mutual Liquid Assets no-action letters. The arguments on the industry's side of the fence are premised largely on innuendo and a snippet or two of legislative history. Such arguments are better than none at all, but not by much.

What really appears to bother the staff and the Commission is the prospect of abuse of fund shareholders if the Commission were to give advisers carte blanche to dip into assets to stimulate sales. As

82. For a no-action letter authorizing a fund to serve as its own underwriter, see SEC No-Action Letter to First Safe Fund (Dec. 8, 1971) [1969-1973 Transfer Binder] MUT. FUNDS GUIDE (CCH) ¶ 9376.
83. It is germane to note that in an amicus brief filed in 1976 in connection with a brokerage recapture case, the Commission admitted:  
There is no specific provision in the [1940] Act . . . that would explicitly remove the decision on recapture from the discretion of the board of directors. While this factor is not dispositive, it does indicate that Congress did not believe that the potential for abuse in this type of decision was sufficient to warrant statutory removal of the matter from the board of directors' discretion.  
84. The situation has been correctly stated by one industry member as follows:  
Much of the problem involved in determining the extent to which fund assets
noted earlier, new sales automatically benefit the adviser if the advisory fee is based on assets, as most are. Much less clear is the nature and extent of any advantages flowing to existing fund shareholders whose money is risked in the marketing campaign. To be sure, there are checks on director and investment adviser overreaching in sections 15 and 36 of the 1940 Act. Simply put, the Commission does not trust the system to prevent this form of abuse. Section 15 provides for review of underwriting and advisory contracts by disinterested directors and fund shareholders. Neither group has been viewed by the Commission as providing an especially effective check on adviser overreaching. Section 36(a) authorizes SEC suits in cases involving breaches of fiduciary duty may be used for distribution purposes derives from the fact that the Act does not contain express comprehensive provisions which specify what constitutes proper fees or expenses for investment companies. While the staff has cited a number of provisions in the Act as being applicable, most of the opposition to distribution fees or expenses has been based upon the general fiduciary standards embodied in the Act.

Mr. Mostoff [then Director of the Division of Investment Management] in his letter with respect to the Lionel D. Edie Ready Assets Trust distribution fee stated:

Investment companies are, by and large, merely pools of money to which many individuals have contributed so that their individual participations may be invested in securities or held for investment, in common and under a common management. Any use of an investment company's assets for purposes not necessary to that function may, therefore, be impermissible. In this connection, our concern focuses on the trustee's duty of loyalty, that is, his obligation to act solely in the interests of the beneficiaries of the trust. Were fund assets to be used as you proposed, it is difficult to see how this obligation could be satisfied in view of the benefit that would be afforded the investment adviser from the arrangement.

The other sections in the Act cited by the Commission in objecting to distribution expenditures have largely been speculative secondary arguments and are not absolute impediments against the use of fund assets for distribution purposes. Statement of Merrill Lynch Asset Management, Inc., supra note 43, at 6-7.

The staff apparently is no longer adhering to the questionable premise, stated in the quotation above, that the common law of trusts defines the scope of an investment adviser's fiduciary duty to fund shareholders. See Jones, supra note 62, at 18.

The legislative history of the 1940 Act suggests that the drafters did not intend for investment company managers to be held to the standard applicable to a trustee. See 1940 Senate Hearings, supra note 62, at 262 (testimony of David Schenker). See also Brown v. Bullock, 194 F. Supp. 207, 241 (S.D.N.Y.), aff'd, 294 F.2d 415 (2d Cir. 1961). There is no evidence that the drafters of the 1970 amendments to the 1940 Act meant to establish trusteeship as the standard for measuring an adviser's fiduciary duty.

86. Id. § 80a-35.
“involving personal misconduct” by fund officers, directors, advisers or underwriters, and section 36(b) provides a cause of action that can be asserted by the Commission or by a mistreated mutual fund (directly or derivatively) to recover payments made where the recipient has breached its fiduciary duty to the fund with respect to such payments.\textsuperscript{88}

If the staff viewed sections 15 and 36 as effective deterrents to overreaching in the area under consideration, then presumably it would not have been so quick to advance some of the flimsy claims in favor of absolute prohibition that were reviewed earlier. On the other hand, one suspects that if the industry were confident of its ability to defend section 36 actions successfully, there would be much greater overt use of fund assets to finance marketing of fund shares than now exists.

\textit{Tannenbaum and Business Judgment}

Obviously, fund managements overwhelmingly endorse the view that the use of fund assets to aid distribution is legal, and that its legality should be officially declared in an SEC rule or interpretive release. Three arguments supporting the fund industry’s position were noted earlier,\textsuperscript{89} but from a qualitative standpoint, they are not nearly as strong as the basic claim that fund directors do not necessarily breach their fiduciary duty by agreeing to pay marketing costs from assets. The heart of this claim is the premise that use of assets to assist distribution is to be decided by the fund’s disinterested directors (those who are not affiliated with the adviser) in the exercise of their business judgment and after full disclosure to them of all material facts. This business judgment argument stems from the Second Circuit’s recent decision in \textit{Tannenbaum v. Zeller}.\textsuperscript{90} The case involved, in part, the question whether a fund’s directors acted properly in deciding to forego recapture of brokerage commissions where the commissions were allocated in part to stimulate sales of fund shares. In \textit{Tannenbaum} the SEC as amicus took the position that the adviser and the defendant interested director did not vio-

\begin{footnotes}

\footnote{89. \textit{See} text accompanying notes 65, 80 & 82 \textit{supra}.

\footnote{90. 552 F.2d 402 (2d Cir.), \textit{cert. denied}, 98 S. Ct. 421 (1977).}}
late their fiduciary duty to the fund if the decision was approved by the fund's disinterested directors and if the disinterested directors:

"(1) were not dominated or unduly influenced by the investment adviser; (2) were fully informed [of all material facts]; and (3) fully aware [of all material facts] reached a reasonable business decision . . . after a thorough review of all relevant factors."91 The appellate court adopted the test, found each prong to be satisfied, and upheld the lower court's ruling92 that fiduciary duty had not been breached. The appellate court, however, did find a violation of rule 14a-9 arising from a failure to make full disclosure of the recapture opportunity in proxy statements sent to shareholders.93

The Independence Requirement

While Tannenbaum undeniably lends credence to the industry's argument that the use of assets for distribution is fundamentally a business judgment matter, it by no means guarantees that the practice will withstand a challenge. For one thing, the independence of disinterested fund directors has long been the subject of derision,94 and one senior SEC official recently charged that even today "a lot of" legally disinterested directors are in fact dominated by the investment adviser.95 This is a serious allegation since disinterested directors are supposed to serve a watchdog function for the protection of the fund's shareholders.96

91. Id. at 418-19 & n.24.
94. See Survey, supra note 9, at 906-07, 915-16; Hills Address, note 87 supra; Brief of the SEC as Amicus Curiae, supra note 83, at 37. "Our experience is that rarely are the independent directors truly independent of domination by the adviser." In a footnote, the SEC's brief offered this opinion: "Our experience with respect to the question of actual independence of directors leads us to suggest that the burden of demonstrating independence of action be a heavy and convincing one on the defendant." Id. at 37 n.47. See also Lasker v. Burks, [Current Volume] Fed. Sec. L. REP. (CCH) ¶ 96, 282 (2d Cir. Jan. 11, 1978) (holding that, as a matter of law, disinterested mutual fund directors lack authority to terminate a non-frivolous derivative suit attacking the conduct of the fund's interested directors and investment adviser).
95. Jones, supra note 62, at 18.
96. 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 Management 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.

The matter of domination obviously is a factual question. One factor a court might want to consider is whether the disinterested directors were nominated by the directors affiliated with the adviser. \(^7\) A demonstrable history of directorial independence of the adviser would also be relevant, as would proof of consultation by the disinterested directors with independent experts, including independent counsel, prior to reaching a decision. \(^8\) The need for retention of outside experts would be especially great where the outside directors are not sophisticated in business or investment matters. \(^9\)

Evaluation and decision-making by the disinterested directors out

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In Tannenbaum, one firm represented all sides to the bargaining. The SEC's amicus brief pronounced the Commission "troubled" by counsel's dual representation. Brief of the SEC as Amicus Curiae, supra note 83, at 42 n.52. But fortunately for counsel, the appellate court was able to find that "counsel correctly advised the independent directors as to the applicable law and the necessity for reaching a reasonable business judgment . . . ." Tannenbaum v. Zeller, 559 F.2d 402, 428 (2d Cir.), cert. denied, 98 S. Ct. 421 (1977). Former SEC Chairman Hills summarized the Commission's position on the subject of independence thus: "Unquestionably, the outside directors should be urged to engage separate counsel for the fund, at least for some matters." Hills Address, supra note 87, at 13,719.

Independent legal advice is not the only type of outside expertise that may be useful to the independent directors. A recent application to the SEC by Investors Diversified Services, Inc. mentions in a footnote that the disinterested directors of IDS's funds retained the management consulting firm of Booz-Allen & Hamilton, Inc. to review a plan designed to restructure the system used to market the funds' shares. See Amendment No. 1 to SEC Application of Investors Diversified Services, Inc., Pursuant to Section 17(d) of the Investment Company Act of 1940, at 32 (Sept. 12, 1977). See also Goldberg, supra note 87, at 585.


In approving the contract the unaffiliated directors acted wholly independently of the affiliated directors and at meetings not attended by the latter. Each unaffiliated director was a man of maturity, experience in the world of finance or commerce, reputation extending beyond provincial limits, vigorous mind, and strength of character. None of them was subservient to [the adviser's personnel] or anyone else connected with this case.


See Goldberg, supra note 87, at 583-84 for further discussion of sophistication as a criterion for independence on the part of mutual fund directors. For argument that sophistication is relevant when analyzing potential liability of directors under the securities laws, see Address of A.A. Sommer, Jr., entitled Directors and the Federal Securities Laws, reprinted in [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) \(\$\) 79,669, at 83,801, 83,805-06.
of the presence of the interested directors is also a relevant factor.\(^{100}\) Another would be the extent of services rendered by the adviser to the fund. As noted earlier, fund advisers historically have rendered a broad array of operational services to their funds.\(^{101}\) The practical independence of a fund’s directors may indeed be doubted if, from an operational standpoint, the adviser “does everything for a fund but comb its hair in the morning.”\(^{102}\)

**The Full Disclosure Requirement**

*Tannenbaum*’s full disclosure prerequisite is likewise a question of fact. The adviser and interested directors clearly have the responsibility for identifying and quantifying the economic and practical pros and cons of a proposal they put forward for approval.\(^{103}\) There is good reason for them to be completely truthful, since there is no shortage of case law holding that concealment of material facts from disinterested directors by the fund’s adviser and its interested directors constitutes a breach of fiduciary duty actionable under the 1940 Act.\(^{104}\) Nondisclosure to shareholders is actionable under rule 14a-9, as *Tannenbaum* itself illustrates.

**The Due Care Requirement**

In the context of the present problem, the third prong of the *Tannenbaum* test presents the biggest hurdle for the fund industry. Wanting use of fund assets to pay marketing costs to be legal is one thing; it is another thing to be able to formulate defensible business

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101. See note 11 supra and accompanying text.
103. The mandate of the 1940 Act was articulated by the Second Circuit in *Fogel v. Chestnutt*, 533 F.2d 731, 749-50 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976):

The minimum requirement to enable the Fund’s independent directors to discharge these duties with respect to recapture was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons.

arguments why the practice is proper. People who buy mutual fund shares are not philanthropists, they are investors. It is sensible to argue that their money should be committed by the managers only to those endeavors that are reasonably likely to yield positive investment returns. Further, from a legal standpoint, prior to approving a scheme involving use of assets to pay for distribution, the parties in the conflict of interest position should have the burden of identifying and quantifying the gains expected to be realized by existing shareholders by risking fund assets on marketing endeavors. This data must be evaluated by disinterested directors who must then independently find, in essence, that the expenditure of assets promises to yield significant tangible benefits to fund shareholders. Assuming the scheme involved substantial modification of an advisory contract, implementation would require shareholder approval after full disclosure. Obviously, implementation of any subsidization program would require constant monitoring by the disinterested directors to assure that adequate tangible benefits are being realized by existing investors.

Many business arguments have been advanced in support of the idea that fund shareholders benefit from new sales. One argument is that increased sales can lead to increased size, with resultant


106. A former Director of the Commission’s Division of Investment Management had this to say about the exercise of due care in director decision-making:

With regard to whether shareholders benefit from increased sales of shares, I'm not sure we can say much more than that it is a question of judgment, that the answer might vary from fund to fund and from time to time, and that it is up to each fund's directors to figure out the answer in a particular case.

Of course, leaving this decision up to the directors puts a tremendous burden on them. If they come up with the wrong answer, they could be very sorry. If I were a fund director in this situation, there are two things I would do. First, I would worry a lot. Second, when the advisor came to me with a recommendation that the fund bear distribution expenses, I would ask him for enough justification and supporting data to choke a horse.

I would study it all, and then send him back for more. This burden on directors might not be entirely fair, but it might help ensure that in deciding whether a fund should pay for distribution, the disinterested directors will also be independent directors.

Jones, supra note 62, at 19.


108. The value and importance of periodic review by a fund board is discussed in Lipton, supra note 103, at 1261.
Use of Fund Assets

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The main deficiency with this claim is that even if economies were certain to result, expansion still would not be justifiable unless there was a reasonable likelihood that the savings realized would more than offset the cost of capital used to achieve them. Another line of argument is based on the idea that fund shareholders will benefit from new sales because an inflow of cash into a fund assists portfolio management, making it easier to achieve good investment performance. Similarly, it is argued that growth helps fund management attract and keep good people who supposedly will yield superior performance. There are three major weaknesses with the claim that a net cash inflow benefits fund shareholders. First, the premise has no empirical support. Funds with net cash inflows have not been shown to out-perform closed-end funds or funds experiencing net redemptions. Second, the premise is logically deficient. No fund can expect to have net sales forever. At some point growth must level off. Third, it has been asserted that growth and prosperity in the fund industry is a function of superior investment performance and effective shareholder service. If this is so, fund managements already have it within their power to grow without dipping further into shareholders’ pockets.

Another industry argument for use of assets for distribution costs is that payments for distribution are a necessary part of fund owner-

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111. Statement of the Vanguard Group, supra note 10, at 10; Statement of Waddell & Reed, Inc., supra note 55, at 10.

112. See Jones, supra note 62, at 18-19.


114. See Freeman, supra note 23, at 104 n.321. Regarding the consequences of issuing a redeemable security, the Department of Justice has argued that there is nothing sacrosanct about preventing redemptions from exceeding sales. The guaranteed redemption feature of mutual funds is a strong selling point and funds should be willing to accept the burdens of this feature as well as the benefits. If enough investors do not have sufficient confidence in a fund to retain their shares they should redeem them, even if this forces the fund to liquidate some of its portfolio. This is entirely consistent with the economic policy of free competition and it is unlikely to produce market chaos. The argument that such liquidation always would hurt the remaining shareholders is plainly unsound since that effect depends on whether the stocks liquidated subsequently performed better or worse than the remainder of the fund’s portfolio.

Statement of the United States Department of Justice, SEC File No. 4-164, at 18 (Feb. 2, 1973).

115. E.g., Statement of the Putnam Companies, SEC File No. 4-172, at 5 (Aug. 21, 1974).
ship, because the redeemable nature of fund shares means that a
fund which does not continuously distribute eventually will be re-
demed out of business.\textsuperscript{116} This argument is persuasive as to the no-
load segment of the industry, where assets are the only source of 
funds for marketing. It has less force with respect to the load funds.
The sales load ceiling in section 22(b) of the Act presents a serious 
problem, and it would seem that, in the absence of prospectus dis-
losure at the time of investment, shareholders of such funds legiti-
mately can argue they were led to believe they paid a one-time tax 
for marketing costs when they bought their load fund shares.\textsuperscript{117} 
Moreover, if direct appropriation of assets to pay marketing costs 
is essential to the viability of the load fund segment of the industry, 
how did the load funds grow to over $40 billion without engaging in 
the practice?

Another possible justification for using assets to pay for market-
ing has been overlooked by proponents of the practice. This argu-
ment starts with the premise that fund shareholders, “like purchas-
ers of homes, automobiles, and major appliances,”\textsuperscript{118} experience 
post-purchase anxiety. Negative post-purchase feelings, which may 
be based on adverse publicity, may prompt a fund purchaser to seek 
to return the product by redeeming.\textsuperscript{119} This would be a foolish deci-

\textsuperscript{116} E.g., Statement of the Investment Company Institute, \textit{supra} note 5, at 15; Statement 
of Merrill Lynch Asset Management, Inc., \textit{supra} note 43, at 4. The Justice Department 
certainly sees no reason why liquidation should be prevented. See note 114 \textit{supra}.

\textsuperscript{117} There are, of course, various ways assets of a fund could be used to pay distribution 
costs. One way would be for continuing compensation payments to be made to fund dealers. 
This was the approach used for years by one of the Axe-Houghton load funds. See text 
accompanying notes 28, 35 \textit{supra}. It was also the approach advanced by Armstrong Associates 
and Mutual Liquid Assets in their no-action requests. A solid analysis of the problems posed 
by continuing compensation fees is presented in Statement of Waddell & Reed, Inc., \textit{supra} 
note 55, at 7-9. At the Distribution Hearings, the Investment Company Institute’s spokesman 
did not argue forcefully that continuing compensation arrangements were permissible under 
the 1940 Act. See \textit{Official Transcript of Proceedings} 28 (testimony of David Silver). Another 
party to the proceedings took the position that existing funds could lawfully impose a continu-
ing compensation charge against assets as to all shareholders, not just new ones, and that 
failure to treat all shareholders the same could result in a violation of § 18(f), 15 U.S.C. § 
80a-18(f) (1970) (which outlaws issuance of “any class of senior security”). Merrill Lynch 
Asset Management, Inc., \textit{supra} note 43, at 21. Still another party to the proceedings argued, 
along the lines of the text, that “[i]t is difficult to justify charging the shareholders of 
existing funds for costs which they believed were covered by the sales charge they paid when 
they bought their shares.” Statement of Keystone Custodian Funds, Inc., SEC File No. 4-
186, at 8 (Dec. 1, 1976). For a description of proposed corporate action submitted for SEC 
approval, which aims to saddle fund shareholders with a continuing charge, see \textit{Application 
of Investors Diversified Services, Inc., \textit{supra} note 98. The effect of the proposal on existing 
load fund shareholders is discussed in \textit{id. at} 33-35.

\textsuperscript{118} F. \textsc{Kotler}, \textsc{Marketing Management} 135 (2d ed. 1972).

\textsuperscript{119} A discussion of post-purchase anxiety, or “cognitive dissonance,” in the context of 
mutual fund and life insurance marketing is presented in \textsc{Freeman, \textit{supra} note 23, at 54-56, 
91 & n.281.
sion if the investor ends up with a less suitable product than what he or she began with. Thus, it might be defensible for fund directors to commit a portion of assets to fund or trade association-sponsored promotional campaigns aimed at keeping fund investors from making imprudent switches of their investments. As a popular marketing text states:

The existence of possible negative post-purchase feelings indicates that the marketer might profit from directing some of his communications to the recent buyer . . . . The recent buyer may need assurance that he has made the right choice. If he is in a dissonant state, he will be looking for supportive evidence in the form of advertising and other communications. The marketer may take the opportunity of building assurances into the information brochures that accompany his product. [Marketers] also can run advertisements showing recent purchasers showing satisfaction with their choice and why. Unless the seller dispels the dissonance by some positive efforts, he may lose the customer unnecessarily. 120

A case can be made for some use of fund assets to finance promotional schemes aimed at bolstering the confidence of fund shareholders in the product they have bought. This might forestall unsuitable switches by some shareholders. The promotional effort may also generate new sales to fund investors and others. In fact, fund shareholders themselves comprise a very attractive target market for new sales. 121 Assuming the promotional effort is truly intended to function as a shareholder service and that suitability requirements are met, the fact that new sales result would not seem objectionable.

It should be noted that two questionable premises support use of assets to pay for promotional efforts directed toward existing shareholders. First, it is by no means certain that the number of share-

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120. P. Kotler, supra note 118, at 135.
121. Consider this admission by Investors Diversified Services, Inc., concerning the mutual funds in its complex: "In recent years approximately 80 percent of the dollar amount of Fund sales (excluding reinvested dividends) have been made to existing Fund shareholders. Such shareholders constitute approximately 10 percent of the total number of shareholder accounts." Application of Investors Diversified Services, supra note 98, at 34. The full magnitude of IDS's reliance on sales to its own shareholders is seen by considering that total sales in 1976 were $209,000,000 (excluding reinvested dividends and underwriter fees and including amounts invested for continental plans). Reinvested dividends generated a cash inflow for shares of $167,000,000. The total inflow for 1976 was thus approximately $376,000,000, of which approximately $334,000,000 ($167,000,000 + 80% x $209,000,000) or 89%, was generated by IDS funds' shareholders. See id. at 26. The Vanguard group reports that in 1976 approximately 50% of fund sales, excluding dividend reinvestments, were to existing shareholders. See SEC Investment Company Act Release No. 9850 (July 15, 1977), at 3.
holders who stand to be benefited by dissonance reduction can be known or reasonably estimated. Second, a board can by no means be certain that dispelling shareholder dissonance will result in a net gain to shareholders. If the expenditure causes nonredemption by shareholders who otherwise would have redeemed and earned a better return elsewhere, the payment for anxiety-reducing ads would amount to money spent on a shareholder disservice.

Summary

The best argument in favor of allowing the use of fund assets to pay marketing costs is that the SEC really cannot prove the practice is automatically illegal under the 1940 Act. Indeed, the Commission was willing to agree that the use of recapturable brokerage commissions to generate sales was valid in Tannenbaum. It is not a big jump from that position to allowing the direct use of assets to pay marketing costs. The industry can well argue that the business judgment of a fund's disinterested directors, not the iron will of a regulatory agency, should control the issue of how the fund's assets are allocated. Tannenbaum certainly lends support to this view, but it only opens the door. The business judgment of the disinterested directors deserves to be sustained only if it is reasonably exercised after full disclosure. To date, no hard evidence has been adduced to show that the allocation of assets to pay for distribution of load funds is really cost-effective or a prudent use of existing shareholders' money. On the other hand, it deserves mention that the court in Tannenbaum apparently did rely on the dubious economies of scale and performance arguments to support its decision to uphold the reasonableness of the practice.2 Fund directors and attorneys

122. See Tannenbaum v. Zeller, 552 F.2d 402, 428 (2d Cir.), cert. denied, 98 S. Ct. 421 (1977). In its amicus brief the Commission took the position that the question of reasonableness on the part of the board was a close one. The SEC judged “persuasive” the argument that, “in view of the competitive consideration arising from the virtually universal use in the industry of excess commissions to pay for sales,” the directors acted prudently in deciding that increased sales would be beneficial to the fund's shareholders. Brief of SEC as Amicus Curiae, supra note 83, at 52.

123. See Tannenbaum v. Zeller, 552 F.2d 402, 427-28 (2d Cir.), cert. denied, 98 S. Ct. 421 (1977). Furthermore, it may be noted that the SEC itself has recognized the possibility that increased size can benefit a fund. See PUBLIC POLICY REPORT, supra note 15, at 180:

[U]nder present industry compensation patterns increases in fund size result in increased advisory compensation. The funds and their shareholders, however, benefit only to the extent that fund growth reduces advisory fees and other operating costs or enables fund managers to build a stronger advisory organization. To the shareholders of some small funds these benefits could be substantial; to shareholders of larger funds and to the shareholders of those smaller funds which belong to large complexes, they may be less significant.
should anticipate that business judgment evidence will be more closely analyzed in future cases.

The SEC's chief worry to date has been the conflict of interest posed by the coupling of external management with advisory fees based on a percentage of total assets. The staff has indicated that it may be more willing to approve schemes using assets for marketing costs where the affected funds have a complete internalization of management or where the external adviser is compensated either on a fixed sum basis or on performance. While the Commission's concern over the conflict of interest problem is easy to understand, it is not easy to see why directors of externally managed funds having percentage-of-assets advisory fees should be viewed as incompetent to decide whether their funds will bear marketing costs. After all, they clearly are competent to decide—in their business judgment—whether to approve a direct rate hike for the adviser, or whether to change to a more expensive adviser. And it is by no means uncommon for a fund to agree to an increase in its advisory fee; in fact, since 1972, no fewer than ninety-one mutual funds have done so.

The SEC's proposed requirement of internalized management, a performance fee, or a fixed fee may purify the decision-making process from a conflict of interest standpoint, but these supposed safeguards do not immunize a board's decision from attack on due care grounds. No matter how disinterested the board is, its action is defensible only if the perceived benefits are carefully identified, quantified, and evaluated in advance of approval. If implemented, the marketing program must be carefully monitored, and if net gains for shareholders fail to materialize, the practice must cease.

**The Hidden Issue: Ongoing Nondisclosure**

It was noted earlier that the use of assets to pay fund marketing costs is a matter of everyday life in the fund industry. Both the industry and the SEC know it. The SEC generally has been willing to look the other way, rationalizing that marketing costs are paid not out of shareholders' savings but out of “advisers' profits.”

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125. See Proposed Vanguard Statement, supra note 18, at 4 & Exhibit II-1.
126. *E.g.*, Statement of Merrill Lynch Asset Management, Inc., supra note 43, at 11, quoting a former director of the SEC's Division of Investment Management as follows: [W]e see a real distinction between a fund paying for sales activities directly from its net assets and paying an investment adviser a fee for investment advice and management services, where the adviser may use part of that fee to pay for distribu-
When fund sales were booming in the 1950's and 1960's, there was no great concern over the practice, for the good reason that marketing activity on behalf of funds generally was profitable, or at least not very unprofitable.

The fund industry has claimed persistently that the SEC should revise its traditional position because the circumstances of the industry have changed, i.e., fund shares are harder to sell, costs are up, and losses on marketing activity are devouring advisers' profit margins. The SEC staff's 1974 report on mutual fund distribution described instances of increased reliance on advisory revenues to support marketing effort, and more recent written admissions are on file at the SEC. What the 1974 report failed to focus on, and what the SEC to date has ignored, are questions such as: When does this allocation of advisers' profits become so material as to require disclosure under section 15 of the 1940 Act and rule 14a-9 of the 1934 Act? When subsidization of marketing effort consumes twenty percent of the management fee? Thirty percent? Fifty percent? Ninety percent? Never? Is it not possible for the same entity to provide a fund with both excellent investment advice and profligate marketing programs? How can the directors ascertain whether the fund is obtaining fair value in each area unless costs are broken down and analyzed in detail? How can a board weigh the advisability of switching distributors, or of internalizing distribution, or of discontinuing marketing of new shares, unless it knows the extent to which marketing is a drain on assets? What are the consequences of non-disclosure of the use of a material portion of the management fee to subsidize distribution costs?

In Tannenbaum, the Second Circuit accepted that the adviser and the defendant affiliated director "were under a duty of full disclosure ... to these unaffiliated directors in every area where there was even a possible conflict of interest between their interests and the interests of the fund." Whenever fund assets are claimed...
by the adviser, there is an inherent conflict of interest and, under Tannenbaum, a duty of full disclosure as to how those assets are to be used. Full disclosure to shareholders is necessary when a contract is modified to allow payments of assets to finance marketing effort. This duty of full disclosure for the benefit of fund shareholders is mentioned in the preamble of the 1940 Act, which declares "that the national public interest and the interest of investors are adversely affected—(1) when investors . . . vote . . . securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning . . . the circumstances, policies, and financial responsibility of such companies and their management . . . ." Furthermore, the full disclosure requirements of the 1934 Act cannot be ignored. As noted earlier, Tannenbaum itself upheld a rule 14a-9 claim based on nondisclosure of material facts.

A case can be made that the use of assets to subsidize marketing effort in the fund industry presents an example of "creeping materiality," whereby increasing indulgence in an initially insignificant practice eventually leads to conduct that must be disclosed. In

( quoting from Moses v. Burgin, 445 F.2d 369, 376 (1st Cir.), cert. denied, 404 U.S. 994 (1971)).


133. An omitted material fact is defined as material for purposes of rule 14a-9 litigation in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976):

if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . . Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

Another way of looking at the ambit of the duty to give information is presented in the Restatement (Second) of Agency:

Unless otherwise agreed, an agent is subject to a duty to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have and which can be communicated without violating a superior duty to a third person.

Restatement (Second) of Agency § 381 (1958).

It has been suggested that a fund board called on to approve an advisory contract would want to focus on such things as: "the actual amount of all compensation paid to the advisor; the expenses incurred by the advisor attributable to the fund and the general profitability to the advisor of its services to the fund . . . ." Lipton, supra note 103, at 1261-62. This suggests that the fact and extent of distribution losses paid for by the advisor out of its fee are well worth the attention of the independent directors. Similarly, former SEC Chairman Hills implicitly recognized the need for furnishing detailed financial disclosure to the independent directors when he said: "In the course of reviewing the advisory and underwriting arrangements, the directors surely must consider whether there are viable alternatives—including 'internalizing' the management of the fund . . . ." Hills Address, supra note 87, at 13,720.
herent in the Mutual Liquid Assets no-action request was the affirm-
original that the fund was able to charge the customary advisory fee,
render competent investment advice for a profit, and still give up
half of its management fee to pay for marketing costs. The applica-
tion implied that other such funds were doing the same thing, with-
out being as candid about it. If the implication is true, then the SEC
would do well to stop using its "advisory profits" euphemism when
it is referring to surreptitious siphoning of assets to pay marketing
costs. At one time this diversion may have been insignificant, and
the euphemism apt, but the times have changed, and a formerly
insignificant practice seems to have taken on major importance. If
so, fund advisers who fail to disclose their use of substantial sums
of assets to pay marketing costs are running a serious risk of liability
under section 36 of the 1940 Act and rule 14a-9 of the 1934 Act. The SEC
would do well to make this clear to the fund industry.

CONCLUSION

It has been claimed that the SEC has authority under the 1940
Act "to permit, prohibit or limit the use of mutual fund assets to
pay distribution expenses." Like a number of the claims made in
the course of the debate discussed herein, this one is hyperbole, at
least to the extent it insinuates that the Commission has authority
under the 1940 Act automatically to bar any internally managed no-
load fund from distributing its own shares and bearing reasonable
costs in connection with that activity.

See also Note, Duties of the Independent Director in Open-End Mutual Funds, 70 MiCh. L.
Rev. 696 (1972) (positing different duties to be discharged by disinterested directors, includ-
ing the "duty to review regularly the feasibility of internalizing fund management").
134. At least one member of the mutual fund industry seems to recognize this fact:
Because the use of fund assets for distribution purposes directly or indirectly
raises questions with respect to the fiduciary standards in the Act and because such
expenditures indirectly benefit the investment adviser to the extent new sales are
created, full disclosure of any such arrangement should be required in both the
annual proxy material and the currently effective prospectus of the fund. A failure
to make full disclosure of policies in this area may constitute a fraudulent practice.
136. There is not the slightest trace of evidence that the drafters of the 1940 Act meant
to discourage the operation of such a fund. Indeed, the indications are the other way. See
1940 Senate Hearings, supra note 62, at 235 (testimony of David Schenker) (observing that
self-distribution of shares by a fund may be a "model situation"). Consider the force of this
defense of internalization of distribution:
In the mutual fund industry today . . . the advisory and management fees paid
by mutual funds are the source for the payment of distribution costs. If it is illegal
for these costs to be "unbundled" and charged directly to the fund . . . it follows
as a matter of elementary logic that a mutual fund is required to retain an external
adviser. For if distribution is essential, and if it cannot be financed directly and
The mutual fund industry is a marketing industry. Control over marketing decisions rests primarily with the board of directors of each fund. The major SEC concern is that many fund boards are too incompetent, or corrupt, or corruptible to make decisions that other boards of directors may properly make. If the goblins the SEC sees are real, one wonders why the SEC's enforcement machinery is not humming and why the SEC has no legislative proposals pending before Congress to upgrade the quality of fund boards. The truth is that the 1940 Act vests the SEC with far-reaching regulatory and enforcement power, and the SEC has been the dominant force on the fund scene for nearly forty years. If fund managements generally are not competent or trustworthy today, then why does the SEC tolerate the status quo? In truth, in the debate considered here, the SEC's lack of candor and its vacillation set a poor example for any group having a leadership role.

If it believes that fund managements generally are competent and trustworthy, the SEC should make it plain that the sensible three-prong approach of Tannenbaum is the pertinent test with respect to use of fund assets to pay marketing costs. Whether the Commission decides to go the Tannenbaum route or to continue its past practice of selectively authorizing certain funds to charge assets directly for distribution costs, it would do well to enunciate in a release the factors independent directors should consider when deciding whether to implement or continue a marketing program financed by fund assets. In light of past pronouncements by Commission personnel and recent case law, it may be expected that anyone willing to serve as a disinterested director for a mutual fund will be anxious to have all the guidance the SEC can furnish.


137. Case law from the Second Circuit supports the proposition that mutual fund directors are not competent to take at least one type of action that directors of industrial corporations properly may take, i.e., terminating a non-frivolous derivative suit. Compare Lasker v. Burks, [Current Volume] FED. SEC. L. REP. (CCH) ¶ 96,282 (2d Cir. Jan. 11, 1978) with Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976).
One noteworthy area where SEC guidance is needed is that of disclosure requirements concerning the ongoing appropriation of fund assets to support marketing activities. “Advisers’ profits” once may have been a reasonable way of describing one source of cash to pay marketing costs. But “creeping materiality” appears to have set in, and advisers who choose continued nondisclosure of the use they make of substantial sums of shareholders’ money do so at their peril.