

THE FINANCING OF SALES OF MUTUAL FUND SHARES

THE SALES LOAD

INTRODUCTION

PROFESSOR ROBERT H. MUNDHEIM: The subject of today's discussion calls to mind the time when a friend of mine flew to Philadelphia from Florida and the plane on which she was traveling ran into extremely turbulent weather. Even in the best of weather she was not a good airplane traveler. And so, in absolute terror and fright, she turned to the person next to her—a minister—and said: "Can't you do something?"

He replied, "I'm sorry, Ma'am, but I'm in sales, not management."

Sales are the focus of today's discussion, and I would like to start the discussion by looking at what is probably the most controversial of the Commission's recommendations: namely, that legislation be enacted which will reduce the sales load from its present norm of 8.5 per cent of the offering price or 9.3 per cent of the asset value, to a maximum of 4.6 per cent of the offering price or 5 per cent of the asset value.¹

The premise for the Commission's recommendation is, as it was with respect to management fees, that there is a lack of competition at the customer level. The Commission concluded that competition does not exert any restraint on sales charges to the customer. The Commission did find competition, but it was competition among underwriters for dealer favor. This competition, the Commission found, has created a rise in the sales load charged investors, at least with respect to purchases under the breakpoint, and an even sharper rise in the amount of compensation going to the dealer.

It seems significant that the point where some reduction in the sales charge has occurred is in sales to a volume purchaser. Such volume purchasers are often customers of some sophistication, who are aware of, and can be influenced in their investment decisions by comparative costs.

In addition to pointing out the lack of competition at the customer level as a justification for governmental interference and setting maxi-

¹ Securities & Exchange Comm'n, *Public Policy Implications of Investment Company Growth*, H.R. REP. No. 2337, 89th Cong., 2d Sess. 223 (1966) [hereinafter cited as SEC Mutual Fund Report].

imum price levels, the Commission points, as an additional justification, to the government protection against retail price competition. The umbrella of protection against retail price competition is found in Section 22(d) of the Investment Company Act.²

Under that provision, if the prospectus of Fund *A* says that the sale price of shares shall be net asset value plus 8½ per cent of the offering price, every dealer must sell that fund's shares at net asset value plus 8½ per cent of the offering price, even though a particular dealer may think that he can make an adequate profit by selling the shares with a sales load of 5 per cent of the offering price.

With that background in mind, I'd like to start by asking Professor Friend how he evaluates the Commission's approach to the problem of the level of sales charges.

AN ECONOMIST'S EVALUATION OF THE COMMISSION'S RECOMMENDATION

DR. IRWIN FRIEND: While I am sympathetic with its purpose, I have significant reservations about the SEC's recommendation that new legislation be enacted limiting sales charges of mutual funds to 5 per cent of their net asset value (with this statutory maximum subject to change by the Commission). The problem the SEC is attempting to deal with in this matter is very real, and no proposal is likely to be completely satisfactory. It is even possible that the Commission's solution may ultimately be necessary, but it involves a philosophical approach which I feel should be followed only if other alternatives do not work. It should be noted that the members of the Wharton School group who worked on the 1962 Study of Mutual Funds are not unanimous in questioning the desirability of this recommendation by the SEC, so that the views I shall be expressing should be regarded as personal.

² Section 22(d), 54 Stat. 823 (1940), 15 U.S.C. § 80(a)-22(d) (1964) provides: No registered investment company shall sell any redeemable security issued by it to any person except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus, and, if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter or the issuer, except at a current public offering price described in the prospectus: *Provided, however*, That nothing in this subsection shall prevent a sale made (i) pursuant to an offer of exchange permitted by section 80a-11 of this title including any offer made pursuant to clause (1) or (2) of section 80a-11(b) of this title; (ii) pursuant to an offer made solely to all registered holders of the securities, or of a particular class or series of securities issued by the company proportionate to their holdings or proportionate to any cash distribution made to them by the company (subject to appropriate qualifications designed solely to avoid issuance of fractional securities); or (iii) in accordance with rules and regulations of the Commission made pursuant to subsection (b) of section 80a-12 of this title.

The SEC's position on fund sales charges is based largely on two facts: first, such charges as a per cent of sales price or net asset value are generally much higher than on exchange transactions, and higher on the average than charges on over-the-counter and new issue transactions, with the differentials, in the Commission's view, not justified by differences in the types of transactions involved.³ The industry has taken exception to the Commission's comparison of fund sales charges with exchange commissions on the ground that the two types of transactions are not comparable; when you buy a fund share, you are really buying a diversified group of securities, and if you bought this diversified group in small lots, which is typically what mutual fund investors purchase, you would be paying rather substantial exchange fees. The Commission's answer, presumably—though it isn't spelled out in the report—is that it isn't fair to compare the cost of buying a large number of securities in small lots with the cost of buying mutual fund shares, since the cost of purchasing stock is borne by the investor through the fund and not by the selling organization.

Second, the Commission noted that sales charges have increased markedly since the early 1950's, with the entire increase going into higher dealer concessions. (Actually, there has been a decrease in the average fund underwriting spread.)⁴ The Commission concluded:

More than a quarter of a century of experience shows that the sort of competition which in fact generally prevails, *i.e.*, competition among principal underwriters for the favor of retail dealers rather than price competition among retail dealers, has had the effect of raising rather than lowering prices to the investor. . . . Most fund managers believe that to achieve maximum sales of new shares they must make the sales loads on such shares as attractive as they possibly can—not to the investors who buy them but to the dealers and salesmen who sell them.⁵

There is considerable merit in the SEC's position that competition in this industry has not served its traditional function of reducing the cost to the purchaser or (though the Commission does not make this point explicitly) of improving services in the form of investment performance for a given price—at least to the extent that this can be ascertained from published studies.⁶

³ *SEC Mutual Fund Report* 209-15.

⁴ Typically the sales load is allocated between the principal underwriter and the retailer. The Report stated that the principal underwriter usually retains from .5% to 2.5% of the offering price and allots from 6 to 8% to the dealer. *Id.* at 207.

⁵ *Id.* at 221.

⁶ *Ibid.*

The weakness of ordinary competitive forces in the industry can be further highlighted by reference to the availability of similar investment media offering comparable portfolio performance and diversification but at a much lower price—that is, the no-load mutual fund or the closed-end company selling at a sizable discount from asset value. It is clearly the higher priced product which has had the growth, reflecting the selling pressures associated with high sales charges.

The Economic Benefits of a High Volume of Fund Share Sales

There is, however, another side to this coin upon which the SEC does not touch. The intensive selling effort associated with the current level of sales charges might be considered to have a significant social utility so long as the rate of return on common stock (which accounts for an overwhelming share of funds' portfolios) is substantially in excess of the return on alternative forms of investment. Since the latter part of the nineteenth century, the annual rate of return on common stock has amounted to fully twice the average corporate bond yields. Apparently only part of this differential can be explained by the difference between the ex-post or realized and the ex-ante or required rate of return on the two types of securities. The post-war surge in stock market participation by mutual funds as well as other institutional investors has bolstered stock prices and lowered the required rate of return on equity investment. This lowered rate of return is related to the funneling into equities of money which otherwise would have been channeled into fixed interest obligations, and the willingness of institutions to accept a lower premium for uncertainty in view of their ability to diversify.

To the extent that such institutional developments lower the risk premium and thus lower the cost of capital to business, investment demand and economic growth are stimulated (assuming that realized investment is not completely determined by the supply of saving). While there is reason to believe that institutional developments have somewhat reduced the disparity between the required rates on stock and bonds, the disparity still seems to be substantial.

Any such reduction of the extremely large risk differential between the yields on equity and on bonds has potentially favorable implications not only for the total amount of investment, but also for the optimal allocation of investment funds, in that it no longer may be necessary for business to pay a much higher premium for risk investment, which is typically financed by equity, than for less risky investment which is ordinarily financed by some combination of bonds and equity. While this premium may be fully warranted from the view-

point of individual investors in the absence of a substantial mutual fund industry or similar institutions, the social cost may be considerable.

Moreover, the apparent economic advantages of a burgeoning mutual fund industry do not seem, as yet, to have been associated with significant hardships to a substantial fraction of mutual fund investors apart from those investing in contractual or front-end load plans. As a whole, such investors—and I am speaking about investors in non-contractual plans—fared well in comparison with the performance they would have had in the alternatives realistically open to them.

It is true, of course, that, if possible, it would be desirable both from the viewpoint of the investor and of the economy to have the growth of the mutual fund industry (or similar alternatives) involve less selling costs. This requires more effective price competition which might be achieved through one of three approaches, only two of which could be implemented by legislation or regulatory action.

Alternative: Revise Section 22(d)

The first, which is discussed briefly in the SEC report,⁷ is to remove the retail price maintenance provisions of Section 22(d) of the Investment Company Act, permitting retail dealers to attract customers by offering lower prices. The SEC gives a number of reasons for recommending a maximum sales load in preference to amendment of 22(d), but apparently the most cogent argument in the Commission's view relates to

. . . the unsettling and unforeseeable effects which abolition of retail price maintenance might have on the broker-dealer community⁸

It can, however, be argued that freeing competitive forces by revising section 22(d) might be preferable to government price-fixing, and that the net result of such competition would be that a much higher proportion of fund business would flow to the more efficient and lower-cost members of the financial community.

Alternative: Improve Disclosure to Potential Investors

A second approach to more effective price competition in the setting of sales charges, one which is not considered in the SEC report, is to provide potential investors with "full disclosure" so that they are aware of the performance and costs of the funds offered to them

⁷ *Id.* at 218-23.

⁸ *Id.* at 223.

compared with the broad alternatives which include other load funds, no-load funds and closed-end investment companies—the latter frequently selling at a discount. This is, at least in theory, more attractive than a maximum sales load and may be less disruptive than a revision of 22(d). The implementation of this approach might involve the front page of the prospectus presenting information in a manner prescribed by the SEC comparing the performance and cost of the fund, over as long a period as feasible, with the corresponding averages of other load funds, no-load funds, closed-end companies, and over-all market performance weighted by the portfolio composition of the fund in question. Costs would, of course, have to be related to size of transactions.

Either of these two approaches appears to have significant advantages over the setting of a maximum sales load. However, both pose a number of problems, and there may well be other alternatives which would be preferable. It seems to me that the SEC has demonstrated the absence of effective price competition in the selling of mutual funds, arising basically from the inability of fund investors to appraise the product they are buying. The indicated solution to this problem is less clear, and it may be that the mutual fund industry will have some useful proposals toward this end.

Alternative: Encourage New Competition

While a concentrated effort to achieve fuller disclosure seems to me to be the most appealing alternative, at least initially, for immediate regulatory action, there is still a third way of achieving the Commission's objective—the entry of new competition into the mutual fund field. Large brokerage concerns and other large financial institutions not now in the business might very well be in a position to sell fund shares aggressively and profitably at a significantly lower cost than the current sales charges. However, while this possibility might be stimulated by the SEC report, it clearly is outside the Commission's purview.

RESTRICTIONS ON ADVERTISING

PROFESSOR MUNDHEIM: Irwin, you raise the question of competition. An obvious competitor on the size of the sales load within the mutual fund industry is the no-load fund. However, no-load funds have not been very successful in selling shares compared with the load funds. Do any of you have ideas as to how the no-load story can be more effectively presented to the public? Are these funds—or indeed

all funds—unduly restricted by present SEC rules or regulations with respect to advertising?

Advertising Restrictions. Should Not Apply to Mutual Funds

MR. GORDON D. HENDERSON: I have long felt that the advertising restrictions on mutual fund shares are too stringent, and I was disappointed that the report did not deal with that question.

It seems to me that the present rules overlook a very fundamental difference between a mutual fund share and other kinds of securities. In a real sense, the mutual fund share is not so much a security as it is a service. In other words, what's really being purchased when an individual buys a mutual fund share is an investment management service. He is not buying a security in the same sense as when he buys General Motors and American Telephone.

The advertising restrictions that exist in the securities business today were developed to prevent too much pre-selling of the market when someone floats a new issue of bonds or a new issue of stock. The purpose is to prevent creation of an erroneously high price for the issue by pre-selling through overly bullish advertising.

This problem doesn't exist in the mutual fund business, because the advertising that is put out is not going to affect the price of the mutual fund share. So I think we are dealing with a different conceptual situation.

And yet when we look at the way funds have to be advertised—I guess the most dramatic example, Bob Loeffler, would be your company's ads—where on one page of *Life Magazine* we find an advertisement for IDS insurance, with a picture of a happy family and the usual kind of advertising presentation; and, on the next page, an advertisement for the IDS fund which fits the "tombstone" requirement, has no pictures, and generally, is uninteresting.

MR. ROBERT M. LOEFFLER: The Advertising Department always complains to me about that very fact.

MR. HENDERSON: If you were selling not a mutual fund share but an investment management package, like a *Value Line* book, the rules wouldn't be quite as tight; and I think the distinction is not entirely logical.

I think that it might be more helpful in the sales end to improve the freedom of advertising in the fund business, rather than dealing with the sales load problem in the way the Commission suggests.

For example, what would be wrong, if you want to encourage competition between, say, no-load funds and load funds—and, indeed, between load funds, at the retail level—with an advertisement, that

shows a happy family and points out the competitive advantages of the particular fund?

I know it wouldn't fit—I guess—current policy, but what's really wrong with that?

PROFESSOR MUNDHEIM: I'll let either Phil or Dick answer that, if they wish.

A Commission Staff Viewpoint

MR. RICHARD M. PHILLIPS: Well, first of all, I think you all ought to know that the SEC is not against happy families.

The question of advertising for mutual funds is a matter that in recent years has received a good deal of consideration by the Commission, with a resulting liberalization of the rules.

I would disagree with Gordon, however, on his premise that there is no comparability, or very little comparability, between an investment in a mutual fund and an investment in other types of securities. In a mutual fund you are buying investment management. You are committing your capital to the management of others. When you invest money in a specific security, you are also buying management to a large extent. There are other factors that differentiate between an investment in a specific security and in a mutual fund, but in both there is a complex decision to be made, and it is a decision that very often can't be made on the basis of the limited information that necessarily goes into an advertisement.

Now, to the extent that there is a justification for more liberal advertising rules in the mutual fund field, it stems from the fact that the mutual fund purchaser, as a matter of practice, gets a prospectus before he buys the security. Prospectuses in connection with conventional distributions of securities are not required to be, and frequently aren't, delivered until there is a confirmation of the sale. This difference has been recognized by the Commission, particularly in recent years, and I think the door to the Commission for discussions of further proposals on advertising is always open, and adjustments in existing restrictions can be made.

On the happy family question I prefer not to express an opinion, because I don't know whether the Commission has ever passed upon it, and what I would do with the happy family picture might be pure "heresy" to the five men who sit at the Commission table.

I think there is room for further discussion and further liberalization of the advertising rules; it is an area that cannot be left without policing. Advertising has as much potential for false and misleading

impressions as any other form of selling technique. I'm sure we all realize that.

MR. PHILIP A. LOOMIS, JR.: May I add just a little?

This isn't wholly a matter of Commission policy. This restriction arises under the Securities Act, where the Commission doesn't have any general power to grant exemptions, as it does under the Investment Company Act. While I can understand Gordon's economic argument, the fact is that, legally, a mutual fund share is a security, and to say that it can be sold by means of advertising, while no other securities can, under a statute which draws no such distinction, is not too easy.

There possibly could be special legislation for the mutual funds in this area, exempting or easing their restrictions. I think some case could be made for it. On the other hand, this would open up the whole question that was decided by Congress in 1933 and reaffirmed in 1954—securities should be sold by supervised disclosure in a prospectus and by oral solicitations, but not by unsupervised advertisements.

PROFESSOR MUNDHEIM: I suppose some people might argue that it's easier to supervise written advertisements than oral solicitation.

MR. LOOMIS: I might add that Congress recognized that, and the reason we don't supervise oral solicitations, except perhaps in a proceeding after the fact, is that it's just impossible.

Impact of Liberalized Advertising Rules on Sales Cost

PROFESSOR MUNDHEIM: I'd like to ask some of you who sell fund shares whether or not expanded advertising rules would really help your sales effort? If you could have expanded advertising, could you get your story across to the public more cheaply, and therefore be able to make your sales at a lower over-all cost?

MR. RAYMOND GRANT: I don't think so, because we have found that the mutual fund, being the complex investment medium that it is, has to be sold by salesmen. As a matter of fact, our position is quite comparable to the life insurance industry. Although that industry has many more billions of dollars in assets than we have, and a much more sacred image in American financial planning, it still finds it necessary to send an army of salesmen out to sell policies in people's homes, around the kitchen table with both husband and wife present.

MR. HERBERT R. ANDERSON: I was interested to hear the first man from the industry speak that way. I feel, frankly, that the happy family ad probably should not be allowed.

I would like to make one other observation which is quite obvious to those of us in the business, but not always to others. The other financial institutions—insurance companies, savings and loan institutions, banks—use the shareholders' money to run their advertising. They have quite large budgets. In the case of the investment company, the essence of the structure is to protect the fund shareholder from the entrepreneurial risks and costs of promotion, so the \$40 billion of investment company managed assets is not a source for any expenditures for advertising. It would have to come from the sponsors, and they don't have \$40 billion.

PROFESSOR MORGAN SHIPMAN: Bob, I agree almost completely with the position that you and Gordon have always taken. There should be a complete and basic rethinking of the advertising question. At least some underwriters want to experiment with written advertisements. In the sale of mutual fund shares, it appears that the prospectus is in fact used and read before the security is sold; that provides solid ground for liberalizing the mutual fund advertising rules. I'm not nearly as concerned as Phil that this is so difficult to do under the Securities Act. The American Depositary Receipts experience⁹

MR. HENDERSON: If I can just make a comment, I know when we were working on this that we found most people we talked to in the business had Herb's reaction; namely, we don't have the money; we couldn't put on a big advertising campaign; and we're doubtful as to how much good it would do.

None the less, I think that consideration ought to be given to liberalization of these rules. I think, for example, that it might be useful if an ad came out from a group of no-load funds that advertised that they were offering a mutual fund share without a load. This would get their name in front of people who didn't even know there was such a thing as a no-load fund; or if they knew there was such a thing, who didn't know how to go about finding out the names of the funds and where to write. If an ad was attractive and simple and gave the names of a series of no-load fund sponsors and an indication of where you could write for information, this might be all to the good, assuming that adequate controls were put on it. You might find that the closed-end funds would engage in some advertising and you might get some interesting and imaginative counter-advertising from the load funds.

One of the problems of this business has been in getting people to understand what a mutual fund share is. While salesmen are

⁹ See 1 LOSS, SECURITIES REGULATION 463-65 (1961).

needed, a little bit of good pre-selling with interesting advertising would be very helpful.

PROFESSOR MUNDHEIM: This approach also gets at the public's lack of awareness of alternatives, a problem emphasized in the Special Study.¹⁰

The Requirements of the Cashion Opinion

MR. LOEFFLER: We at IDS do, I suppose, substantially more advertising—or have in the last few years—than is common in our industry, although it's still much less than any other type of sales organization.

First, I would like to comment on the Cashion opinion,¹¹ on which maybe I'd better elaborate a little bit because I have had the experience of trying to explain the Cashion opinion to the Director of Advertising at IDS on innumerable occasions, and have never succeeded in making myself clear. I'll make another effort at it here.

The Cashion opinion, in effect, says that if a dealer distributes any number of securities, so that he has no specific security in mind—theoretically—when he advertises, he is permitted to make a general advertisement about mutual funds. He is not then restricted by the tombstone requirement, which in effect requires that all you can say in an ad is: we've got something if you want to inquire about it, and then maybe we'll tell you what it is.

The Cashion opinion requires that if you have a specific security in mind, or if you are a distributor only of certain specified securities (such as IDS which distributes only the securities of IDS-managed funds and other securities sponsored by IDS), then you cannot use any advertisement that does not conform to the tombstone ad requirement, and for example, cannot use a general advertisement that contains any general description of what mutual fund securities are.

I would like to say, just for the record, that we do not agree necessarily with the validity of the Cashion opinion, but that will get us nowhere. We still have to conform to it and the IDS advertisements with respect to securities must conform to the tombstone requirements.

Market Tests of Advertising

You raised the question of whether a liberalization of advertising perhaps would sufficiently aid the sales effort and enable a reduction in

¹⁰ Securities & Exchange Comm'n, *Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess., Pt. 4, ch. XI, 144 (1963) [hereinafter cited as *SEC Special Study of Markets*].

¹¹ National Association of Securities Dealers, *What You Must Know . . . ?* 37-39 (1961).

the costs now necessary for the distribution system as it exists, and thereby provide for a reduction in sales cost. I can only say that I don't know. I don't believe there is any way of knowing, because we have never had an opportunity to market-test, using advertisements designed under a more liberal rule.

Today, we are conducting at IDS a market test on the present form of advertisement to see whether it's worth a plug nickel. We do not have the results of these market tests, but I don't think that anybody feels that the kind of advertising done today is very effective. It may help the morale of the sales representatives, because at least they feel they are getting some kind of support. But I don't think that anybody feels you ever sell a mutual fund share with the kind of advertising permitted today, and I don't think there is any way of knowing if different advertising would aid in the sales effort without an opportunity to try it.

Financing Fund Advertising

PROFESSOR MUNDHEIM: If there is a liberalization of the rules governing advertising and an increase in the amount of advertising, from what source will it be financed?

MR. HENDERSON: I can't speak for the SEC, but the 1940 Act, of course, provides that a no-load fund can only incur a sales expense through the route of the management fee;¹² the manager has to pay for promotion. The fund cannot do so.

I'm anticipating our future discussion a bit, but it seems to me that one of the results of the Commission's recommendations in the three areas of management fees, sales load and reciprocal business—all of which will reduce the money available for sales promotion—will be to increase pressure on managements of load funds to put the cost of sales on the fund.

For example, I suspect the question will be asked: what's wrong with having the fund pay the expenses presently absorbed by the principal underwriter, so that it can pass on to the retailer the entire 5 per cent sales load which the Commission says it will permit? I'm quite certain that if I were a director of a mutual fund, and sales began to nose down after adoption of the Commission's recommendations, I would have to start thinking about that.

There is limited precedent for this in the way the no-load fund pays for sales out of the management fee. There is also some precedent in the load fund area. There have been cases where fees have been

¹² Investment Company Act § 10(d) (5), 54 Stat. 806 (1940), 15 U.S.C. § 80(a)-10(d) (5) (1964).

paid directly by funds to their principal underwriter or even to retail dealers. But, by and large we have had a sort of divided world; the no-load funds have paid for promotion out of management fees, whereas the rest of the funds haven't imposed sales-type expenses directly on the fund shareholders themselves.

If the SEC recommendations in these areas become law, I think we are going to face a lot of questions and problems in that area. Something will have to give.

MR. ANDERSON: The assumption that the no-loads pay for their advertising out of the management fee, because that's the only source of income, is, in my humble opinion, totally unrealistic. The people who organize no-load funds are not philanthropists. They have a business. Typically, they are either in the brokerage business or they are in the money management business, and they decide as businessmen that it would be a good idea to offer a no-load fund, and they advertise it.

Certainly, the day they organize their fund they have no management fee. The average expenditure for advertising by a no-load fund is greatly in excess of the average on the part of the load funds. I think of one no-load fund that ran at one point a series of ten or twelve full-page ads in the *Sunday Times Magazine* section, and that isn't cheap. And when I sent over for the literature that was advertised, I found that it was a packet which, I would guess, cost between \$1 and \$2 each, far in excess of what we could do.

As far as a load fund is concerned, it is selling its management, and if the management fee is a reasonable one, in my humble opinion, the businessman has a perfect right to make a profit, and he has a perfect right to spend his money, from whatever honorable source it is earned, for advertising if he pleases.

PROFESSOR MUNDHEIM: I'm not surprised to hear that no-load funds spend a great deal more on advertising than load funds. How else are they supposed to sell their funds? The question is whether the source of financing of such advertising is proper. Gordon seems to think that fund assets themselves are a possible and appropriate source for such financing.

THE FIVE PER CENT SALES LOAD LIMIT AND THE RETAILER

Perhaps we should now take a look at the 5 per cent (or 4.6 per cent) sales load from the point of view of the retailer. Can the retail organization exist under such a reduced scheme of compensation?

Ray, I think you ought to get the first crack at that.

MR. GRANT: Preliminarily, I would like to say that the Commission in its report had some complimentary things to say about mutual funds. They found that by offering the American public professionally managed investments, the mutual funds fulfill an important public need; that the industry has earned its place as an important member of our nation's financial community; and that, on the whole, mutual funds are diligently managed by competent people.

They may have said these things before, but I haven't seen them in print, and on this occasion I would wonder, perhaps, whether they could not have devoted more than three sentences in a 350-page report to this kind of statement.

PROFESSOR MUNDHEIM: You wanted them to do a little advertising for you.

MR. GRANT: In any case, the Commission likes mutual funds, and this morning we are going to discuss their recommendations with respect to something they like. Later this afternoon we will discuss their recommendations with respect to something they don't like. It seems that they both come out the same.

Chairman Cohen, in his letter of transmittal, made the following statement, which essentially repeated a statement previously made in the Special Study:

The report, of course, makes no attempt to assess the merits of investment company securities relative to other media of investment.¹³

The Unique Quality of the Fund as an Investment Medium

This morning we heard Dick Phillips state that in his mind mutual funds were not essentially different from other securities. I think that this is the basic defect in the Commission's report. Although the Commission's report does draw some distinctions, ultimately it places mutual funds on the shelf of a broker-dealer, side by side with listed securities, over-the-counter securities and uranium stocks—the theory being that a customer will walk in and take his pick.

It doesn't work that way. As a matter of fact, mutual funds are so unique an investment that they virtually comprise a separate investment medium. They are bought differently and they are sold differently. They are, by definition, a long-term investment, to be disposed of only when the investor has finally reached his investment goal, to be substituted for only when his investment objective has changed.

¹³SEC *Mutual Fund Report* viii.

On the base of a diversified, redeemable, professionally managed investment has been built a package of services that have no counterpart in the securities business or in any other investment medium.

Services such as dividend and capital gain reinvestment in full and fractional shares of the fund, accumulation plans of all types, withdrawal plans, letters of intent, cumulative discounts, lifetime volume discounts, exchange privileges in family fund complexes, highly mechanized custodial arrangements and bookkeeping facilities—all built in, all developed accumulatively over the years—have tended to make the product better, finer and more economical.

This is the reason, perhaps, why \$40 billion has been invested by Americans at all economic levels, at every level of sophistication and every level of experience, in this investment medium—which now comprises the fastest-growing investment medium in the United States, if not the world.

Funds Must Be Sold

The question comes up as to why with all of these marvelous attributes people just don't call up to buy mutual funds—and they don't. Perhaps it's because mutual funds offer essentially a deferred benefit, rather than present enjoyment. People buy individual securities with the hope of making, in many cases, a quick profit, but basically they do not buy mutual funds and cannot be sold mutual funds properly with that in mind—certainly not responsibly sold that way, and not responsibly purchased that way.

Human nature being what it is, people tend to buy things from which they get immediate enjoyment. If left to themselves, they'll buy their cars and clothing today, and defer those purchases which offer them deferred benefits. It's the nature of things. It's perhaps the reason why other agencies of the government, recognizing this, have planned Social Security on a mandatory basis. Left to their own resources, most people probably would not plan Social Security for themselves.

It is for this reason, as I stated before, that life insurance, which also offers a deferred benefit, has to be sold—has to be explained to people. You can't expect them to go out and buy it themselves. And if it is a useful product—if it does serve a public need—then it's the kind of a product that should be encouraged rather than discouraged in the American financial community.

Another reason, perhaps, is that mutual funds, being part of a continuous offering, don't lend themselves to the sense of urgency that an underwriting might; getting in quickly at the right price is

relatively immaterial in mutual fund investing. The fact that they have to be sold is apparent—and the load, or the fact that there may be no load, isn't terribly significant, as evidenced by the fact that the no-load funds represent no more than 5 per cent of the total assets of our industry. It's also significant that savings bank life insurance, which is sold without sales charge and which is probably as cheap a life insurance medium as you can find, also represents only a very small fraction of the total life insurance in force in the United States. People just do not, as a matter of fact, plan for next year or the year after—they need help. They need some motivation; and it takes salesmen, in most cases, to motivate people to do this.

The Compensation of the Retailer

If we need selling, and we need salesmen, then we come to the question of compensation. The report tells us—and it's true—that typically the sales charge is $8\frac{1}{2}$ per cent under current conditions; that of the $8\frac{1}{2}$ per cent the principal underwriter typically retains 2 per cent¹⁴—and to my knowledge no one has ever accused the principal underwriter, with the expenses that are incurred by him, of making any profit, or any inordinate profit in this business.

Six-and-one-half per cent, then, is typically retained by the dealer. If he is a one-man dealer, and he works hard, he can make a decent living. He won't get rich. However, if he's a typical dealer who maintains certain facilities and has salesmen working for him, he typically pays out about 4 per cent to the salesmen. From the $2\frac{1}{2}$ per cent that he retains he has to pay his rent, his telephone, his secretarial, bookkeeping and record-keeping expenses. In recent years there has been much more emphasis on proper—and often expensive—supervisory and training facilities. All of these are expensive, and all of these are paid from the $2\frac{1}{2}$ per cent that the retailer retains from the sales that are made by his men.

The salesman, if he is full time, if he can afford to be full time, if he treats his job as a forty-hour per week job, if he is well-organized, and if he's well-supervised, will have to make approximately ten calls before he can generate three appointments, from which he can make one sale. That's our experience for a good man who is working hard and has his time well organized.

He will make, if he works hard, three sales a week, and he will have to see some people two or three times before he can sell them.

I think that the Commission's report states that the typical sale is something like \$1250, or \$1240.¹⁵ I think the typical share sale

¹⁴ *Id.* at 207.

¹⁵ *Id.* at 206-07.

is something higher—closer to \$2,000. If he makes three sales per week of \$2,000 each, he will gross \$240. If he is unfortunate enough to have one of his sales as a \$50 per month voluntary program and he receives two payments down on such program, he will have received \$4 for that night's work. However, he will make some sales that are more than \$2,000, and if he makes any really good sales, he will be making them at a discount from his regular commission.

In any case, we would guess that a full-time man, working under the circumstances I described, will gross somewhere between \$12,000 and \$13,000 a year. He will pay all of his own expenses, his own outside telephone, his own travel, his own dinners in those evenings when he is working, pay for his own automobile and gas, and entertainment to the extent that he entertains. If he is just doing a cash business and a voluntary plan business, he might net out, if he is careful, \$10,000.

He's always seeking new customers, because many of his customers will only buy once. He's not dealing with the kind of security that is traded. Mutual funds are bought for keeping, and many times he will never be able to make another sale to the same customer. Accordingly, he will find himself over the years with 400, 500 or 600 customers on his list.

We have been asked to professionalize our salesmen, to be more careful about our recruiting, to be more careful about our training and certainly to be more careful about our supervising of salesmen. We have a problem, under current standards, of finding the right people, who are prepared to give up what they are doing now in order to make this kind of a living by selling mutual funds in the responsible manner which is expected of them in our industry.

What has been suggested is that roughly a 44 or 45 per cent reduction in sales charge be put into effect, on the theory, perhaps, that we are getting too fat, or that there is some fat that can somehow be redistributed, or that it's unnecessary for us to remain in business and make a profit.

We are in one of the most competitive businesses in America, despite what I have heard and what I have read. We find that we are competing for people's extra dollars. People first pay their rent, and then buy their cars and everything else that they would like to have currently.

In addition to the competition for the dollar, which is the extra dollar, we have a great deal of competition within the industry among dealers and among funds; and if we thought for a moment that we

could reduce the sales charge and double our sales by doing so and still make a profit, as businessmen, you can be sure we would have done this long ago.

What has happened, actually, is that competition has taken on a unique aspect. It has served to improve the product, if it has not served to reduce the sales charge. The product, as we know, has been improved in each and every year. The withdrawal plan, one of our most recent innovations, is an example of the improvement of our product.

My point is that if the Commission has made any economic study of our business, it remains unpublished; at least I haven't seen it. It appears to be an arbitrary selection of 5 per cent, related to, perhaps, other factors in the securities business, to which mutual funds, to my mind, have no relation; an arbitrary—almost a capricious suggestion—that the charges be reduced, without an economic study that would justify the continuance of responsible brokers and dealers in this business, and responsible sales people who have to bring the mutual fund message to the public.

Quite frankly, if the Commission's legislative recommendations are put into law, I look forward to a mass migration of good people from our business to areas where, with the same type of training, the same type of approach to the public, they can make more money or just make a decent living. That's all we're suggesting. That's all the record shows anybody ever makes from selling mutual funds. Nobody has gotten rich selling them. A good living can be made if you work hard, but that's all.

It's almost, to my mind, as severe a recommendation as if the Commission had recommended that we be legislated out of business. What they haven't recommended directly, they have surely recommended indirectly.

PROFESSOR MUNDHEIM: The audience seems to have found your comments very congenial.

MR. GRANT: Thank you.

PROFESSOR MUNDHEIM: I wonder whether everybody on the panel, though, would agree with everything that you have said.

A Sympathetic View of the Five Per Cent Recommendation

PROFESSOR SHIPMAN: Well, Bob, I disagree in several respects. I'm not sure that I have as many supporters in the audience, but I shall proceed.

First, I'm upset when we hear words like "capricious" being used concerning the Commission's report. In discussing these very hard problems, language like that will not enable or aid anyone—especially Congress—to fashion sensible solutions.

The Commission approaches the problem differently than Ray does. The Commission does not point to excess profits in the sale of mutual fund shares. I have not seen any figures showing that the salesmen are overcompensated or that the underwriters are necessarily making excessive profits. Rather, the focus of the Commission has been a comparison between sales charges on exchange-listed securities and on mutual fund shares; and they aren't that different. I think that the diversified closed-end investment company listed on the New York Stock Exchange would be startled to learn that the mission and function of it and the mutual fund differ fundamentally. Both provide diversification. The no-load funds also provide diversification and professional management, paid for by the advisory fee. The sales load is paid solely for sales effort.

The Commission, looking at the disparity, is saying—and this is conventional in securities regulation—that the load or commission can become so high that it's unreasonable—almost grossly unreasonable—to charge an investor this much in a particular transaction.

On management fees and sales loads, the Commission chose to recommend extremely conservative solutions—solutions much more favored by the industry. Paradoxically, in each area, the Commission-recommended solution is harder to defend, in terms of pure symmetrical logic, than alternatives requiring basic changes in industry structure.

In the management fee area we see a suppression—a partial suppression—of arm's length bargaining. The most straightforward, but most radical, thing to do would be to change the structure of the industry by saying: all funds internalize. We would have no conflict of interest. This would be a simple piece of legislation, and conceptually it would be quite neat. However, I don't think the industry wants that. The Commission adopted the far, far more conservative view that internalization should not be recommended at this time and that the Commission should not regulate management fees, but that in court they be subject to a test of reasonableness.

Turning to sales loads, again the Commission, by choosing a more conservative and industry-favored recommendation, took the hardest path—although I think the Commission is acting very responsibly on both management fees and sales loads. On sales loads, there is no competition in the usual sense. We have the only mandatory federal fair trade law on the books, section 22(d), which

makes it a positive violation of the act for any dealer to deviate from the sales loads that have been set.

I have great sympathy with what Dr. Friend said; I'm close to the line on this. And it would be much easier for the Commission to say: let's repeal section 22(d). Let's see what competition does, and let's stay out of it.

However, everyone knows that one of the major presentations made by the industry to the Commission during the period in which the report was prepared was a plea for the preservation of section 22(d). The Commission feels that the industry can't have it both ways. They can't suppress competition with section 22(d) and then set their own levels of sales loads. The Commission found the acquisition cost of listed securities—for example, shares of a diversified closed-end investment company—to provide a useful comparison. I think that on some of the very small transactions, 5 per cent is too little.

THE ECONOMIC IMPACT OF A DECREASED SALES LOAD

PROFESSOR MUNDHEIM: Irwin, can I get a reaction from you on (1) whether or not the attempt to compare mutual fund sales loads with, for example, underwriting spreads or the New York Stock Exchange commission rates is a proper method of comparison? (2) if the sales load is cut down almost by a half, what impact on the flow of money into fund shares can one predict?

DR. FRIEND: Well, can I answer those two specific questions initially, and then address myself to the general point that you made? First of all, my own feeling is that the correct price for any commodity or service is a competitive price, and I think it's perfectly clear that most economists—99.99 per cent of economists—would not consider the current pricing policy of the industry as competitive, even though they would consider it quite rational. I'll get back to this point.

Now, the second question. The Wharton School Study showed that there was a very strong positive correlation between sales charge and growth of funds—*i.e.*, the net flow of money into the fund—much stronger, incidentally, than the correlation between performance of the fund and the sales charge.¹⁷

This indicates, I think pretty clearly, that with a drop in the average sales load to 5 per cent or something below that, depending on the base you use, you would have, at least initially, a rather substantial decrease in the flow of money into the mutual funds, unless other alternatives came into the picture—for example, some new

¹⁷ *Id.* at 347-48.

financial organization entering the mutual fund business; but my best judgment would be that there would be a substantial decrease in the flow of money into mutual funds.

However, I would like to go on to something a little broader. I'd like to attempt to summarize very briefly what I understand to be the Commission and the industry view, as just expressed.

Investor Ignorance of Alternatives

The Commission is essentially taking the position that sales of mutual fund shares are not operating under competitive conditions. They say, on what I would consider to be pretty incontrovertible evidence, that people just don't realize the alternatives open to them. I have heard no one answer this argument.

The fact is that you do have closed-end funds selling at very substantial discounts from net asset value. These are presumably better buys than even the no-load funds. You do have no-load funds, and there have been a number of performance studies indicating that there is no difference between the average performance of no-load and load funds, and between the average performance of a closed-end company and a mutual fund.

The second basic justification for the Commission's position, apparently, is that there has been a trend to do whatever is required to sell mutual funds—whatever is required, under legal restrictions, of course—and the question they raise, which I think is a perfectly valid one, is: where does this end?

One could argue that there are certain economic constraints, but on the other hand you probably could sell more mutual funds, if you paid the salesmen a lot more money. There is a limit, but no one knows where that is.

Benefits of a High Volume of Sales

Now, the more thoughtful industry answer, apparently, is (or should be)—I gather it probably is—that mutual funds represent a useful commodity, a proposition about which there seems to be little question. Mutual funds have to be sold. So long as the experience that people have with such funds is favorable in relation to the alternatives currently available to them, the current situation isn't bad. There is some merit, I think, to this argument.

Commission Responsibility for the Cost of Sales

However, the Commission does take a further position which has a considerable amount of justification: one of its responsibilities is

to see that institutional arrangements are as good as they can be; not merely to say that they can understand why certain institutional arrangements exist, and as long as people are not getting hurt too badly, what of it?

If a regulatory approach can give the economy what it is already getting in terms of a healthy flow of money into the industry, and do it at less social cost, less selling cost, I see no argument against it, unless one feels that there is something socially desirable about giving salesmen work or income; and I don't think anyone here is taking this position.

Recapitulation of Alternatives to Commission Recommendations

So the crucial question really is: can you have a healthy flow of funds into the mutual fund industry, and still do something about this clearly non-competitive sales charge?

I tried to suggest two alternatives, and one is the repeal of section 22(d). It is true that the industry has been operating under this section for many years, and this alternative would change the rules of the game. Moreover, it is possible that more than this may have to be done.

I think it would be most sensible to go first via the route of much more extensive disclosure. I think there is no question that you can do much more in this area than is currently being done. I agree that it's far from clear just how much you can do. I think the suggestions made a little earlier about a more lenient attitude toward advertising under effective SEC supervision are highly desirable. I heard no arguments this morning against them. Some people don't think it would work, but I see no harm in trying. Actually, I should think the SEC would be all for it, since, as was pointed out by Phil Loomis, it's much easier to supervise written advertising than oral presentations.

Finally, I would be interested in knowing: what is the industry attitude toward taking care of a clear deficiency in our system, namely, that investors don't realize the alternatives open to them, thus preventing the operation of effective competition? Selling costs are much higher than they would be under a truly competitive system. What does the industry propose to do about it?

A STAFF EXPLANATION OF THE COMMISSION'S RECOMMENDATION

MR. PHILLIPS: I think there are a couple of notions that have been articulated here which suggest things about the report that just aren't so.

Commission Recognizes That Funds Must Be Sold

One is the thought that the Commission in its report regards mutual funds as just a shelf item, and that there is no need for any selling effort. Nothing could be further from the truth. If that were so, there would be no justification for a sales load that exceeds an exchange commission rate. In fact, the Commission recommendation is for a maximum sales load that would amount to five times the exchange commission rate and two-and-a-half times the round-trip commission.

The Commission recognizes that the sale of mutual funds involves selling effort. The question is: how much should the investor pay for that selling effort?

Commission Doesn't Argue That Distributors Are Over-Compensated

Another thought that has been expressed is that perhaps the Commission's recommendation is based on the theory that those who sell mutual funds are getting "fat" on the sales load. That's not so. There is no suggestion in the report that an excessive profit is made in the selling end of the mutual fund industry. The fact is that the type of competition that does prevail in this industry makes that an impossibility.

The sales load is consumed by selling effort. The more sales load, the more selling effort there will be. To a large extent, mutual fund managers do not look upon underwriting as a source of profit. Many managers of the largest mutual funds and fund complexes subsidize their underwriting functions, and they do so deliberately, making a business judgment: we want to sell as many shares as we can, in order to earn management fees on it.

We don't quarrel with that business judgment, as long as the subsidy does not come from fund shareholders in the form of unreasonable fees.

In the retail end of the business, entry is relatively easy. Mutual fund dealers do not need large amounts of capital to finance inventories. In fact, inventories of mutual fund shares are prohibited. The principal operating expense is salesmen's commissions, which vary in proportion to sales. The industry tries to get as many dealers and as many salesmen as possible to sell fund shares. Hence the individuals in the industry who do the selling, because of competition with other sellers, have a competitive limit on the amount of profit they might make.

Distinction Between Investment in Mutual Funds and Other Securities

The question is: how much should the investor pay for the selling effort in mutual fund shares? To what extent does a mutual fund investment differ from an investment in exchange traded securities, and differ in a way that justifies a disparity in the selling compensation?

It has often been said that a mutual fund is a longer-term investment than investing in a particular security. We don't quarrel with that statement, although there is no reliable information which shows length of mutual fund holding periods, or any comparative data on the length of holding periods with respect to other kinds of securities.

But the fact is that mutual fund shares can be a long-term investment only because the nature of the investment changes through portfolio turnover. The average portfolio turnover rate of the funds is, in fact, higher than the stock market average. Turnover costs money, and it's the mutual fund shareholder who pays for it. This type of expense has to be taken into consideration in evaluating the reasonableness of the sales load.

It's this kind of approach to the problem that forms the basis of the Commission's recommendation—not any misconception that people are getting "fat" on sales loads or that salesmen don't work hard at selling—but the question of fairness from the point of investors and the justification for the disparity in cost between investing in exchange-traded securities and mutual fund shares. It's on this basis that the Commission reached its conclusion.

Evaluation of Proposal for Expanded Disclosure

Now, there have been a couple of suggestions made here as to possible alternatives. One is comparative disclosure. That was discussed somewhat by the Commission as an alternative, and it seemed pretty clear to most of us who would be engaged in the job of implementing any comparative disclosure rules that, to a large extent, it would be administratively unfeasible.

I question whether any prospectus that makes full and accurate disclosure of the comparative costs of a mutual fund investment in a particular fund with other alternatives, would be, as a practical matter, readable to the person who is making the investment decision.

Evaluation of Proposal to Revise Section 22(d)

The alternative that did get extensive consideration by the Commission was a modification of section 22(d) to permit retail price competition. The Commission, in the course of its deliberations,

sought out the views of a number of persons in the industry concerning what the possible impact would be. These persons, who have a feel for the practical aspects of mutual fund selling, thought that competition would lower the sales load far below the 5 per cent limit. I don't believe that the Commission was persuaded that this would necessarily be so, but it was made very clear to the Commission that to deal with the sales load problem via the competition route would raise uncertainties as to what would happen to sales load levels in an industry that has been living under the shelter of price protection for more than twenty-five years.

The Justification for the Five Per Cent Recommendation

In that sense, the Commission viewed the statutory sales load limitation route as being the most conservative way of dealing with what it believed was a problem.

Now, I don't believe that the 5 per cent limitation can be defended as the "correct price" by any kind of slide rule formula derived from economic analysis, and I don't believe that the sales load ought to be used, as Professor Friend seemed to suggest, as a way of moderating or accelerating the capital inflow into the equity markets. Securities regulation isn't designed for that purpose, although there is no question that regulation does have an economic impact.

Securities regulation ought to be molded from the point of view of the protection of investors, and from this point of view a 5 per cent sales load is a much fairer price to pay for the benefits conferred by a mutual fund investment than the 8½ per cent (or 9.3 per cent of net asset value) sales load that's now charged.

PROFESSOR MUNDHEIM: Is it clear that the major standard by which to measure your regulatory purpose is protection of investors? Isn't the public interest another and possibly broader standard for regulation? In that connection I am not clear why the Commission chose to take so much in one bite—particularly when it is so difficult to predict the impact of a substantially lower sales charge. Was any consideration given to a more gradual approach? For example, lower the sales load one per cent this year, study the effect, lower it another per cent the year after and study the effect, and so on. Such an approach permits the Commission to call a halt if it appears that serious and undesirable dislocations would occur.

MR. PHILLIPS: I think that the Commission would provide for adjustments in terms of the impact in another way. Its proposal would

provide for rule-making authority to raise rates, if the circumstances indicated that would be in the public interest. Should—and I don't believe there is any reason that it should—a 5 per cent sales load have definite harmful effects on the securities markets, that authority could be used to adjust it.

Economic Impact of the Commission's Recommendation

I don't believe that the Commission's recommendation will have a far-reaching economic impact on the channeling of equity capital to the markets. I don't question Professor Friend's suggestion that there will be, initially, some drop in sales, but sales of mutual fund shares, even in recent years, have fluctuated widely, particularly in the last half of 1962 and 1963, and at the present time.

Although the period of time in which the funds have become an important factor in the market is rather short, there seems to be a pattern developing whereby mutual fund investors react to market breaks, not through redemptions, but by curtailing their new purchases of shares for a considerable period after a sharp market break such as we had in 1962, and as we had more recently.

The securities markets, as well as the mutual fund industry, have survived these kinds of fluctuations in investment buying patterns, and I think those who suggest that they can't survive a 5 per cent sales load should read the legislative history of the other federal securities laws, where speaker after speaker warned, and witness after witness testified: if you pass this law, you will wreck the economy of this country.

The federal securities laws so far have not wrecked the economy of this country, and I don't believe that the Commission's recommendations, if enacted into law, will have any such effect.

IMPACT OF FIVE PER CENT RECOMMENDATION ON
LARGE NYSE FIRMS

PROFESSOR MUNDHEIM: I must read one question from the floor, which I think is very appropriate at this point.

As a sales manager of a very large, profitable member firm of the New York Stock Exchange, I look forward to a reduction in sales load to 5 per cent for several reasons:

1. Our fund business will grow and generate more profits at the expense of small firms.

2. Many of Mr. Grant's salesmen will be delighted to join our firm and benefit from our other merchandise, brokerage and underwritings.

3. Small over-the-counter firms will disappear. Regional operations will decrease, which means less competition for our firm—[and more profits; he didn't say that].

I'm very happy that the direction of these proposals will make us bigger, more profitable, more efficient.

MR. ANDERSON: What's the signature on that, Bob?

PROFESSOR MUNDHEIM: Just "a large, already profitable stock exchange firm."

Let me give Gordon the first crack at it.

MR. HENDERSON: I would say that your anonymous commentator has really put his finger on it! What your commentator is really saying is that the Commission's proposals will not only have an effect on funds and their investors but on the entire structure of the broker-dealer business, and that this effect will benefit the large NYSE member firms and hurt the small firms and the non-NYSE firms. I tend to agree. Let me explain why.

A reduction in the sales load would reduce the initial cost of fund shares to investors. This is the Commission's goal. But this is only the first and most obvious part of the story.

For, by the same token, the amount of money available for stimulating and compensating the sales effort for fund shares will be drastically reduced. This will occur not only because of the sharp reduction in sales loads from 9.3 per cent to 5 per cent (or 8.5 per cent to 4.8 per cent), but also because the Commission's recommendations regarding management fee profits and portfolio brokerage commissions would reduce the amount of management fees available to subsidize the underwriting effort and the amount of brokerage commissions available for sales purposes.

The Commission's recommendations regarding give-ups and volume discounts would also affect the ease with which brokerage commissions could be allocated to small NYSE member firms and to nonmember firms. One effect of these proposals would be to make it difficult if not impossible to get *any* meaningful brokerage commissions out to firms which are not capable of acting as primary executing brokers. The small firm which today is providing only research or sales effort for the fund brokerage commissions it receives, will find it quite difficult to keep this business if the Commission has its way. The result will be, I think, that fund brokerage business and probably also fund sales business will concentrate in the larger NYSE firms. The small firms and the nonmember firms will be hurt. Thus, despite implied suggestions to the contrary in the

report, I think one effect of the Commission's recommendations regarding sales loads and brokerage commissions will be to strengthen the position of the New York Stock Exchange relative to the regional exchanges and the Third Market, and the position of the larger NYSE firms relative to all other firms. I think this is the point your anonymous commentator is hinting at, and I agree.

Effect on Fund Share Sales

I think there are some other possible side effects. For example, the effect of all this on sales of fund shares is unclear. Possibly the lowering of cost to the investor may increase fund sales, or at least neutralize the effect of any loss of promotional effort by salesmen (so that overall sales may not be affected). However, past experience would suggest it is perhaps more likely that fund sales will be reduced. I would guess that most of us here would predict that this would be the result.

If in fact fund sales are reduced, and if the reduction reaches the point where funds begin to be threatened with the possibility that redemptions may exceed sales, the result can be harmful to fund shareholders. Portfolio management may become more difficult; it is my understanding that management of a declining portfolio can be more difficult than management of a growing one. And the per share cost of management would probably increase as total assets decline.

There is another factor. To the extent these recommendations reduce sales of fund shares, there may be a negative effect on general levels of securities prices. Everybody seems in agreement that the net inflow of money into mutual funds has tended to increase stock prices. It would seem to follow that a reduction in this inflow would work in the other direction.

I am a bit worried about a governmental policy which may well have all these side-effects, unless the need for the policy is terribly great.

Argument That the Level of Sales Load Is Not a Problem

How great is the need for the proposed reduction in the sales load? Irwin Friend said he felt that the area of the basic sales load is a problem area. Here I must confess—and I think this will not come as a surprise to Phil Loomis or Dick Phillips, who know something of the views I have had on this—that I do not agree. I am not really very worried about the size of the basic sales load. A principal reason why I am not worried is that the investor has a chance to buy a

no-load fund, or a closed-end fund, rather than a load fund, if he so desires. And I do not find the present basic load shockingly high.

I am also troubled by the reasons the Commission has advanced for its proposal. For example, the report makes a finding that the sales load is larger than standard stock exchange commissions, over-the-counter commissions, or underwriting commissions, and then reaches the value judgment that this is bad because it gives securities salesmen an incentive to recommend fund shares to customers rather than other securities, whereas we ought to promote so far as possible neutrality instead of disparity in the incentives for investment recommendations. But the Commission's recommendation would not eliminate disparity. There will still be differences between various over-the-counter rates, exchange rates and underwriting rates. These disparities cannot be eliminated. Indeed, it may even be that the Commission's recommendation would increase rather than reduce the actual economic disparity, by possibly making fund sales less profitable than other sales. I think the report gives inadequate recognition to the fact that, as Ray Grant mentioned, there tends to be less activity in mutual fund shares than in other securities. The present stock exchange commission may provide greater economic incentives (taking into account excepted turnover) than the present mutual fund sales load.

In addition, even if it is one's judgment that a real disparity in favor of the funds does in fact exist today, one must recognize that out of 20 million investors in the United States only 4 million own fund shares.¹⁸

Next, the Commission indicates it is troubled by the fact that while the policy judgment reflected in the 1940 Act was to leave the level of sales loads to be determined essentially by competition (so long, I might add, as the level did not exceed 9 per cent), the effect of competition has been to cause some increase rather than a decrease in the overall amount of the average sales load (from roughly 7.5 per cent to 8.5 per cent), and a marked increase in the proportion of the sales load allocated to the retail dealer.¹⁹ Compared to increases in other costs in our economy over this period, however, it seems to me that the increase in the amount of the sales load is not very great. And the tendency of competition to increase rather than decrease overall sales loads and the proportion of them allocated to retail dealers was not unanticipated by the framers of the 1940 Act. The Commission's Investment Trust Study, which provided the foundation for the 1940 Act, specifically noted that the effect of competition among under-

¹⁸ INVESTMENT COMPANY INSTITUTE, *THE MUTUAL FUND SHAREHOLDER* 3 (1966).

¹⁹ *SEC Mutual Fund Report* 208-09.

writers for the favor of retail dealers had been to prevent the reduction of loading charges.²⁰

So I have troubles with the reasons given for the Commission's proposal to reduce the basic level of the sales load.

DIFFICULTIES IN JUSTIFYING A PARTICULAR SALES LOAD LIMITATION

But what really bothers me most is that the Commission gives no reason for choosing its recommended 5 per cent figure. It is presented as a purely arbitrary one. I think that when Dick Phillips says he can't justify the proposed 5 per cent as being the absolutely right figure, he has lost his case right there.

It is true that we live with somewhat arbitrary figures elsewhere. For example, there is the NASD 5 per cent markup policy. But this was not established in a completely arbitrary way. A study was made of actual over-the-counter experience. The clustering of actual markups was examined and the 5 per cent figure was established as one which pretty much reflected what most people were doing.²¹ Another example is the 9 per cent ceiling on contractual plan loads set forth in the 1940 Act. While this specific ceiling was limited to contractual plans, it has in fact provided a ceiling for all fund loads. People have been unwilling to go above this figure for fear the Commission would consider any higher amount to infringe the statutory provision against basic sales loads that are "grossly excessive."²² I don't recall the precise statutory history on this, but it is my recollection that the 9 per cent figure represented pretty much the upper level of a clustering of actual basic sales loads, if not of total contractual plan loads and charges.

What bothers me about use of a wholly arbitrary figure is that it cannot be analyzed in terms of objective standards. How does one write the brief for the Commission that says that 5 rather than 6 per cent is right; or for the fund that says that 6 rather than 5 per cent is right? What are the standards to guide judgment? I can't find the answer. When we discuss management fees, we can base our determinations on comparisons with fees charged to other funds or to pension funds or in other contexts. We can argue rationally about what situations are comparable or not comparable, what adjustments have to be made, and so forth. We can base our determinations on objective grounds. But here admittedly we are dealing with a figure that has not been determined, or at least has not been sup-

²⁰ Securities & Exchange Comm'n, *Investment Trusts and Investment Companies*, H.R. Doc. No. 279, 76th Cong., Pt. 3, 826-27 (1939).

²¹ See NATIONAL ASSOCIATION OF SECURITIES DEALERS, *MANUAL* ¶2154 (CCH 1967).

²² Investment Company Act §22(b)-(c), 54 Stat. 823 (1940), 15 U.S.C. §80 (a)-22(b)-(c) (1964).

ported in the report, by reference to objective standards. If 5 per cent is better than 9.3 per cent today, what is to prevent the Commission from deciding tomorrow that 1 per cent is better than 5 per cent? What standards are being applied?

I'm not worried just about the 5 per cent. I'm also worried about the scale-down, because, as I read this report, it says that the Commission wants to have rule-making power governing volume discounts for basic fund sales loads.

Well, what's going to happen when the Commission tells a fund: "You've got to have a volume discount." And the fund says: "What kind? Where? How much?"

The Commission may reply: "Well, we guess maybe the scale ought to be like this one." And it hands out a scale, and the fund says: "Why this? Why do we have to cut down our load to 4½ per cent at \$1,000, and 4 per cent at \$2,000,"—or whatever the figure is going to be—"Why?"

And if we can't get a reason for that, we are now in an area where everything is utterly arbitrary, and I would find this very difficult to live with.

The net result for me, therefore, is that I have trouble with the Commission's proposal.

I would like to see some more effective promotion of no-load funds, closed-end funds and load funds, if that's possible; I may be naive in my feeling that better advertising will foster it, but I would rather work in that area than get the Commission involved in making these very arbitrary decisions where the results aren't defended by reference to objective standards.

That's my problem.

PROFESSOR MUNDHEIM: I think we ought to give Dick or Phil an opportunity to try to help Gordon solve his problem.

Justification for the Five Per Cent Maximum Sales Load

MR. PHILLIPS: Well, I think that Gordon, as an attorney, and mutual fund underwriters and dealers, as businessmen, solve these problems every day. When they decide to set a sales load at 8½ rather than 7½ per cent, they have no mathematical formula that tells them: this is "the correct" sales load. They reach a judgment, and they reach it on the basis of as many facts as they can possibly get. But essentially it's a judgment.

When Congress in 1940 established the 9 per cent sales load limitation for contractual plans, and when the industry supported that decision, there was no slide rule formula demonstrating that it was

“the correct” limitation. That was a judgment, a judgment made on the basis of facts before them, a judgment that was not necessarily right, but one they believed was right. When they enacted it into law they took a step forward in protecting investors from unreasonably high sales loads.

The step we are suggesting here was arrived at by the same method, and, I think, on the basis of more facts than has been suggested.

MR. LOOMIS: Could I say something too?

PROFESSOR MUNDHEIM: Yes, surely.

MR. LOOMIS: In the first place, I don't agree with Gordon that the 5 per cent figure is as unsupported as he suggests. It was based on a comparison with the sales compensation prevailing elsewhere in the securities markets, with a judgment that the sales load for mutual funds should be higher than prevails elsewhere, substantially higher, but not way, way out of line.

In the second place, I think that Gordon somewhat misinterprets the question which Bob read. The man who asked it appeared to be of the view that because he is with an efficient firm having a diversified product line, he can operate profitably on the 5 per cent figure. In fact, it won't hurt him at all—which, I think, tends to detract from the argument that this will have a devastating over-all effect on the level of mutual fund sales or on the public interest. That indicates that this is a figure that an efficient firm is satisfied that it can live with.

The Special Study's report on mutual fund selling not only turned up some practices which it regarded as contrary to the interests of investors, but also showed that the operation was essentially inefficient.²³ The reduction in sales load will have an impact there. I am not inclined to believe that this will have a major effect on the public interest over all.

There is authority in the Commission to vary sales loads. Gordon, I think, raises an imaginary spectre when he thinks that the break points will come out of thin air. The industry has had break points for years.

MR. HENDERSON: Would you say that they have been at points which are effective?

MR. LOOMIS: We do feel that in most instances, although not all instances, they are too high, but we can do just what you said was done in connection with the 5 per cent policy, and elsewhere: build on the existing pattern and practice, cutting off what seemed to be excrescences, just as was done when the 9 per cent limit was set.

²³ See generally *SEC Special Study of Markets*, Pt. 4, ch. XI, 102-39.

And as Dick says, if we find that there is an impact, as some suggest, on small dealers out in the country which is different from that on the metropolitan dealers, the rules could take that into account as well. But the basic object is to reduce the sales loads to a point where they are more nearly compatible with the sales compensation that prevails in other areas, while still recognizing that they must be higher.

Impact of the Five Per Cent Maximum Sales Load on Non-NYSE Firms

PROFESSOR MUNDHEIM: I thought the question implied an additional point. The reason that this New York member firm was going to be able to compete better with a 5 per cent sales load is that its compensation package is higher net than that of most nonmember firms. In other words, in addition to its share of the 5 per cent sales load, it gets perhaps 3 per cent for reciprocal business, which Ray Grant's firm perhaps doesn't get, and perhaps Bob Loeffler's sales force doesn't get. When you look at the sales compensation picture, don't you have to look at everything that goes to make up sales compensation—sales load plus whatever money is in the reciprocal business end of it?

Ray, isn't that why a reduction of the sales load to 5 per cent would hurt you more than it might hurt somebody else?

MR. GRANT: Yes, and it isn't a question of being more or less efficient in our operation than anybody else. It resolves itself down to how many products we plan to sell.

If we are in the mutual fund business, and we stick to that business, then we have to look to our compensation from the structure of that business. What was suggested in that question, as I interpreted it, was not that the questioner's firm had a more efficient operation, but that he could then proselytize all of my salesmen to do whatever other business he happened to be handling at the same time. I can see our men drifting into life insurance and conglomerate financial corporations, probably getting into all kinds of allied financial intangible selling. That, I think, is the main thrust of that particular letter.

I would like to make two comments while I have the microphone. First of all, I think that Mr. Shipman and Dr. Friend made the point that there are alternatives, and particularly Dr. Friend pointed out that it was ignorance in some regard that kept people from electing the other alternatives. I take issue with that.

I don't think that it's a matter of ignorance. I think it's a matter of, going back to my own argument, which the facts of life reveal to us, that people just don't do things by themselves. They may know all about no-load funds; they may know all about closed-end funds; and they do nothing about them. My point is that they have no real alternatives; that if they decide to get into the market with modest amounts of money, the chances are more likely that they will buy some low-priced over-the-counter security, and probably get killed in the process; that these are the experiences that we have with people of modest means, when they seek other alternatives.

The comparison that Mr. Shipman makes with closed-end funds, I think, is altogether unrealistic. A closed-end fund is nothing more to me than just another security. What is selling at a discount today may very well be selling at a greater discount two years from today. It's no different, in my opinion, than a well-diversified company that has engaged in a series of acquisitions, so that it's in eighteen different businesses, and it's just another security, subject to price movements that depend to a large extent on public popularity. It is in no way comparable to a long-term investment program in mutual funds that, if properly sold and properly explained by salesmen, will be continued by purchasers as an existing program possibly for the duration of their lives, or until they reach the objective for which the program was purchased.

INDUSTRY VIEWS ON THE SALES LOAD

MR. ANDERSON: It's a strange thing to me that the facts that are available don't seem to be given any credit. I happen to have the actual figures in the case of Distributors Group's sales of our fund, and the average sales charge—the effective rate paid—declined 15 per cent in the ten years from 1955-65.

If we throw in the amount of money that also was invested in the fund through reinvested dividends, the decline is 20.6 per cent. If I exclude the accumulation plan sales from these figures, the decline in the ten-year period has been 21.3 per cent.

Now, I don't know whether this was competition or magnanimity or good business judgment, because I'll also confess to you that at these lower rates Distributors Group made more money, and I think that's perfect.

Adequate Compensation at the Retail Level

On the need for adequate compensation for the retailer, look at closed-end funds. They have been in business a long time. They

are good funds. They are well managed. They trade for a commission, but they continue to sell at a very substantial discount because the commission is inadequate for an investment which tends to be held rather than traded.

One more comment. Yesterday there was a lot of conversation about management fees. Mr. Phillips scared the hell out of me this morning when he commented that 5 per cent was fairer than 9 per cent. I take that back to yesterday's conversation, when we talked about "fairness."²⁴

Mr. Phillips also talked about the comparability of fund shares to other securities. Only through a fund can the investor be assured of what I call the attributes of equity investing—that is, the purchase of a cross-section of securities under supervision. That is what you get when you buy a fund. There isn't a single stock that anybody today can pick out with any assurance which ten years from now, or five, or any other reasonable period, will share in the long-term growth of the economy.

MR. LOEFFLER: To come back to the adequacy of the compensation for the retail effort, let me approach it from the point of view of a businessman who must operate from specific statistical data.

I can only describe IDS from that standpoint, because it's the only company on which I have data. IDS distributes only through its own sales force. It has a force of four thousand sales representatives who are full-time sales representatives of IDS, engaged only in that employment. That's their only means of livelihood.

IDS does not subsidize the distribution of securities out of the management fee. It doesn't subsidize the distribution of the securities by using fund portfolio brokerage. So the distribution system is supported and must be supported, only from the sales load—from distribution income.

Considering the total distribution income, I should point out that our investors obtain, in addition, free automatic reinvestment of income dividends and capital gain distributions, and free transfer from one fund to another, if their investment objectives change. If you take the money invested by all methods and divide it by the gross distribution income of IDS, you come out with an average sales load of 4.37% per share.

IDS starts its sales load at eight, and graduates it down to one percent for sales of \$700,000 or more; when it's all totalled up, this is what is available to support the distribution cost. I don't know whether they have ever made one of those sales of \$700,000 or more.

²⁴ See text at p. 760 *supra*.

I suppose I would know about it, if for no other reason than from seeing the red flags wave outside the office of the Vice President of Sales.

The average income of the IDS sales representative is \$8,077, or was for the year 1966. This was what was available for the average man to support himself and his family. So when we talk about decreasing the amount of the cost, we are talking about: is this too much for this man to earn?

Let me say that there is very little profit in the distribution. It's self-supporting, but barely, and I think this is true for a lot of companies.

The Realities in Reducing the Sales Load

Now, in terms of objectives, I would say that we do not differ from the Commission. IDS would love very much to bring down the eight per cent beginning figure. We'd dearly love to do so, even the sales force, because to the extent you incur resistance to the sale of mutual funds, they tell me, you do incur it from the sales load. In that sense the sales load is competitive, and I do differ with the idea that there is no competition. There is. You are competing for dollars with a lot of other alternative uses—and I mean investment uses—that the customer has for his money.

IDS has studied the sales load structure to see if there is any way that distribution can be done for less and has not yet come up with an answer. Now it's all very reassuring, if I say to our Vice President of Sales: Bill, don't worry. The lawyers at the Commission tell me to just have faith, because they have faith that if they impose a five percent limitation, you will be able to devise some ingenious plan by which you can support the sales force. I have told him that, but so far it hasn't given him any comfort at all.

Arriving at a Sales Load Rate

I think it's a pragmatic problem. The real question is: what is the right figure, then? We are told that the five percent figure is really not defensible. I was going to ask where it came from, but now I don't need to. The businessmen tell me the right figure is the eight per cent on down we're using, because that's what's needed to support the distribution cost. If that is the figure which is necessary to support the distribution cost, and that's what we are charging, I don't know where the problem is. Why is there a need for regulation? I think this can be demonstrated by many others on the basis of their own figures and experience.

PROFESSOR SHIPMAN: Gordon mentioned the nine per cent figure presently in the Investment Company Act, which is explicitly applicable only to completed contractual plans. Congress picked that figure at a time when the load on completed contractual plans tended to average 13.39 per cent. There, Congress saw the pre-existing figure, and had no hesitation in adopting a lower figure.

More generally, I think Gordon's remarks typify an attitude that we have heard today and yesterday—that if there is a problem and if the Commission does not have the perfect answer that can be defended by slide rule techniques as the perfect answer, we must do nothing. If society proceeded on that basis, we would not progress. Precise judgments simply cannot be made with slide rule accuracy in this area.

I note that the industry is not saying: we don't like the SEC proposals, and we support Dr. Friend's counterproposals. I am quite close to the line concerning his counterproposals. Perhaps the best answer is to introduce competition by giving full knowledge and comparative data to all investors in the prospectus, and by repealing section 22(d).

PROFESSORIAL VIEWS ON THE SALES LOAD

PROFESSOR MUNDHEIM: Irwin, I said I'd give you two minutes.

DR. FRIEND: I'll address myself rapidly to the comments made by several people here on the panel.

First, turning to Mr. Phillips, I find it a little surprising that, since the Commission's position has to be based on the absence of price competition, it does not address itself to the basic cause of that deficiency—the inability of investors to appraise the product they are buying. I must confess that I don't recall any discussion of this point in the report. If it is there, I did not see it.

Second, in view of the uncertainty, on which we all agree, attached to the implications of these different approaches to the problem, I would think that he would want to start with the mildest approach, the one which is addressed specifically to what I think we agree is the basic cause of the deficiency which exists—and then go on to more heroic measures if they turn out to be desirable. And I would find the repeal of section 22(d) much more economically justifiable, since it is addressed specifically to a deficiency that exists, and is not arbitrary.

Third, he mentioned that I implied the sales load should be used to moderate the flow of funds into the equity market. I did nothing of the sort. I simply implied that the Commission should be concerned not only with the investor welfare type of consideration that they usually look at, but also with the over-all social welfare. The Commission, at least in law, does have such a responsibility, though, I think, since it's basically run by lawyers, it does not pay adequate attention to the economic implications of its acts.

Incidentally, just to correct a factual misconception, it is not true that we don't have adequate data on turnover rates in mutual fund shares. We do have, and they are, as I recall, less than half of the turnover rates for the exchange securities as a whole.²⁵

Turning to Mr. Loomis' comments, I don't understand the basis for considering that a comparison of the selling charges of the funds and of non-fund shares is relevant, so long as, first, there is no exorbitant or non-competitive return which is being received from the selling operation—and this I think we all agree is true—and, second, there is no indication that mutual fund shareholders as a whole suffer as a result of the current operations of the system.

Turning next to some of the other comments. Mr. Henderson does not consider the sales charge a problem area. He never indicated—at least to me—why this was so. He did not seem to deny the fact that there is investor ignorance in this area, or that it is desirable, if possible, to lower selling costs. Although he said that he thought investors are always free to buy no-load funds, I don't really think, and I wonder whether he thinks, that's realistic in terms of the state of investor knowledge.

I might refer to a Wharton School Study both in reply to this comment by Mr. Henderson and in reply to a comment by Mr. Grant that there is not as much ignorance as I thought, or was implying, on the part of investors as to alternatives. This study, which I consider a pretty good one, does indicate, on the basis of a fairly comprehensive sample of investors, that investor knowledge of alternatives open to them is pretty low.²⁵

Moreover, in connection with Mr. Henderson's comments, I didn't hear a single argument which really applied to either of my two suggested alternatives. He only opposed the five per cent sales maximum, which I also don't like.

Further, in connection with Mr. Grant's comments, again I don't know that he has said anything which would take issue with my two

²⁵ *SEC Special Study of Markets*, Pt. 4, ch. XI, 144.

suggested alternatives, particularly the full disclosure alternative. Even if he is right that investors aren't as ignorant as I think they are—and as I said, there is some factual basis for my disagreement with him—I don't see what harm results from adopting my suggested full-disclosure alternative.

Finally, Mr. Loeffler said that he feels it's necessary to look at the figures to determine whether persons "engaged in the distribution process" are making exorbitant profits, and if they are not what is the issue all about? Clearly, salesmen have to be paid to sell; underwriters have to be paid to wholesale the shares. I think that rather misses the point.

It has already been granted several times this morning that at the selling end no one is making exorbitant profits; but the point, rather, is that clearly you can fix sales charges at different levels, and if you want to pay a twenty per cent sales commission, you probably could sell a lot more. No one is going to be getting an exorbitant profit, but the economy might be a lot worse off as a result. The fact that there are not exorbitant profits is not really relevant to this issue.

THE CONTRACTUAL PLAN METHOD OF FINANCING FUND SHARE SALES

PROFESSOR MUNDHEIM: I know that all of you have more comments to make in this area, but we must move on. I would like to direct your attention now to the Commission's recommendations in the contractual plan area.

I would like Dick Phillips to begin by explaining the Commission's recommendations.

THE COMMISSION'S POSITION

MR. PHILLIPS: At the outset I think it ought to be made clear that the Commission did not recommend the abolition of the contractual plan itself—by that I mean abolition of the custodial arrangement and the custodial fee which pays administrative expenses for handling small investments, for sending reminder notices, and for various other features of the contractual plan. The Commission recommended the abolition of the front-end load by amending the provisions of the Act which allow up to 50 per cent of the investor's first year's payments to be deducted as sales load based on the entire amount that would be invested if the investor completes the plan.²⁶

²⁶ Investment Company Act §27(a)(2), 54 Stat. 829 (1940), 15 U.S.C. §80(a)-27(a)(2) (1964).

The Effect of the Front-End Load

Now, a contractual plan investor who in fact does complete his plan pays no more sales load than the voluntary plan purchaser, but the effect of the front-end load on the first year's payments is a dramatic one. Compare a contractual plan holder with a voluntary plan holder, both of whom seek to accumulate \$6,000 in fund shares by paying \$50 a month for ten years. They would both pay a total sales load of \$510 on their \$6,000 investment in a fund with an 8.5 per cent load. On the voluntary plan, where the sales load is deducted evenly from each payment, the load would amount to \$51 on the first year's payments of \$600. On a \$600 investment in a contractual plan, \$300 would be deducted for sales load in the first year, and a lower sales load deducted from subsequent payments. The effect of a front-end load is simply this: the investor pays, and the salesman receives, about six times more sales compensation on the first year's payments on a contractual plan than if the same amount had been invested through a voluntary plan.

The Commission's report, of course, points out that the front-end load has an impact on all contractual plan investors, whether or not they complete their plans. This is so because during the early years all contractual plan holders have less money at work for them than investors who have paid an equal amount under a voluntary plan. In our example of the \$6,000, ten-year plan, the voluntary plan purchaser would have \$549 invested from his first twelve payments totaling \$600. But the contractual plan holder would have only \$294 of the \$600 invested in fund shares, assuming a one per cent custodian's fee.²⁷

But the prime concern is the impact of the front-end load on contractual plan purchasers who do not complete their plans. Both the statistics of the Commission's Special Study and statistics developed from data submitted to the Commission by the Association of Mutual Fund Plan Sponsors make clear that a substantial proportion of investors in fact are in that category. The Special Study found that three-and-a-half years after the plans were purchased, over 35 per cent of the accounts surveyed had become inactive either because investors had redeemed or because they had made no payments for a period of at least one year.²⁸ Sixteen per cent of all plan holders had made no payments beyond the first year.²⁹ These people paid an effective sales load of 50 per cent on the amount invested. That's a sales charge of

²⁷ Custodian fees normally are not charged in connection with voluntary plans.

²⁸ *SEC Special Study of Markets*, Pt. 4, ch. XI, Table XI-e at 191.

²⁹ *Ibid.*

100 per cent on the amount actually invested in fund shares. For each dollar of fund shares they paid a dollar of sales load.

The data submitted by the Plan Sponsors showed the payment status of all contractual plan accounts opened ten or twelve years previously by four large contractual plan sponsors. It reveals that ten and twelve years after a plan has been opened, and at a time when the schedule provided for completion, from 25 per cent to 43 per cent of the accounts had made no payments beyond the first three years. About half of these accounts had not paid more than the first year's installments, on which the front-end load was deducted.³⁰

Rejected Justifications for Front-End Loads

In arriving at its recommendation, the Commission also had the benefit of an extensive rebuttal of the Special Study findings submitted by the Plan Sponsors, and the report discusses in some detail what the Commission considered to be the four main arguments raised in defense of the front-end load by the Plan Sponsors.³¹

The report considered—and rejected—the argument that the front-end load was a stimulus to systematic investing. This is not surprising, since the Plan Sponsors' own data indicated that ten to twelve years after the plans were initiated, less than one-half of the plan holders had finally completed them, and from one-third to three-fifths of the plan holders had made less than one-half of the scheduled payments.³²

The Report makes the point that the front-end load structure itself is a poorly designed stimulant to systematic investment, since one-half and sometimes as much as four-fifths of the total sales load to be paid on a completed plan is deducted from the first year's payments.³³ Thus the commissions available to salesmen as incentives to persuade their customers to continue payments after the first year are very small.

The Commission's report also rejected the argument that disclosures pertaining to the front-end load are an adequate protection for investors. The fact is that disclosure cannot be meaningful for the kind of decision that a contractual plan purchaser is forced to make when he enters a plan. He has to make a determination that for a period of ten or twelve or more years he'll have the willingness, the determination and the capacity to keep up the payments. Few investors enter into plans thinking that they will not complete them, but the high percentages of lapses and redemptions show that many of

³⁰ This data is still unavailable to the public.

³¹ *SEC Mutual Fund Report* 240-46.

³² See note 30 *supra*.

³³ *SEC Mutual Fund Report* 230.

them are not in a position to make a forecast of their future willingness and ability in a realistic way.

The Plan Sponsors also have defended the front-end load by arguing that only a few investors, including those who redeemed or lapsed in their payments at an early stage, have suffered a loss on their investment. During the period of generally rising price markets and during the period in which I believe only one or two funds showed a negative investment performance, the Plan Sponsors' own statistics showed that in two of the four plans, losses would have been incurred by 33 per cent and 44 per cent, respectively, of all account holders after ten or twelve years.³⁴ This is because of the front-end load, and for no other reason, since the underlying funds during this period showed appreciation.

Moreover, the Commission's report adopts the view expressed in the Special Study that traditionally in the securities business the reasonableness of a sales charge is not judged by the ultimate success or failure of the investment, but by the relationship of the sales charge to the amount invested. On this basis, there seems to be no justification for the sales loads, which can run as high as one hundred per cent of the amounts invested or higher, paid by a substantial portion of contractual plan holders who in fact do not complete their plans.

The Plan Sponsors basically argue that the front-end load is a necessary incentive if small investors are to be provided with opportunities for fund investments. The Commission's report does not deny that abolition of the front-end load will have an effect upon the sales effort for contractual plans. The report questions, however, whether imposition of a front-end load is a means which justifies the objective of selling efforts in connection with contractual plans.

The report, of course, realizes that salesmen of insurance, for example, are also compensated by a front-end load. It doesn't believe, however, that insurance commission arrangements are an appropriate basis for evaluating sales charges for the relatively high-risk merchandise of securities. To the extent that those who buy insurance pay a front-end load, they do so to get death protection, and regardless of the sales load, they get the full amount of that protection from the time they make their payment. People buy contractual plans primarily to invest in securities, but because of the front-end load they achieve only a small portion of their objective at the time they make their first payment.

The basic issue here, I think is this: should sales to small investors be financed by imposing a substantial risk, in addition to the normal

³⁴ See note 30 *supra*.

investment risks, on that class of investors who can least afford to assume it? Should the substantial proportion—perhaps not a majority, but a substantial minority—of the investors who do not complete their plans and who pay sales loads of more than 25 cents, 50 cents, and one dollar on every dollar that they actually invest in securities—should they finance the selling efforts of the contractual plan industry? The Commission believes not.

PROFESSOR MUNDHEIM: Did I hear the beginning of faint applause?

MR. HENDERSON: That was a pin dropping.

PROFESSOR MUNDHEIM: Mr. Roach?

THE ADVANTAGES OF THE CONTRACTUAL PLAN

MR. CORNELIUS ROACH: As the growth of contractual plans has attracted attention, there has been an increased volume of comment about them, and seemingly without examination, analysis or serious thought, many commentators and some regulators have automatically pegged contractual plans as just another security, have assigned them to the securities business, and have undertaken to judge and value them and their offering by tests and standards generally applied to listed and over-the-counter securities. Now, this assignment is clearly erroneous.

While contractual plans are, by legal definition, "securities," those who offer them are primarily engaged in the thrift business. The plans they offer are long-term plans of accumulation involving numerous payments of relatively small sums of money and competitive with thrift plans offered by commercial banks, savings banks, savings and loan associations, building and loan associations and life insurance companies. Thrift plans have only superficial similarity to listed and over-the-counter securities.

General Benefits

These plans have been described as complex. They are that, and something more. They can very properly be described as sophisticated plans for ordinary people. To support this thesis I'm going to review the elements of a contractual plan.

First, they provide for the investment of relatively small sums of money.

They provide for regular investments over terms of years.

They provide broad diversification in selected securities.

They provide continuous professional investment management of the underlying portfolio.

They provide for the compounding of shares through the automatic reinvestment of all dividends and distributions without additional sales costs.

They provide for the application of the principle of dollar-cost-averaging, which results in a better-than-average cost position.

They provide opportunity for participation, through equity investing, in the average annual growth and productivity of American business and industry, amounting to some 2 to 3 per cent per year.

They provide opportunity for participation through equity investment in the average annual increase in market value of equities brought about by inflationary pressures.

They provide flexibility, in that payments may be regular, accelerated or postponed, all without penalty, and do not lapse in the sense that a life insurance contract may lapse.

They are redeemable at full value on any market day, with no waiting for a quarter-annual or semi-annual date or a buyer.

They may be used as collateral for borrowing.

At the end of the line, whenever the plan holder desires, he may liquidate or convert his plan to shares which he may liquidate wholly or partially as his needs require. If his investment has totaled \$10,000—and some require less—or has become worth that amount, he may establish an automatic withdrawal plan of X number of dollars or the liquidation of X number of shares, payable monthly. His accumulation plan has become an annuity funded by equities.

Now, add to this the fact that since the plans are securities by definition, there has been full disclosure to the investor of the sales charge, the amounts and manner in which it is to be deducted and disclosure of all other costs and pertinent facts.

Features Peculiar to Contractual Plans

In addition, there are special features peculiar to contractual plans. These provide a definite investment goal of an amount certain; for example, \$2,000 or \$5,000.

By reason of the front-end sales charge, these plans provide motivation, or, if you prefer, discipline and encouragement designed to promote persistence, which is vital to the success of any long-term thrift program. In the make-up of these plans there is the short-term goal to get the substantial part of the sales charge paid and out of the way, and the long-term goal to be achieved at relatively small current cost.

With these plans there is available low-cost completion life insurance in forty-two states.

Most plans also provide that, if needed or desired, the plan holder

may liquidate up to 90 per cent of the current value of his plan and later replace his investment without sales cost.

There is also the fact that sponsors accounting for some 70 per cent of the total contractual plan business—that is, members of the Mutual Fund Plan Sponsors Association—give each new plan holder thirty days to examine his plan—and himself—and decide whether to request his money back or keep his plan.

There is also the fact that, because of the front-end sales charge, these plans are more apt to bring a salesman to explain and instill confidence in the favorable results that can reasonably be expected from an investment in American business and industry over a long term of years.

When these elements and features are considered, the contractual plan becomes something quite different from a share of stock purchased for cash on a stock exchange or over-the-counter, and takes on the characteristics of a ten-, fifteen-, or twenty-year endowment contract, a savings program offered by life insurance companies, from which the sales charge structure of contractual plans was borrowed.

The Performance of Contractual Plans

Anyone offering a long-term plan of accumulation—that is, a thrift plan—is in truth and in fact offering end results. And anyone buying a thrift plan is in reality, hopefully, buying end results. Contractual plans have produced and are producing splendid end results.

On a hypothetical basis, the summary results of a \$2500 plan offered by one sponsor for every ten-year period from 1941-1950 to 1956-1965 produced total liquidating values at the end of each such ten-year period—and there were sixteen of such periods—varying from a low end result of \$4,282 to a high end result of \$7,441. For purposes of comparison, an equivalent investment at fixed interest of 4 per cent, compounded quarterly, would have produced \$3,722.

Here is my own experience. On March 23, 1950, I began the purchase of a series of six contractual plans aggregating \$17,500 face amount, with all payments completed on June 11, 1959. These six plans, on which over the nine-year period I paid a total of \$17,500, were, on January 20, 1967, worth in the aggregate \$54,429.

Now, in connection with that series of plans there were 103 payments, and our principal accounting officer tells me that each one of those payments involved thirty-six operations, so that over the life of those plans 3700 operations were involved in servicing those plans.

My experience is not isolated. I have here the record of all the plans sold by one sponsor in the year 1956, and I am looking at the record of where those plans stood at August 31, 1966, ten years later.

In 1956, this sponsor sold 15,203 plans, of which 385 were converted to shares, leaving 14,818 plans. Of these, 7,682 plans were still open on August 31, 1966, and on these 7,682 plans \$22.8 million had been paid, and the plans had become worth \$39.5 million, a gain of \$16.7 million.

Five thousand one hundred sixty-seven of these plans had been liquidated with a gain. On these plans \$14.1 million had been paid, and on liquidation \$20.1 million was realized, a gain of \$6 million.

The remaining 1969 plans had been discontinued by liquidation at a loss. On these plans \$2.177 million had been paid, and they had been liquidated for \$1.895 million, a loss of \$282,000.

So here we have a gain of \$22.8 million achieved or realized by 86.7 per cent of the total number of plan holders, against the loss of \$282,000 taken by 13.3 per cent of the total number. Other sponsors have comparable or superior records.

Now, our research discloses that less than one-half of those liquidating with losses in the early stages were forced to do so by need or emergency. The majority exercise a free choice, with the most frequent reason being simply a change of investment objective. In subscribing to his plan, each plan holder has the opportunity to test his ability to carry out a long-term investment objective. It's perfectly clear that in making that test each risks a relatively small sum of money.

It is significant that the record here reveals that every plan holder who used his plan or gave it time to work for him achieved a gain. The ultimate fact is that every single plan holder included in this record had an opportunity to achieve good investment results. Those that did not were prevented from doing so only by terminating their plans before they had had a chance to do so.

These plans do produce satisfactory end results, and, as long as our economy maintains its present course, can reasonably be expected to continue to produce good end results.

The Typical Contractual Plan Purchaser

Now, who buys contractual plans? The most recent survey of mutual fund plan shareholders is dated January, 1966 and was conducted by Benson & Benson for the Investment Company Institute. It presents the following findings with regard to contractual plan holders.³⁵

Their median age is 43.1.

³⁵ INVESTMENT COMPANY INSTITUTE, *THE MUTUAL FUND SHAREHOLDER* 3, 5 (1966).

Their occupations are: professional, 27.5 per cent; executive and administrative, 21.7 per cent; clerical and sales, 12.1 per cent; skilled and semi-skilled, 21.2 per cent; housewives, 1.2; retired, 2.1. Others, 14.2.

The median yearly family income is \$11,100. The median value of mutual fund holdings is \$2,485. The median life insurance held is \$13,050. The median bank account and U.S. Savings Bonds is \$2,055. The median value of the home lived in is \$17,000.

The contractual plan holder, then, is mature, is likely to be in the professional, executive, administrative, clerical or sales classification, has a substantial annual family income, has substantial life insurance in force, has some \$2,000 in quick assets, and lives in a home valued at some \$17,000.

It is a matter of particular interest and significance that the professions represent the highest percentage of the occupations which have bought contractual plans. Although relatively few in number as a class, the professions represent education, experience, intelligence and judgment, and it is a source of satisfaction and some pride that the professions have by their purchases evidenced their approval of contractual plans.

By the same token, the growing use of contractual plans is really a compliment to the members of the Securities and Exchange Commission and its staff, the representatives of industry, and the members of Congress who in 1940 cooperated to formulate the make-up and mechanics of these plans. Their combined effort produced a prudent, effective and rewarding thrift plan, an endowment plan funded by equities, which fits admirably the economy of our times and the needs of the provident and ambitious members of our society.

PROFESSOR MUNDHEIM: In listening to the comments of both Dick Phillips and Cornelius Roach, it strikes me that one thing we might probe a little bit more deeply is that part of the Commission's analysis which relates to the large number of people who started contractual plans but did not carry them through, and thus incurred the penalty of the higher load.

I know that some people find this the most disturbing aspect of the analysis of contractual plan sales. I know that Ray Grant has been concerned about this finding. Would you comment on how one might meet that deficiency?

AN INDUSTRY RESPONSE TO THE COMMISSION CRITICISMS

MR. GRANT: I think the industry owes a debt of gratitude to the Special Study because it brought some of these deficiencies to our

attention. I can only tell you what we did about these deficiencies, in the hope that our response might be one part of the answer.

Self-Regulation by the Industry

One of the things which I found deficient in the report was that there was really no followup of what has happened to the contractual plan business since 1963, when the Special Study was first published. Actually, responsible members of the industry took this report very seriously, and stepped back from their own businesses to take a look at what was going on. The finding that thirty-five per cent of our customers, if the figures are accurate, were paying sales loads of between eighteen and fifty per cent, gave us some reason to question our own activities.

I know what we did, and I know that what we did was not unusual in the industry because many others did the same. We took a good look at our sales organization. We restructured it. We prepared for much tighter supervisory procedures. We beefed up our legal staff, and placed them in charge of establishing supervisory procedures, and, in fact, reviewing transactions on a daily basis.

We tightened our recruiting requirements. We tightened our training and supervisory requirements. And, quite frankly, we dismissed about 2,000 sales representatives from our organization, on the theory that they were not devoting sufficient time to properly following up and servicing their clients. We were not terribly interested in retaining people who made an occasional sale, and then didn't do anything but collect commissions.

In addition, we have established certain procedures for obtaining records from our custodian bank that indicate to us exactly how effective these measures are. The figures developed by the bank indicated those accounts which were delinquent and there were followups on those accounts to find out why they were delinquent.

Although the period is too short to determine how effective we have been, I would like to give you the figures. For the seventeen-month period from August 1, 1965 to the end of 1966, we had a 3.3 per cent delinquency rate, based upon the following definition of delinquency, which is somewhat different from the one used by the Special Study. Bearing in mind the flexibility of the contractual plan itself which allows for accelerations and decelerations in payment, we consider an account delinquent which is twenty-five per cent behind in scheduled payments, and in which no payment has been made within the last three months.

Now, that's arbitrary. I don't know whether it signifies anything. I think that over a long term it certainly will be significant, although in seventeen months it's relatively inconclusive.

But we think that the answer here is to tighten supervision. You know that the salesman has an economic interest in the first year of activities. You know that the firm has a more significant interest in the trail than in the first year's activities. These seem to be adverse interests, but if you set the ground rules tight enough, with enough muscle behind them to force your sales staff, under threats of termination, to follow up on delinquent accounts, you may have an answer.

You may also have an answer in the sense that they will qualify their customers much more carefully.

At least this is the attempt that we have made and are making. I would have hoped that between the time the Special Study was published and the time this report was written, the Commission would have had the opportunity to take another look at the impact of their own Special Study, which I don't think they fully recognized. The industry was trying in every way to upgrade its standards and upgrade its people, so that its customers would not be hurt. It doesn't help the customer, it doesn't help the salesmen, and it surely doesn't help the firm to have delinquent accounts.

Compensation of Contractual Plan Salesmen

I don't know whether this is the time, but if I have one more minute I would like to put this problem into arithmetical terms. Under our schedules, if we had a good salesman—a full-time salesman—who went out and devoted forty hours a week and did a well-supervised job and was able to sell ten \$50 monthly programs per month, with an initial payment of \$100 on each program, which is a double payment, based on ten-year volume—such a man would be placing, under our arithmetic, \$60,000 per month face amount of plans on the books. On the twelve-and-a-half-year programs he would be placing, on a regular basis, \$75,000 per month face amount of plans on the books. This kind of man is exceptional in our industry. He would be very, very good for any firm.

Under present standards he would have made gross commissions of \$12,375 during the year, against which he would have had to pay all the expenses I delineated previously. He might net out about \$10,000 in his first year on that basis.

Under the proposed legislation this same man, with a maximum sales charge of 4.76 per cent, which would permit him about a 2½ per cent commission, if he sold ten \$50 a month plans with a double initial payment, assuming full persistency in all of his programs, would earn

\$25 in his first month. By the twelfth month he would be earning at the rate of \$300 per month, and his total for the first year would have been gross commissions of \$1,800. I would ask: on what basis could we attract the kind of professional salesmen we are looking for and are asked to find in this business?

The question then logically is: so what? Mutual funds are not necessary for everybody, and perhaps some of the people we are selling shouldn't be buying them. What we are trying to arrive at, between the industry and the regulators, hopefully, is some way of bringing mutual funds to that vast segment of the American people for whom mutual funds in modest amounts on a monthly basis are suitable investments. There is a large, indefinable, amorphous group of Americans who have a good, steady wage, who have all the protection of hospitalization, medical programs and pensions for whom mutual funds in modest amounts are suitable.

My question is: how in the world can you make it economically possible for a good salesman to bring this mutual fund message on a voluntary program basis to such potential investors?

Just one last point. Proceeding on the theory that people do not buy funds—that they in fact are sold funds—which I know to be true, although apparently it's still a matter of dispute, I think we are faced with two options: one option is to keep something like the present structure—something like it, with a lot more tightening of controls in terms of supervision, qualification, suitability and whatever else the industry can really absorb; the alternative option is preclude this group from equity investments in mutual funds, because there will be nobody who can possibly bring the story to them.

Another Type of Contractual Plan Financing

PROFESSOR MUNDHEIM: You raise the need to keep the front-end load as the only way adequately to finance the sales effort. I think we can turn very usefully to Bob Loeffler, because IDS, which is one of the most successful of the fund selling organizations, didn't have any kind of front-end load program for a long time. Then in the early sixties, when IDS began to explore this problem, it came out with a solution which is somewhat different from the kind of plan which is sold by your organization, Investors Planning Corporation.

I wonder, Bob, whether you can (a) briefly describe the IDS system, and (b) evaluate whether or not that kind of financing of salesmen's compensation has proven workable.

MR. LOEFFLER: The IDS plan was first made available for distribution and offered on October 1, 1965, so our experience with it to

date is limited by the fact that we have only been doing this for about eighteen months.

The IDS plan is relatively simple to distinguish from the others. It's often referred to as a spread load. Under the IDS contractual plan 20 per cent of the first year's payments are deducted as sales load, 18 per cent of the second year's payments, 18 per cent of the third year's payments, 7 per cent of the fourth year's payments, and thereafter it's 4.2 per cent of the remaining payments.

The plan goes for 12½ years, 150 monthly payments. The over-all sales charge, upon completion, would be 8 per cent.

Also the plan holder has the option to continue payments for another additional ten year period after the twelve-and-a-half-year period at a 4 per cent sales load. Thus, if the plan holder wished to continue the plan for the full period for which the option to do so is available, the average sales load for the full period would be 6.2 per cent.

If a plan holder wishes to continue investing after the initial 12½ year period, it is to his advantage to continue the plan because of the reduced load at that point.

In the approximately eighteen months that the plan has been offered, 58,251 plans have been sold with a total face amount of \$274 million.

The experience to date on redemptions, which I think is interesting, has been very much like that which Ray was describing under their new procedures. To date the termination rate on the plans—those where the customer has cancelled out and discontinued the payments, or where there has been a suspension of payments for over a period of time, or where the customer never made six consecutive payments—is 2.3 per cent of the plans. So the experience has been very favorable.

Also, the plan is limited to investments of no more than \$100 a month. The plan was devised to reach a market which IDS could not otherwise reach—the customer who does not have any accumulated funds for investment but who is in a position to make a small monthly payment and to accumulate funds in that way. Thus the plan is available at \$20 a month, and currently the average size of the monthly payment is \$31.26.

IDS has always had, and still has, a voluntary accumulation plan available, but it requires a minimum down payment of \$300 and a payment of \$50 a month thereafter. The contractual plan was designed primarily for customers not in a position to invest on this voluntary basis. If there is any indication that a customer is in a

position where the voluntary program would be more appropriate, under our new business acceptance procedures, our salesmen must obtain a written explanation of why a contractual plan rather than a voluntary plan was sold to the customer.

The persistency so far is much greater under the contractual plan than under the voluntary plans.

I think that I feel very much as Ray, in the sense that I think a large part of the solution of the problem with respect to contractual plans is in the sales procedures used to sell them. Contractual plans simply should not be sold to a person for whom they are not appropriate, and I think that it's a sales practice problem as much as—or more than—anything else.

In that context I would like to say that IDS in its sales policy has long had its own suitability requirement, which reads as follows:

Every effort must be made to understand the customer's personal and financial situation, so that the manager, or sales representative, will have reasonable grounds for believing that the investment plan is suitable for the customer and within his means.

This requirement is most important, particularly with respect to contractual plans.

I should say one other thing about our contractual plan. When I said it's limited to a maximum of \$100 a month, that requires explanation, since there are very few plans involving that large a monthly payment. Another provision of the plan is that it cannot be prepaid. We feel if a customer has enough money to prepay a plan, then he can make lump sum payments and doesn't need to go to the contractual route. Thus, there is another acceptance procedure on contractals: they cannot be prepaid in other than a limited amount until they have been in effect for three years. At that point, because the reduced load comes into effect, the plan holder does have the option of a complete pay-up, if he wishes.

THE IMPACT OF FORBIDDING THE FRONT-END LOAD

PROFESSOR MUNDHEIM: There is one additional point which a number of questions from the floor raise. If you forbid the front-end load, don't you, in effect, underwrite a movement of mutual fund salesmen into insurance selling where a front-end load is permitted. Such a trend gives an impetus to the sale of endowment policies, whole life policies and various forms of annuity contracts with the result that money now flowing into the equity markets may be re-directed into fixed return securities.

Sales Diversion

MR. LOEFFLER: I want to make one comment because of its particular appropriateness to IDS. The IDS sales representative offers life insurance and fixed income securities, so that these options are also available. Nevertheless, only a relatively small percentage of the total income of sales representatives comes from the sale of life insurance and fixed income securities.

PROFESSOR SHIPMAN: Bob, abolition of the front-end load might have the effect you suggested. But several points should be made.

First, insurance and mutual fund shares are not interchangeable. One accomplishes one thing, and the other accomplishes something else. Thus the salesman selling both, as at IDS, must take a rather careful look at the over-all situation and see that what he sells is appropriate to his customer's needs. Second, the Commission's recommendations would not limit custodians' fees. Also, to the extent that there is—to use this term, "persistency"—in a level load contractual plan, as compared with a front-end load contractual plan, the sales compensation over the life of the plan is the same; in those circumstances it's a question of paying the salesman a larger percentage at the beginning. The front-end load also creates suitability problems. There may have been some change in the industry, but at one point people were upset when suitability was mentioned; it was a rather nasty word. I am happy to hear two industry men here endorsing the concept. In my mind, the overriding consideration is the injustice of the higher-than-normal sales load—up to 50 per cent (or 100 per cent)—paid by the fellow who terminates or lapses.

PROFESSOR MUNDHEIM: Are you suggesting that the front-end load really is important only as a method of financing a salesman's compensation? Thus the larger organizations like IDS, IPC, and maybe some of the conglomerates will find it easier to work out something than a smaller retailer who won't be able to provide such financing. The large organizations can generate financing internally, particularly if they are confident about the rate of persistency of investment.

MR. LOEFFLER: Bob, I think we might send up a comment such as the one that came up from the New York Stock Exchange member this morning.³⁶

Elimination of the Front-End Contractual Plan

MR. ROACH: I might say that I wonder if there is a difference of understanding. There is no doubt in my mind but that the recom-

³⁶ See text at p. 794 *supra*.

mendation of the Special Study is to eliminate the front-end sales charge. And when you have eliminated that, you have eliminated the front-end contractual plan. Let there be no mistake about that.

I'm sure that the plans presently outstanding will continue, and I think that was the sense and intention of the Commission, but the elimination of the front-end sales charge certainly will eliminate the contractual plan as it is presently known.

MR. LOEFFLER: It would eliminate the IDS plan as well as all the others. There's no doubt about that.

MR. ROACH: Let me respond to the question as to where the salesmen would devote their efforts. I won't predict the future, but in December, the month in which the report was issued—we had our smallest plan month and our largest insurance month. (We are also in the insurance business.) That rather foretells what the future would bring if the contractual plan is eliminated.

PROFESSOR MUNDHEIM: Herb Anderson?

MR. ANDERSON: I simply would like to point out that the package, including the five per cent limitation, would not only eliminate the contractual or front-end plan, but also, in my opinion, would tend largely to eliminate the voluntary plan, because I can't conceive of a meaningful voluntary plan that would be able to be handled at a 5 or 4.7 per cent charge.

AN SEC REBUTTAL

PROFESSOR MUNDHEIM: Phil?

MR. LOOMIS: I first want to disagree slightly with Mr. Roach. Elimination of the front-end load doesn't mean necessarily that the essence of the accumulation plan is eliminated. There are alternatives, certain types of voluntary plans, and the IDS type plan, or some modification thereof, to offer to the investors all the services which Mr. Roach has outlined. The real problem is not making this thing available, but rather determining how the sales force is to be financed. The Commission's position was that it should not be financed by imposing what seemed to us an undue or unsupportable amount of risk on those plan holders who either misinterpreted, or didn't understand or were unable to predict their own financial desires and abilities in the future.

Now, I recognize—and that's the real problem here—that a salesman doesn't get very much under the level load plan—at the moment we are not talking about what the level load is to be—when he first makes a sale under this plan; and I would think that there

could be created in one way or another devices to deal with that problem and give the salesman a suitable initial payment without putting the risk of the financing on small investors.

I agree also with Morgan that if the plan holder persists and the salesman persists, the salesmen will ultimately get the same amount of compensation in both cases.

PROFESSOR MUNDHEIM: Your comment suggests, Phil, that perhaps the Commission's recommendation is broad enough to encompass some kind of stretched-out load? Is that what you meant when you said that something like Bob Loeffler's company's arrangement is possible?

MR. LOOMIS: No, the Commission's recommendation is for a level load plan. This, however, doesn't mean, for example, that the firm couldn't finance the salesman to some degree.

MR. LOEFFLER: I think, Bob, that is what I meant when I said that it might be appropriate for IDS, and perhaps Waddell & Reed, and maybe one or two others, to send up a nice "Thank you" note such as the member of the New York Stock Exchange sent up this morning.

FINANCING FUND SHARE SALES WITH RECIPROCAL BUSINESS

PROFESSOR MUNDHEIM: Perhaps now we ought to turn to some of the problems relating to reciprocal business. The phrase "reciprocal business," has received some rather sinister connotations in discussions in the last three or four years, but in its broadest aspects, reciprocal business describes a universal business phenomenon.

BACKGROUND

The Commission's analysis of reciprocal business practices in connection with the mutual fund industry tends to focus on sales reciprocal, the attempt to reward the seller of fund shares by allocating to him, directly or indirectly, some of the fund's portfolio business. The fund may place an order directly with the seller of mutual funds or may direct that a portion of the commission earned on the execution of a portfolio transaction be given, through one of an increasing number of routes, to the seller of fund shares.

Pressure for such sales reciprocals seems to be on the increase. What started out as a plea for investing the dollars brought into the fund portfolio, through the broker who was responsible for the inflow, has developed into a highly organized system, both from the point of view of the broker-dealer and from the point of view of the fund, designed to maximize the reward for selling efforts.

It is the pressures created by this highly organized system which seem to be causing the Commission its concern.

The Areas of Concern

Among the areas of concern which the Commission identified are:

(1) Execution of transactions in markets which may not be as favorable as other markets, either from the point of view of speed of execution or price, but which do have the advantage of providing better devices for making reciprocal business available.³⁷

(2) A disposition to have higher turnover of portfolio securities than may be dictated by investment considerations alone.³⁸

In addition, the willingness of brokers to give up a large proportion of the commission earned on the execution of mutual fund portfolio transactions has made the Commission wonder whether or not the public isn't becoming uneasy about the justification for charging a commission—I'm here talking about the New York Stock Exchange commission—which has so much apparent fat in it that brokers who have performed no service in connection with the execution of the transaction can be rewarded out of that commission.

The Beneficiaries of the Present System

One other aspect of reciprocal business practices also deserves mention, and it relates to the beneficiaries of the present system, and that's a point that I think we touched on, perhaps humorously, earlier this morning. One of the beneficiaries is, of course, the larger funds. They can use a larger portion of their portfolio business to reward sales efforts, and the greater volume of their business permits them to negotiate more favorable give-up ratios than the smaller funds. The second beneficiary of the present system is the New York Stock Exchange member firms. The reason for that is that it's just easier to get reciprocal business commissions to them than to those people who sell fund shares but are not members of the New York Stock Exchange. And, finally, there is also a beneficial effect to those markets which provide the best—I believe "gimmick" is the correct word—for wide distribution of reciprocal business commissions.

That, I think, is the background as we find it in Chapter IV of the report. Perhaps Phil will fill in whatever details he thinks would be appropriate, and then perhaps he can go on to explain how the problems which seem to be created in this area are met by the Commission's recommendations.

³⁷ SEC Mutual Fund Report 175-77.

³⁸ *Id.* at 174-75.

THE COMMISSION'S RECOMMENDATIONS

MR. LOOMIS: You have given a good outline of the problems which the Commission saw. It's necessary at the outset to draw a few distinctions.

In the first place, it has always been the practice for mutual funds and other persons having brokerage business to transact, to give that business to brokers who have conferred some benefit on them. This is what is meant by "reciprocal" business, and it is generally pervasive in the securities industry. The Commission took no steps to abolish it, except in so far as it takes forms which are designed to evade any prohibition which may be directed toward give-ups.

In the second place, it was always a practice, or it has been for a long time a practice on the New York Stock Exchange, for member firms to combine in various ways to perform the function of executing an order. In some cases, one firm may originate the order, and someone else may execute it, or a customer down in Florida may go into an office of a broker there and ask that broker to direct the order for execution to his own broker in New York.

Again the Commission has not proposed that where more than one broker plays a necessary part in the execution of an order, the commission should not be divided. I emphasize the "necessary." We do not propose, if the typical give-up which we are objecting to ceases to exist, that it be replaced by paperwork which serves no useful purpose and increases the cost of executing transactions, merely to provide a substitute.

Customer-Directed Cash Give-Ups

Finally, there is the customer directed cash give-up, which is part of the problem. This is a more recent phenomenon, and involves the situation where a broker executing for a mutual fund is directed by the fund to parcel out portions of his commission, sometimes up to 60 per cent, to brokers named by the fund who had nothing to do with the transaction, but have furnished some service to the fund—ordinarily, the sale of fund shares. This has become a highly organized procedure, with schedules made up by principal underwriters, with careful records kept as to just who is entitled to what, and the regular payment of the amounts, which are treated as practically an obligation, and are ordinarily proportional to sales.

There are further refinements which the industry itself finds objectionable. For example, there is the one-shot promotion where a large amount of brokerage is directed to particular brokers so that they can reward the man who sells the most Fund *A* shares during a

particular period. This is the sales contest. Also, cash give-ups are directed through brokers to particular salesmen.

There are several problems with this to which Bob has alluded. Beyond that, I guess I better get into another refinement. So far, I have just dealt with the New York Stock Exchange, where probably a predominance of mutual fund transactions are executed. But not all dealers who sell mutual funds are members of the New York Stock Exchange. Consequently various—what Bob referred to as “gimmicks”—have developed, which are designed to get some of this brokerage out to non-member firms.

Use of the Regional Exchange to Direct Give-Ups

The development is a rather interesting one. There have been a number of non-member firms which were skillful in executing bloc transactions as brokers, normally by finding both sides of the deal, by knowing what securities institutional investors, mutual funds and others might have an interest in buying or selling, and utilizing that knowledge to place or to obtain securities that institutions want in large blocs. This was a useful and an inexpensive service. They found, however, that the mutual funds didn't particularly want it, and that in order to survive competitively they would have to join a regional exchange, which allowed the passage of give-ups to all members of the NASD or to other people who are on a preferred list; and so they joined regional exchanges, in effect raised their charges and distributed give-ups. Mutual funds liked it better that way.

The regional exchanges saw that this was an opportunity, and in recent years there has been a sort of race of diligence among the various regional exchanges, particularly the smaller ones, to facilitate the distribution of give-ups. On some exchanges, particularly some of the very smallest, where there really isn't any auction market, all that happens is that the broker or brokers who have found both sides of the deal just telephone it out to somebody in an outlying exchange, and it is crossed there, and give-ups are distributed. The whole mechanism is completely non-functional, so to speak, in so far as the execution of the customers' orders is concerned.

Bob has outlined some of the difficulties which the Commission found with this situation, which may interfere with the best execution of customers' orders. It creates an incentive to unnecessary turnover. You can't prove whether that temptation is yielded to, in most instances. It tends to favor the New York Stock Exchange member firms selling mutual fund shares over the non-members selling mutual fund shares, because of the gimmicks that have to be resorted to in order to compensate the latter type of person; and, as the New York Stock

Exchange has recently conceded, it raises questions concerning the integrity of the commission rate structure itself.

The essential justification for fixed minimum commission rates on exchanges is that brokers should be fairly compensated for their service in executing orders, and that customers should be treated equitably. The customer directed give-up isn't really consistent with either of these ideals. The broker doesn't receive the compensation which the structure designs for him—somebody else gets half of it or more—and the mutual funds themselves are not equitably treated in so far as their portfolio brokerage is utilized as additional sales compensation, although the portfolio transactions are for the benefit and are transactions of the fund, and not that of the underwriter or the manager.

Volume Discounts and the Abolition of the Give-Up

For these reasons the Commission has, as outlined in more detail in the report, requested the Exchange—the exchanges, really—to abolish the customer directed give-up.³⁹ The Commission does not need legislation to accomplish this purpose. It has power under section 19 of the Exchange Act to require changes in exchange rules with respect to commissions, by order, after an administrative proceeding;⁴⁰ but so far it has proceeded on the basis of discussions with the Exchanges, rather than by formal legal proceedings. I would hope that avenue could continue to be followed.

The New York Stock Exchange, as I say, in a statement released, I believe, within a week or ten days, has discussed this matter.⁴¹ It's a long and complex statement which is a little difficult to understand, and maybe I don't understand it fully, but it does seem to manifest a willingness to at least not fight too much against the abolition of the customer directed give-up.

Intertwined, related, but not the same as the customer directed give-up problem, is the problem of whether there should be a volume discount on the exchanges. Obviously, as Bob has pointed out, if an executing broker can give away 50 or 60 per cent of his commission on a large institutional order, this gives rise to an inference that perhaps the commission on that type of an order is higher than it needs to be to compensate that broker for his service; and if the customer directed give-up were abolished, there might develop a greater pressure for a volume discount on the part of mutual funds and others than now exists.

³⁹ *SEC Mutual Fund Report* 185-86.

⁴⁰ Securities Exchange Act of 1934, 48 Stat. 898, as amended, 15 U.S.C. § 78s (b) (9) (1964).

⁴¹ Letter From Keith Funston to the Exchange Community, Feb. 1, 1967.

On the other hand, the devising of a suitable, equitable, workable volume discount, and the consideration of its impact upon the financial position of member firms, is a task of considerable complexity, and it may be that the two problems don't have to be solved together as one ball of wax.

I should mention also the fact that the customer directed give-up is generally considered to be improper in the over-the-counter market, where there is no minimum commission structure, and the compensation to executing brokers or dealers is negotiable. The States, the Commission, and, I think, the industry generally, agree that customer directed give-ups in the over-the-counter market are an improper practice; give-ups there represent an obvious and unnecessary diversion of the fund's money to a purpose which is not necessary to the execution of the transaction.

However, there has developed more recently pressure for some devices to try to introduce give-ups on over-the-counter trades, in order that those funds which invest in over-the-counter securities might be on a par, in so far as their ability to give out sales compensation, with those firms who invest in listed securities. These devices, fortunately, have not progressed very far, though I suspect on the basis of what I have heard that there are probably more improper attempts to arrive at the equivalent of give-ups in over-the-counter transactions than come to our attention.

In any event, this problem is another discriminatory aspect, in that it gives the listed market an unfair advantage, it seems to us, or at least a competitive advantage unrelated to efficiency in the execution of orders, over the over-the-counter market, including the third market. These, then, are some of the problems we see.

THE OPERATION OF RECIPROCAL BUSINESS IN PORTFOLIO TRANSACTIONS

PROFESSOR MUNDHEIM: Before we explore how the Commission's proposals would work, let me ask Herb Anderson to explain how his fund, Group Securities, presently transacts its portfolio business and how it gets reciprocal business to the sellers of its shares; and then, Herb, after you have done that, perhaps you could explain how the Commission's proposal to prohibit give-ups would affect your fund's operation.

The Case for Industry Self-Regulation

MR. ANDERSON: Well, inasmuch as I have only fifteen minutes, I can't cover that. So I would like to make what I believe to be

general comments that are more basic, and we can get back to any detail or any specific point that may be of interest.

I have been puzzling about how to get this organized, and it occurred to me that someone had counted the words in the report, and came up with the figure of 210,000. That total increased to about $\frac{3}{4}$ million when the words in the Wharton Report were included; which is pertinent because of its tie-in, both by philosophy and by the many references to it in the other document. There are quite a few more words in the Special Study, which is rather extensively incorporated by reference in the report—to use a phrase of the legal profession, of which I'm not a member, and, I guess, the only one on the panel who is not.

While the chapter of the report with which I am now directly concerned consists of only forty-five pages, there is a great deal more which has been written and said in this area of portfolio transactions, the manner and cost of their execution and how, and by whom, they should be handled.

I take this much time out of my precious fifteen minutes to make clear that, much as I would like to go through the chapter and the other material point by point, this is not possible. Instead, I will speak to what seem to me to be rather key points underlying these proposals—or demands, as they have been called—relative to the execution of portfolio transactions by mutual funds, and presumably all other institutional accounts.

In the give-up letter of July 18 of last year, the statement was made that:

We [the SEC] have found a general recognition in the industry that the "give-up" practice in the exchange communities has developed to a point where it threatens the integrity of wide segments of the securities industry.⁴²

This is simply not so—yet the statement seems to be an important part of the base from which the later recommendations and conclusions are made.

As in any human endeavor, some things are done that can and should be criticized and corrected. Were these problem areas approached in the same manner as those applying to sales literature in 1950, the industry could and would have responded and, in my opinion, a sound result would have been achieved, as I think one was in the writing of the Statement of Policy.⁴³ As evidence of a

⁴² Letter From Irving M. Pollack, Director of Division of Trading & Markets, SEC to Securities Exchange Presidents, July 18, 1966.

⁴³ SEC Statement of Policy Regarding Investment Company Sales Literature, in NATIONAL ASSOCIATION OF SECURITIES DEALERS, MANUAL ¶ 5101 (CCH 1967).

desire by the great majority to conduct their business in the area of reciprocals and elsewhere, in accordance with high standards of commercial honor, I cite the adoption by the membership of the Investment Company Institute (I.C.I.) of the Guide to Business Standards in 1962.⁴⁴

But there is much more to this record. The I.C.I. has no power of enforcement; and, while this is not true, cynics might say that the Guide was no more than a self-serving statement of principles which were generally intended to be ignored.

The NASD does have a considerable amount of authority over its members—indeed, it administers enforcement of the Statement of Policy (in so far as its members are concerned), at its own expense and, in my opinion, more effectively than has been done otherwise with respect to nonmembers.

In the area of reciprocal business, the NASD has consistently and conscientiously tried for more than seven years to develop rules and interpretations which generally would have had at least the effect of enforcing on its members the principles of the Guide to Business Standards, but it has been thwarted in its efforts by an unwillingness on the part of the SEC to allow their adoption or, indeed, to discuss the NASD proposal.⁴⁵

So now, instead of the kind of discussion between industry and government which has had so much constructive value, a new philosophy seems to have emerged: let's not try to isolate and correct abuses; let's capitalize on these to achieve an intended purpose.

If these words seem harsh, I need only refer you to the "or else" suggestion in that part of the report dealing with reciprocal business which states that if the Commission's proposals are not adopted, perhaps it would be necessary to prohibit a retailer of fund shares from acting as broker for any fund whose shares it sells, or otherwise share in commissions arising from the fund's portfolio transactions.⁴⁶

Turning more directly to this business of give-ups, as long as there is anything in the amount charged for executing buy and sell orders above out-of-pocket costs, something is "given up," in effect, to someone. Someone receives this credit above actual cost. When it is not given up to another firm, it remains with the executing broker. When part of it is given up to another firm, nothing essentially different occurs. It is simply an acknowledgment of the fact that the person or firm who was responsible for getting the business in the first place is entitled to some compensation, even if he, or it, did not

⁴⁴ See *SEC Mutual Fund Report* 184.

⁴⁵ See *Id.* at 184 n.12 for a brief summary of NASD proposed amendments to its Rules of Fair Practice.

⁴⁶ *Id.* at 188.

actually execute the order on the floor of the exchange or physically assist in its clearance.

After more than thirty-seven years in this business, it seems strange to me that an investment company, whose function it is to manage the assets of its shareholders, should not execute its portfolio transactions, where possible, through qualified broker-dealers, from or through whom the assets were received in the first place. And, unless there is to be nothing left over above out-of-pocket costs for anyone, I see no reason for government to interfere through some artificial restriction on give-ups, with management handling this business in accordance with its best judgment.

So let's turn briefly to the amount of the commission and the question of quantity discounts. Here, first I must say that I doubt seriously if the price for anything we buy, in the nature of either goods or services, is ever exactly correct, except for the sheerest coincidence. The Stock Exchange commission on a single transaction of 100 shares is no exception. It probably is "too high" in some cases and "too low" in many others. But, as is said in a rather well-known commercial, "We must be doing something right."

To borrow another phrase, "people's capitalism" has flourished here to an extent that is the envy of the world. As a Canadian put it in discussing certain of their problems relative to the insufficient ownership by their people of companies operating in Canada, "Capitalism without capitalists is a rather tough thing to sell."

As a fund manager, I obviously am interested in lower costs. However, in my higher duty as a citizen, I am not in favor of changes which may be harmful to our way of life. I want the other person to get along, too.

Last year the total commissions paid by the fund with which I am identified amounted to 2.2 cents per fund share outstanding, on a weighted mean price of about \$12.60. I say this not to belittle even 2 cents a share over a twelve-month period, but rather to make the point that whatever savings may be involved are relatively immaterial in relation to the risk which significant reductions of cost to the larger and more profitable accounts may create for the health of a securities distribution system which is such an essential part of an economy on which much of the world has come to depend.

Actually, the facts seem to raise a question whether the generally satisfied mutual fund shareholder is the real cause of concern, or whether the point is simply that the profits of the securities business generally should be reduced—without, I might add, any evidence that the change is justified.

I'm sure some questions will be raised by this statement. I still haven't answered the specific question, which I would be glad to do at *any* time.

Recapture of Commissions Through Membership on a Regional Exchange

PROFESSOR MUNDHEIM: Fine. One of the statements you made reminded me of something that Bob Loeffler alluded to yesterday. He indicated that the management fee of the IDS sponsored funds had been reduced by the net profit earned on the commissions paid in the execution of portfolio transactions generated, directly or indirectly, by the funds. Perhaps, Bob, you can elaborate on how this arrangement works.

MR. LOEFFLER: IDS, as I mentioned earlier, distributes fund shares exclusively through its own sales force, so we have never used the give-up system for the purpose of supplementing income of dealers for sales of shares. We don't distribute through dealers. Nevertheless, IDS pays the full brokerage commissions; that is, under the exchange rules, the funds managed by IDS have to pay the full brokerage commissions on all transactions executed through any of the exchanges.

In 1965, after discussions of some length with the Pacific Coast Stock Exchange, a new subsidiary of IDS called IDS Securities Corporation, obtained a membership on the Pacific Coast Stock Exchange. Securities transactions for the funds now are handled through IDS Securities Corporation (IDSS).

IDSS does not itself have any men on the floor of any of the exchanges, but there are various procedures by which a portion of the funds' commissions can be recaptured.

IDSS began operating in September of 1965 (when the membership on the Pacific Coast Exchange became effective) and our procedures have changed, and are still evolving. At the same time the decision was made by IDS to try to obtain a membership on an exchange, the decision was made that the management fee charged the funds by IDS would be reduced by providing for a reduction equivalent to the total net profits of IDSS resulting from the execution of the fund portfolio transactions. This decision was later incorporated in the contract.

There are two processes, or procedures, by which the funds' commissions are recouped by IDSS. One is, of course, by the direct execution on the Pacific Coast Stock Exchange of security portfolio transactions. This is done whenever the same execution can be obtained. The volume of business on the Pacific Coast Exchange by IDSS has

grown substantially since the membership was obtained. In 1966, approximately 13 per cent of the funds' securities transactions were executed on the Pacific Coast Stock Exchange. When a transaction is executed on the Pacific Coast Stock Exchange, it is handled through a floor broker, and I think that approximately 30 per cent of the commission is retained by the executing or clearing broker on the Exchange, and 70 per cent then is given-up to IDSS.

With respect to the execution of portfolio transactions on the New York Stock Exchange, and a substantial volume of the funds' portfolio transactions are executed on the New York Exchange (this is a question of the availability of the shares), we go through some of the procedures that Phil was describing earlier in order to be able to recoup a part of the funds' commission expenses. A New York Stock Exchange member cannot be directed to give-up any portion of that commission to IDSS, because IDSS is not a member of the New York Stock Exchange but only a member of the Pacific Coast Stock Exchange. However, a New York Stock Exchange member executing a transaction can be directed, by the funds, to give up a portion of that commission to another New York Stock Exchange member. Usually either the first New York Stock Exchange member, whom I will call the executing broker, or the second one, to whom he is directed to give-up a portion of his commission, is also a member of the Pacific Coast Stock Exchange. In reciprocity for the business received on the New York Stock Exchange, or for give-ups received on New York Stock Exchange business, brokers will then, on business which they otherwise do on the Pacific Coast Stock Exchange, give-up a portion of the commissions to IDSS as a member of the Pacific Coast Stock Exchange.

Indirectly by these procedures there comes back to IDSS some portion of the commissions paid by the funds to the New York Stock Exchange member firms for the executions of transactions on the New York Stock Exchange. IDSS ultimately realizes a profit. Monthly, the management fee is credited or reduced by an amount equivalent to that profit. The total reduction achieved for the calendar year 1966 came to approximately \$3,100,000. So it turned out to be a worthwhile membership.

An Alternative Recapture Arrangement—NASD Membership

PROFESSOR MUNDHEIM: When I explained the IDS procedure to my students, one came up with a question to which I was not able to give a satisfactory answer—but perhaps some of you on the panel can. Since most of the regional exchanges permit 40 per cent give-ups to any NASD member, wouldn't it make sense for a fund which does

regional business to create an NASD subsidiary to receive whatever give-ups can normally be generated, and which would otherwise be paid to brokers who sell the shares.

PROFESSOR SHIPMAN: Bob, I believe there is something in the report on that. The fund does not have to create the subsidiary broker-dealer. Its underwriter, under the rules of many of the smaller regional exchanges, can receive this amount in give-ups and credit them to the fund under an IDS-type arrangement.⁴⁷

As far as I know, that in fact is not done. Underwriters would rather use the money for additional selling effort.

A Response to the Recapture Proposals

PROFESSOR MUNDHEIM: What lies behind the question is: If an arrangement something like the IDS practice is not adopted, are the directors adequately fulfilling their fiduciary obligations?

MR. ANDERSON: That reminds me of Voltaire's statement. I disagree, but I'll fight to the death for your right to say it. I defend the right of IDS to do what they did, although, in my humble opinion, the Pacific Coast Stock Exchange made a grievous error in allowing it to be done.

I have two comments that to me are significant, which would be my response to your question. In the first place, if all institutional accounts are to become their own grandpa, become their own broker, you certainly are going to make a vast change in the structure of our securities distribution system. I don't know how far the waves would go, but I would assume that any brokerage firm of almost any size would have no recourse but to have their own fund. And we would have our own exchange membership, but I don't know who would sell our shares, unless we were to retail them ourselves.

The other thing that confuses me relates to the conversion of a capital account item into an income item. A commission charge is a principal charge. If an individual buys and sells AT&T once or twenty times, he still gets a dividend based on the dividend paid by the company, and he has a commission that he has added to or subtracted from his purchase or sales price.

Now I'm going to turn this around and assume every time we trade a security, we make money. We earn income on that transaction. And so, the more frequently you trade, the more you "earn." These earnings would be added to the earnings from dividends.

Now, initially this develops as negative income, because an advisory fee charge, which otherwise is reasonable, is reduced

⁴⁷ SEC Mutual Fund Report 173 n.82.

to the fund, and thereby the fund has negative income; but if you follow this to its ultimate and logical conclusion, you would go past that to the point where the fund had no expense and had a positive income from its own portfolio transactions. A very low yielding portfolio, if it was traded actively enough, could become an income fund.

PROFESSOR MUNDHEIM: Let me ask Bob Loeffler if IDS's turnover increased markedly since the institution of the IDS subsidiary corporation.

MR. LOEFFLER: Not significantly, no.

MR. LOOMIS: Herb Anderson's remarks seemed to indicate at least part of the confusion that has surrounded this problem. He appears to feel that our objection to customer directed give-ups is a criticism of the funds and of the fund managers, and that the fund managers, or the NASD, or the I.C.I., should do something about it. We don't look at it that way—at least, I don't. So long as the stock exchange rules permit this way of doing things, I don't particularly blame the funds for doing it, and the NASD and the I.C.I. have no power to change the rules of the stock exchanges anyhow.

So long as the stock exchange rules permit this practice, it is to be expected that the funds will do something with these commissions, rather than not do anything with them. Thus, we view this as a problem of exchange rules, not as a practice in which the funds or their managers or the NASD or the I.C.I. are in any way delinquent. Of course, this system does create, as the report points out, and as Bob and I have mentioned, an incentive for funds, and perhaps for fund salesmen, to do things which raise questions. But by and large this is not a problem of any misconduct on the part of funds or fund managements, but, in our view, a defect in the exchange commission rate structure.

MR. ANDERSON: May I please just comment quickly on that? Because this is a switch.

We in the industry see problems. We in the industry see matters that we think should be taken care of, in the form of abuses or potential abuses. Were that not so, the I.C.I. would not have gone to the trouble of trying to adopt a Guide to Business Standards in this area, nor would the NASD have tried to grab hold of what it felt were containable, correctable abuses which, if not restrained or contained, but allowed to go on, would put competitive pressure across the

board on the rest of the world to do likewise. We see problems. And we see practices we would like to see contained.

MR. LOOMIS: Well, we saw problems too, and if there hadn't been anything else that could be done about it except to endeavor to have the NASD and the I.C.I. endeavor to contain it, that would have been an advance. However, we thought that it would be better to deal in a slightly different and more thorough way with the problem.

As for Bob Loeffler's explanation of how his system works, while done for the highly desirable purpose of benefiting the fund, it does indicate the intricacies, distortions and artificialities which this system can create; and also it raises the problem, as Herb Anderson has mentioned, of creating through this aspect of the commission rate structure an incentive for large institutions to, so to speak, move in on the broker-dealer community. And that's another aspect which causes concern.

EVALUATION OF THE COMMISSION'S PROPOSAL TO PROHIBIT GIVE-UPS

PROFESSOR MUNDHEIM: Gordon, I know that you have given some thought to the question of whether or not the prohibition against the give-up gets at the problem which Phil has been outlining, and on which Herb Anderson and Bob Loeffler have commented.

MR. HENDERSON: I want to preface my remarks by making it clear that I am not here as a representative of the "industry" or of the Commission. I'm here simply as an individual expressing my own ideas. They happen to be the same ideas I had when I was at the Commission. If I take issue with Phil Loomis or Dick Phillips or Morgan Shipman on some things, and if I state my position strongly, you will understand that these are people for whom I have a great feeling of fondness, friendship, and respect. The kind of discussion we have been having and will be having here is the kind of discussion we had when I was at the Commission. So, you will pardon me if I feel I'm in the family as I express my views, and if I state them strongly in order to communicate them.

To give you some idea of how that give and take has happened in the past, let me go back to section 22(d). The idea of doing away with the price fixing aspect of 22(d) was an idea that I generated.

I came in one day to Bob and a couple of the other fellows who are in the audience, and I said: I think this may be a good idea. While I don't myself feel that the 8½ per cent load is a great problem,

why wouldn't it nonetheless be in the public interest, and not really harmful to anybody, to do away with the price fixing at the retail end of this business, to open up retail competition similar to that which exists in the automobile and appliance industries. We have to protect the underwriter, so that people can't bypass the underwriter and cause him to pay the expense of preparing prospectuses, without being paid for it. But if we do that, why isn't this a good idea?

And the response was: that's a bad idea. So we sat down and spent a long time arguing the pros and cons of this idea. And some of the con arguments were: that doing away with 22(d) would give an artificial advantage, perhaps, to the captive sales force funds; that we really don't need to change 22(d) to protect investors, since there are no-load and closed-end funds available; and, that doing away with 22(d) might hurt small broker-dealer firms.

So the discussion went on, and I was finally persuaded by the arguments against it, and I still am. So we have had give and take, and now we are going to have some more as we get into the reciprocal area.

The Basic Problem—Conflict of Interest

What is bothering the Commission in the reciprocal area is a problem of conflict of interest. Let me try to define this problem as the Commission sees it. It is this: brokerage commissions can be used to help fund sales; fund sales help the fund manager more than the fund shareholder; but the cost of brokerage hurts the fund shareholder more than the fund manager (because the additional cost to the fund, which the shareholder bears, will probably not affect performance enough to reduce sales). Thus there is an incentive created for the fund manager to misuse fund brokerage for his own benefit to the possible detriment of the fund shareholder.

Various practices have developed in the reciprocal business area which are very troublesome. I do not feel about the reciprocal area the way I feel about the sales load. I feel that reciprocal business is a real problem area. I don't have any question about that. My only question is: what is the best way to address the problems which exist in this area.

Response That Commission Proposals Are Partial Solutions

The Commission has recommended the administrative remedy of reforming the stock exchange commission rate structure by outlawing customer-directed cash give-ups and imposing a volume discount. Un-

fortunately, I have troubles with these proposals and the reasons given to support them, as well as the side effects the proposals might have.

For example, the Commission states that one of the bad aspects of the practice of allocating brokerage business as a reward for sales is that this practice gives the broker-dealer an incentive to push a particular mutual fund on the basis of the amount of brokerage it gives rather than on the basis of investment merit. But the Commission's proposals, while they might reduce the amount of available reciprocal, would not really eliminate this aspect of the reciprocal business problem. There would still be room for this kind of practice.

The report indicates that one of the problems with reciprocal business is that it gives a fund an incentive to use more brokers for its transactions than is warranted from the point of view of obtaining the most efficient execution. But the give-up device is, of course, a means of solving this problem without difficulty to the fund. Banning the give-up will not solve and can only aggravate this problem.

The report indicates that the present pattern of brokerage allocation favors large funds over small funds, because large funds have more reciprocal to allocate for sales than do small funds. However, the volume discount may favor big funds over small funds, since the big funds may be able to appeal to investors on the ground that their net brokerage cost may be cheaper. In addition, it seems likely that the big funds will still have more brokerage available for sales than will the small funds. So this problem will not be solved.

The report indicates that present practices favor NYSE firms over other firms. However, I believe the Commission's proposals will increase rather than reduce this disparity. A volume discount should strengthen the NYSE and its members relative to other markets and other brokers. And the banning of give-ups and a requirement of a volume discount should favor the big NYSE firms relative to the smaller firms. The big NYSE firms will probably do most of the fund executions.

Adoption of a volume discount may also have an adverse effect on small individual investors. The smaller investor presently pays the same stock exchange commission for round lots as the largest investor. With a single commission rate, the exchange can't increase the cost to the smaller investor without equally increasing the cost to the bigger investor. This may provide more adequate practical protection for the smaller investor than SEC regulation. The proposal for a volume discount would remove this protection for the smaller investor. This protection is bartered for a reduction in brokerage costs for the large institutional investors. These are the investors who are

supposed to be best able to fend for themselves without government assistance. The emphasis here seems out of focus.

The report indicates, as a reason for outlawing the give-up, that the cash give-up is a "rebate." This conclusion is debatable, however, since the concept of a rebate relates to the *kind* of service which can be purchased with the commission dollar, rather than to the *manner* in which such service can be purchased through the commission dollar.

An additional problem is that if the volume discount is forced on the exchanges by Commission action rather than through the effect of competitive forces, the Commission will be, once again, as in the case of the 5 per cent sales load, in the position of trying to make determinations for which adequate objective standards do not exist. What is the right kind of volume discount? How does one tell?

So I have problems with some of the reasons given for the Commission's proposals and some of the side effects the proposals may have. As the report points out, however, it is true that the basic conflict of interest in the fund brokerage area can have adverse consequences for fund shareholders. It can lead to possible churning of the portfolio; prevent consummation of favorable transactions that might take place absent reciprocal pressures; cause consummation of unfavorable transactions that would not take place but for reciprocal pressures; cause executions to be handled in a more expensive or inefficient way than otherwise would be the case; and lead to give-ups and interpositioning on over-the-counter transactions.

How do the Commission's proposals solve these basic conflict-of-interest problems? The answer is that the proposals do not really eliminate these conflicts, though they may tend to reduce the dollar impact of them. They are, if you will, like a birth control pill which is not designed to stop conception but is designed simply to guarantee that one will have smaller babies.

I have a basic concern about that kind of remedy. What is likely to happen with such a program is that during the first year people are going to say "Look at those little babies. See how little they are." But the next year someone is going to say "Oh-oh, look at that. Quintuplets!" And the following year people may begin to mutter "You know, I don't think the babies we are getting today are as little as they used to be." And so consideration may finally be given to a remedy that *is* designed to do a more complete job.

Now, as Herb Anderson mentioned, the report in fact warns that if the banning of give-ups and adoption of a volume discount doesn't solve these conflict of interest problems adequately, consideration will have to be given to a more direct remedy.

Alternative Proposals

In my judgment, we ought to look now at some of the possible alternatives. Possibly, the drawbacks of adopting one of these will be less than the drawbacks which are inherent in the Commission's proposals.

The most obvious alternative would be a rule to the effect that managers of mutual fund complexes could not allocate portfolio business to brokers who act as retail dealers for the funds in their complex. Thus, brokers would be required to choose some funds which they could serve as brokers, and others which they could sell. Variations on this would include permitting a limited amount of brokerage to go to brokers who also act as retailers, and making possible exceptions for floor brokerage.

Another basic alternative might be to require that portfolio brokerage, which is allocated to a retail dealer, result in a corresponding rebate or reduction in the portion of the sales load otherwise allocable to such dealer.

All such alternatives have their own difficulties and drawbacks. There isn't time to discuss them in depth today. But what I am suggesting is that it might be wise to explore these now, since it is possible this will have to be done eventually anyway.

PROFESSOR MUNDHEIM: You have given us some alternatives to think about. I hope they stimulate some comment.

May I start at the far left of the table with Morgan, and work my way around?

Volume Discounts

PROFESSOR SHIPMAN: Many of Gordon's points are quite perceptive and illuminate the complexity of a number of the problems the Commission faces. I have several comments.

The question of volume discounts is one that pertains to all institutional and large investors; and the Commission has viewed this, I think, as closely related to the give-up problem, but separable from it, and something which will be examined after the give-up problem.

Also, the relationship of a volume discount to the small investor is perplexing, because a volume discount to, for example, an IDS-sponsored fund, a very large and sophisticated investor, is given to some of the smallest investors in the country. Thus, you are not necessarily discriminating against small investors when you give a volume discount to large investors. But I think the Commission has wisely put volume discounts on a list of projects to reach after the give-up problem.

The directed give-up goes to the fundamental integrity of the commission rate structure. The power of the exchanges, recently confirmed in court,⁴⁸ to fix rates as a direct exception to the antitrust laws, is based on the premise that the Commission will discharge its oversight duties. The directed give-up practice lacks rationality; it is illogical to have a fixed commission rate structure, and yet allow a large percentage of the commission to be directed elsewhere. Rather fortuitously, the directed give-up is of most benefit to the underwriters of mutual funds.

Concerning Gordon's far less conservative solutions on brokerage disaffiliation, or crediting the amounts to the fund itself, I disagree. It's a matter of philosophy, but I believe that the Commission acted responsibly and correctly when it concluded: let's try conservative reforms before we consider rather radical changes in the structure of the industry. But let me say that it was a very thoughtful presentation concerning many complex problems that the Commission and the industry will be dealing with over the next few years.

PROFESSOR MUNDHEIM: Bob, do you have some comments on the recommendation to prohibit give-ups? Or maybe you would prefer to comment on a related question sent up from the floor. It asks: why don't large funds, like IDS, get together, and instead of utilizing roundabout ways of getting what is in effect a volume discount—lean hard on the Commission and the exchanges, to effect that kind of result directly?

You can take your choice as to which one you want to answer.

MR. LOEFFLER: To begin with, it took a little bit of leaning to obtain the membership on the Pacific Coast Stock Exchange. It was not received, necessarily, with enthusiasm from all quarters.

I would like to comment, however, that I personally never regarded it as necessarily such a novelty. IDS is, after all, a registered broker-dealer. We found that it did not seem to be an uncommon practice for some members of the New York Stock Exchange engaged in the brokerage business, and who also have investment advisory services, sometimes to credit against their advisory charge a portion of the commissions on the transactions that were executed for advisory accounts pursuant to their recommendation. So we did not think that what we were doing was very novel.

I was appalled when I first got involved in this to discover the complexities of the rituals which we have to go through to achieve a given objective. But I also became enormously impressed with the

⁴⁸Kaplan v. Lehman Bros., CCH FED. SEC. L. REP. ¶ 91,864 (7th Cir. Jan. 4, 1967).

delicacy with which you have to maneuver and make changes in this area, to make sure you don't disrupt all kinds of practices, many of which can be justified historically.

The Argument That the Commission's Proposals Are Too Broad

My concern with the Commission's recommendations is that they seem to have become very concerned about a specific practice which they regard as an evil—the use or diversion of brokerage by one means or another to supplement sales commissions. Whether or not it is an evil is another matter.

I am concerned because the Commission, disturbed by one particular practice, has attacked it with a shotgun instead of a rifle, and I am somewhat concerned at the peripheral consequences which may come from that approach.

The reason for concern from IDS's standpoint, is that, while we have managed to devise our own method for solving our problems, we are dependent upon the continued existence of a healthy securities industry. I am troubled by potential consequences, yet unknown and unforeseen and perhaps not fully explored, which might result from this approach of using a shotgun to shoot a rabbit.

PROFESSOR MUNDHEIM: If you had the rifle, at what would you shoot? What does the rabbit look like, or is the proper question: what does the rifle look like?

MR. LOEFFLER: As I understand from the Commission report and from discussions which I have had with members of the staff from time to time, it seems that the specific thing which bothers the Commission the most, and which they wished to get at, is the use of give-ups to supplement sales commissions. That's a specific single thing, but when they take the approach of abolishing give-ups, that's somewhat akin to Fred Brown's comment of yesterday: in order to get at a few bad drivers on the road, we're going to close the road.

I'm just not sure that the shotgun approach is necessary. Maybe I misinterpret all of the potential practices which the Commission wants to get at, but it seemed to me it is letting one practice dictate their entire approach.

PROFESSOR MUNDHEIM: Let me move on to Herb, and then Phil.

MR. ANDERSON: Well, I made a little note as I was thinking along with all these discussions, that it would be very helpful if we could separate principles from practices. If every activity in life were to be banned because of abuses, we wouldn't have much left.

There's one other little observation that I would like to make that has occurred to me all through these proceedings. In all friendliness and good humor, the attorneys insist you can't practice law without being trained in the law, and, as a matter of fact, if you try it, you'll end up in the courts.

But they seem to have very few inhibitions about practicing in our area. And I would tie that in, actually, Phil, with your comment that perhaps some things have been going on that you were not aware of.

Believe me, they have. And, believe me, we know what they are. As a matter of fact, however, they are not all bad. I wasn't objecting to lawyers coming into business. I was commenting that lawyers not in business seem quite uninhibited in deciding how the business can and should be run.

Volume Discounts

Now, let me make a few businessman's observations here. The bleeding hearts talk about the disadvantage to the little fund of quantity discounts, and say it would give the larger fund a great advantage. Well, I happen to have been interested in this particular area, among other things, and a portfolio turnover ratio that is ten times more in one fund than in another is by no means uncommon. And so you would have no problem—in fact, you might pity some large funds like the mammoth \$3½ billion fund represented by Bob Loeffler—because if they have a relatively low turnover, which I suspect they probably do—say, ten per cent—it only takes a \$350 million fund with a 100 per cent turnover to match them.

This raises another point which, as a businessman, confuses me. I was delighted to see that the SEC at least was aware that the quantity discount should not be in such a form that it interfered with proper execution as would the one-stock, one-day, one-broker suggestion made some time ago which, obviously, is nuts.

So, okay, you go to a period—the longer the period, the better: three months, six months, one year. There is still a conflict of interest and a basis for criticizing the fund. If it doesn't qualify, it is deliberately avoiding the break point; if it does qualify, it is churning.

Each of us has his own philosophy and his own approach. Speaking for our approach, we do not have a high portfolio turnover, and yet there are years in which we have a much higher, and in other years a much lower turnover; so, we presumably would be falling in and out of bed, depending on where this break point came. And I suspect that there would be a disposition to avoid falling out of bed, so

that there might be more transactions which in the long run could conceivably cost the investor more.

One final point: the New York Stock Exchange members are the "fat calves." They get most of this dough. But get back to fundamentals; they are members of the New York Stock Exchange, and the order is executed on the New York Stock Exchange because that's where the primary market is, and thereby they get the commission incidental to the execution of the order. They put up a fair amount of money for their seat. They subject themselves to much more in the way of capital requirements, supervision, etc. than other brokers. And so, much as I love everybody, including the non-member firms, I say that the nonmembers are not eligible to get whatever the commission is. Thank you.

PROFESSOR MUNDHEIM: It might be useful to point out that the London Stock Exchange has a volume discount. Apparently institutions there have been able to live with it, without, as you suggest, falling in and out of bed. Phil?

The Commission Staff's Reply

MR. LOOMIS: Well, there have been a good many comments.

As to Gordon Henderson's, I agree with Morgan Shipman's remarks. Gordon's analysis is very interesting and perceptive and it merits consideration. I am not prepared at the moment to suggest that we should go so far as to prohibit dealers who sell shares from executing portfolio transactions. It seems to me that that is unduly drastic.

Also, his discussion emphasizes this as a problem of mutual fund management, while I am inclined, as I have said—and I may be heretical here—to regard it a little more as a problem of stock exchange commission structure of a reasonable and rational character.

As to Mr. Loeffler's rifle, I still didn't hear him identify either the rabbit or the rifle, but if I understand him, he is saying that we should endeavor to prohibit give-ups when used as a reward for sales, but not otherwise. In the first place, I'm not sure of that as a matter of principle, but even if I were, I would hate to try to administer and enforce such a suggestion, because how am I going to know why the give-up went to a firm that both negotiated sales and provided research and did all the other things that it does?

There is a problem here, which is a legitimate source of concern to the New York Stock Exchange, which has not been touched upon: the impact on competition among exchanges, and the use of give-up practices which diverts business from the primary market. I cannot see why it should be said that prohibiting the directed give-up would

in any way hurt the Third Market. Rather the reverse would seem more probable to me, because one reason the Third Market has not received as much mutual fund business as they would like, and perhaps as their capacities deserve, is that they can't give give-ups.

MR. HENDERSON: I think, as to the Third Market, Phil, it is the volume discount which would have the biggest effect.

MR. LOOMIS: I was addressing myself to the give-up problem. I recognize that the volume discount is far more complex.

I can sympathize with Herb Anderson, who has been patient with lawyers interfering in his business, but I'm afraid the Commission has to do so every now and then. That's what we were created for, and we welcome his guidance.

MR. GRANT: The question of reciprocal is not one about which I am particularly competent to speak, and I thought it would be appropriate to thank my fellow panelists for the lessons I have learned today. The only thing that I find disturbing is that they are about to change the rules at a time when people in our position, who are not members of stock exchange firms, are learning how to apply them.

As a matter of fact, as I indicated before, our primary interest is in whatever the sales commission yields. This reminds me of a little story I heard, which I think may be appropriate, about the chicken and the pig walking down the street side by side looking for a place to eat. They saw a sign in a restaurant, "Ham and eggs," and the chicken said, "Why don't we go in here for a bite?" The pig said: "I don't think so. I don't think I'd particularly like to eat in that place. To you it represents only an investment, but to me it's a total commitment." That sums up our commitment to this industry at this moment.

Policing the Prohibition Against Give-Ups

PROFESSOR MUNDHEIM: A question sent up from the floor probes an important aspect of prohibition of give-ups. It asks whether the proposed ban on give-ups will not simply induce funds to spread executions among more brokers, thus leaving the ultimate compensation the same as it is now, but undoubtedly resulting in poorer executions for the funds? It appropriately raises the question of policing and administering the prohibition on give-ups. Won't it be relatively easy for funds to use (and justify the use of) fewer lead brokers than they do now?

MR. LOOMIS: There might be some of that, as the Commission mentions in its report. On the other hand, the investment company

managers have an obligation, of which they are well aware, to obtain the best executions, and to split orders to any major extent would raise a problem for them.

Particularly, I have heard it said that they would divide an order among six brokers, and have the six brokers bidding against each other. I can't conceive that this would go on. In any event, some of the distortions and maneuvers would be out.

PROFESSOR MUNDHEIM: Herb?

MR. ANDERSON: I have a brief comment.

Until rather recently we used the lead broker concept very little, because we felt that even though the broker, Joe Doakes of Minneapolis, would make no more if we used his correspondent, there was a value to Doakes in his correspondent receiving the business, rather than a lead broker. We have now come to use the lead broker concept more, but here you get, in my opinion, to another matter; namely, the philosophy and the policies of the fund.

I would imagine—I couldn't speak for them, but I would imagine—that a so-called performance fund, which moves actively in fair amounts in and out of the market, would find it extremely difficult to spread its orders. On the other hand, we don't operate that way. We typically like to accommodate the public on a rather leisurely basis. When everybody wants a stock, we like to accommodate them and let them have it, and when nobody wants it, why, we like to accommodate them and give them a place to sell. This philosophy typically prefers an average of the market, because we are not that sure that the stock is perfectly priced at any precise point, and that we should either grab it on the buy side or throw it out on the sell side.

With this philosophy, which probably goes back to what we did until recently, I think we would have relatively little problem in, to use your own words, "spreading our business" over a number of brokers, using their own structure of correspondent relationships in New York.

PROFESSOR MUNDHEIM: Can you, for example, send an order through Broker *A* whom you know uses a particular correspondent and thus be assured of the quality of the execution? That would seem to me the same as sending the order to the correspondent in the first place and having him give up to Broker *A*. If there is an understanding with respect to the broker who actually performs the execution, haven't you got the present system? Would those arrangements be prohibited?

MR. ANDERSON: I was delighted to hear Phil say that he didn't fully understand Mr. Funston's letter, because I didn't either, and Phil is much smarter than I am in that area.

The answer at the moment is that nobody knows. It's a matter still to be resolved.

MR. LOOMIS: I think that is probably a fair appraisal.

PROFESSOR MUNDHEIM: Since we are getting close to the end of the day, let me ask if any of you have anything further to add in the reciprocal business area?

The Advantages of the Commission Proposal

MR. PHILLIPS: I've gotten the impression from the discussion here that almost everybody agrees that there are problems in this area, and problems that need solution.

I think that it's also fair to say that they are complex problems, and that there is no one solution or combination of solutions that provides complete assurance of dealing with every facet of them.

But while there has been a lot of criticism of the Commission's suggestions on the ground that they are not perfect, it seems pretty clear also that no one has the perfect rifle to deal with these problems.

The Commission's proposals, I think, offer a very reasonable hope of cutting down the pressures in this area to a manageable size. They also offer an advantage, because they deal with the problems where they start—with exchange rules and a commission rate structure that do not reflect the needs of a securities market which is increasingly influenced by institutional investors, who invest the savings of many small investors. They are directed at give-up rules which grew out of a commission rate structure which provides no volume discount for the very large orders.

The abolition of the customer directed give-up, coupled with a volume discount, offers a great deal of promise for the resolution of the problems; not complete, but, hopefully, reasonably complete.

The criticisms that have been directed against these proposals and the inability to come up with alternatives reflect an awareness of the complexity of the problems. I would be frank to admit that the Commission was at this stage in its thinking some time ago. It considered the alternatives—I believe, every one of them that has been mentioned here—and concluded that the combination of abolition of the give-up and the volume discount represents the clearest and most direct attack on the problems.

If anyone has a better rifle, we'd like to hear about it.

MR. ANDERSON: I would like to comment that I don't think there is any admission of inability at all, except possibly on the part of the Securities and Exchange Commission. I would like to see medication tried, rather than euthenasia. Don't kill the patient; just try to correct any illnesses that exist.

PROFESSOR MUNDHEIM: I think Dick would like you to read the contents on the label of your medication. He would like some specifics. What things do you want to see done in order to correct the abuses that you see, and that you said the industry sees?

MR. ANDERSON: If anybody could recite the problem and describe the cures in the short time left, it would be a miracle. Furthermore, I think it's highly inappropriate to have a public discussion of what may be evils, because some of these evils are a matter of opinion, others are a matter of intent.

I think there could be meaningful discussions, as with this little Statement of Policy that, skipping the preamble, comprises less than three pages. I happened to be on the committee which hammered that out with the SEC, and it took us weeks and weeks and weeks to find a solution, and we apparently did fairly well. I can tell you a few things that are wrong with it, but we did fairly well. I have not heard criticism generally of the sales material of the business—and this is now 1967, and the original Statement of Policy was dated 1950.⁴⁹

PROFESSOR MUNDHEIM: Bob?

MR. LOEFFLER: I'm just throwing this out for consideration, but I sometimes wonder if there is not too much reluctance on the part of the Commission to assume that if they declare a certain practice to be improper, men will be honest and observe that declaration of policy; and if there is a culprit, it will not be impossible to prove.

Let me be a little more specific. I'm not recommending this; I'm just throwing it out.

If you say that the specific evil at which the Commission wants to shoot a rifle is the use of give-ups for rewarding sales, or supplementing, in effect, a commission on sales of mutual fund shares, and if it were to be determined that that is a practice which should be prohibited, the Commission simply should declare, in general terms, that it is a prohibited practice.

Now, I think there is a reluctance on the part of the Commission to assume that 99 and some-odd hundredths per cent of the people

⁴⁹ *Statement of Policy*, *supra* note 44.

involved are going to be honest and are going to observe the rule, and also assume it will not be impossible to prove the case against the occasional violator.

This is perhaps what I meant in terms of the rabbit and the rifle.

Now, I'm not saying that the practice is evil. That I don't know or in any event I have no particular view on it at the moment. On the other hand, the Commission's approach concerns me because of the consequences.

I can't resist the story I heard about the chap who decided to do something about air pollution, so he equipped an automobile to run by electricity, and set off from San Diego to Los Angeles. In due course, he arrived, having proved that (1) you could do it with an electric automobile, and (2) that the prime cost of the electricity was only \$3.25. On the other hand, it cost him \$17,000 for extension cords.

MR. HENDERSON: As I said before, I don't think there is any question that there is a problem in this area. I am inclined to think that failing to recognize the problem is not going to make it go away. If you want to find examples of the problem, there are many places to look. The Special Study had lots of them. The report has them, and I would even suggest that you look at Keith Funston's letter dealing with the give-up problem. I opened it up at random just now, and find these two sentences:

Similar practice has arisen in the over-the-counter market. Some member firms keep a running total of commissions earned on over-the-counter trades and give up fifty per cent of those commissions to NASD members at the direction of institutional customers.

Doesn't that speak for itself? There are bad things going on in this area. There are real problems, and I think, really, the only proper area of discussion is: are there good answers? And, if so, which are the best?

THE IMPACT OF THE PROPOSAL ON REGIONAL EXCHANGES

PROFESSOR MUNDHEIM: One aspect of the proposed prohibition on give-ups relates to its impact on the regional exchanges. We have one here in Philadelphia, and I have heard some dire predictions of what will happen. It will not survive. Has the Commission concluded that, on reflection, the regional exchanges don't serve a useful function? Or do you see the prohibition of give-ups as a way of forcing the regional exchanges to become competitive with the New York Stock Exchange in other ways, in order to survive.

MR. LOOMIS: If you are addressing that question to me, it is my belief that there certainly will be an impact on the regional exchanges. It will vary from exchange to exchange. I would suppose that the impact would cause the regional exchanges to revert to their original function—to provide local markets for local securities, and for New York Stock Exchange listed securities where a local market is needed. There are other ways in which the regional exchanges could make themselves more competitive.

PROFESSOR SHIPMAN: Bob, I agree with Phil. The impact will be significant, and the Commission undoubtedly will have to consider the impact and take it into account in fashioning give-up rules.

The impact on many regional exchanges will be large, because in the past three years the great discovery of many of the regional exchanges has been that they can flower by adopting very liberal give-up rules. A banning of directed give-ups might put the regionals back where they were a few years ago.

What Role For the Regional Exchanges?

PROFESSOR MUNDHEIM: What ways do you see that the regional exchanges ought to be competing? How can they effectively do that? What's your program for their survival?

PROFESSOR SHIPMAN: Their original purpose was to provide local markets for local stocks and some dually traded stocks. The Special Study covered in some detail the work of the regional exchanges.⁵⁰ Many innovations have indeed come from the biggest regional exchanges, rather than the New York exchanges.

The furor in New York City over tax increases and proposed tax increases makes it important that some viable exchanges outside of New York City remain available, so that there will be a counter-pressure against taxation of the remainder of the country for the privilege of having electronic impulses flow to New York City. Some regionals have considerable value as innovators in trading techniques, and bookkeeping and clearing procedures—the Midwest Stock Exchange has been a leader there. The innovation and competition they provide in that way are valuable and must be given appropriate weight by the Commission.

PROFESSOR MUNDHEIM: Would you look to them, for example, to provide competition through leadership in arriving at various ways of structuring volume discounts, or, to take another example, in providing different price structures for executing odd-lot transactions?

⁵⁰ SEC *Special Study of Markets*, Pt. 2, ch. VIII, 911-51.

PROFESSOR SHIPMAN: On volume discounts, I have little to say. I have not studied the current possibilities and data in any detail. The Commission's mid-1966 proposal indicated that perhaps a volume discount might be keyed to total volume on all the exchanges.⁵¹ The structuring of a volume discount will be important to the regionals. Changes in odd-lot structures are a possibility.

MR. PHILLIPS: I'm not sure if I misunderstood you or not, Morgan, but the Commission's report expressly says that a volume discount does not have to be uniform for all exchanges, and it does leave the way open for competition for business in the form of volume discounts.⁵²

PROBLEMS CONFRONTING ALTERNATIVE PROPOSAL

PROFESSOR MUNDHEIM: Gordon, one question from the floor seeks to explore one of your alternative solutions. It reads:

"How would Gordon Henderson prevent the use of brokerage commissions or give-ups from being used to pay for services supplied through an investment adviser?" I take it this refers to the alternatives which would limit the amount of reciprocal business which a fund can do with particular brokers.

MR. HENDERSON: Well, I think, to make a system like this work, you would have to have a strict rule, so that you could not give brokerage to a retail dealer in fund shares and label that brokerage for investment advice or brokerage for best block executions, or something else; and then leave up for grabs the question of whether this really was for investment advice or really was for good bloc executions, instead of sales. I think the rule, to be workable, to be meaningful, has to be a rigid one, in that you just simply cannot give brokerage for any reason whatsoever, more than X amount or more than X percentage of sales, to a retail dealer firm.

Someone asked me during the coffee break: well, how would you do this where, for example, you had used up your limit, or your allocation for a particular firm and you suddenly wanted to do a secondary, and they are the best people to do it. What would happen?

I said: well, I think, obviously, you would have to have some kind of a carry-over arrangement to provide some flexibility; but in the end such a rule would inevitably have some bite to it; there would be some interference with the present execution procedures, some interference with the obtaining of investment advice. There is no ques-

⁵¹ 112 CONG. REC. 17,061-63 (daily ed. Aug. 2, 1966).

⁵² SEC Mutual Fund Report 187.

tion about it. But, I think, to answer that specific question, the rules to be effective would have to be relatively rigid, as they are, for example, in the law of trusts where conflicts of interest are involved.

MR. ANDERSON: What would you do after you had used it up for everybody, and needed a carry-forward?

MR. HENDERSON: Well, you would of course have to have some primary executing brokers, Herb, who are going to handle most of your business and who are not selling your shares.

MR. LOEFFLER: This is not much of a contribution, but sitting here I have been developing a great deal of sympathy for the viewpoint which Herb expressed earlier.

It must be an awful thing for businessmen to sit and listen to a group of lawyers figuring out ways procedurally to stereotype a method of doing business. What always concerns me is that stereotyping has a straight-jacket effect, a tendency to prohibit and restrain the innovation and change which normally comes from the new ideas and the interplay of business and economic forces. I think I tend to have a much greater faith in the development of competitive forces and the normal interplay of economic influences than has generally been expressed.

MR. ANDERSON: Could I just briefly give you an Alice in Wonderland thought that runs through my mind?

We are going to prohibit, now, placing any commission business with brokers that sell our shares. Well, I can envisage getting together with the head of some fund in the business that I think well of, and we'd swap dealers. His dealers would get our brokerage business, and our dealers would get his brokerage business, and it's kind of a weird way of working your way around through life——

MR. HENDERSON: Herb, that's a very interesting idea, but Bob Loeffler said a little while ago that if you just established rules and told people what the right rules were, you ought to be able to trust them to abide by them.

MR. LOEFFLER: I also expressed a faith in the ability of the Commission to prove the case against the occasional violator.

MR. HENDERSON: Well, you see, on this one I tend to think most people feel like Bob, and wouldn't do what Herb is suggesting, but maybe I'm wrong.

The Commission's Resolution

MR. PHILLIPS: This interchange illustrates the reasons why the Commission did not take the positions that Gordon Henderson has suggested—either of his two alternatives. It's a question whether they are really enforceable, and, worst of all, they put the government in the position of circumscribing the businessman's judgment.

But the solution suggested by the Commission would not have that effect; nor is this a question, like Mr. Loeffler suggested, of leaving it to the forces of competition. This is a problem that arises from the exchange rules and not from the forces of competition alone. It's the interaction between the competition for sales in the mutual fund industry and exchange rules, which were adopted in a wholly different market context and for wholly different purposes. The result has been anomalies in the commission rate structure which give rise to a lot of excess brokerage.

Now, to suggest that you tell mutual fund managers that they can't use this brokerage for sales, and to suggest that they have got to waste it, because they have no other use for it, just doesn't make sense. I don't think people voluntarily obey rules that don't make sense.

So we then get into the situation where there are circumstances reported to the Commission which suggest a violation of our rule, and it commences an investigation, and perhaps it can't prove it, contrary to Mr. Loeffler's suggestion that it should be able to; but, in any event, the man who is being investigated gets very upset about this investigation, and the Commission then ends up interfering with his future business judgment since he bends over backward to avoid any appearance of wrongdoing.

I don't think that any of the alternatives are feasible or adequate to deal with the problem, because they ignore the fact that the problem stems from exchange rules and the commission rate structure. It's those rules that have to be modified, and modified in a way that does not circumscribe the business judgment of the fund managers.

The Commission does not want to tell fund managers how to execute transactions, and its suggestions, in my view, represent the kind of approach that would least interfere with the exercise of business judgment in the management of funds.

PROFESSOR MUNDHEIM: It's interesting that you say that the problem is in the commission rate structure. The report curiously attacks the give-up question first, and leaves the commission rate structure as the second item for attack.

Although at first blush that seems silly, it might be the sensible way to handle the problem. The Commission's approach may unleash new forces and new pressures which in themselves eventually, indirectly may help to break down the commission rate structure. That attack is one which I suppose for many good reasons the Commission may not be willing to make directly at this juncture.

MR. PHILLIPS: The fact is that attacking give-ups is simple, and devising a volume discount or an institutional discount is a very complex job. If we could do the volume discount first, we would be pleased to do it, but we have to develop an approach to these problems, and we can't wait until we get into a position where we can do everything at one time. This is not a static industry, and it's not a static problem. The problem becomes more difficult to resolve the longer you wait because people become dependent upon this source of compensation. They make business decisions, open up branch offices and hire large research departments on an expectation of business which will come through the existing commission rate structure. Then their dependence on that commission rate structure is heightened.

I think these are serious questions, and a start to a solution has to be made. It's not a question of waiting until we find a perfect solution, but let's approach this problem step by step until we can devise an exchange commission rate structure and exchange rules that reflect what is happening—the growing institutionalization of the securities markets.

PROFESSOR MUNDHEIM: I think it is time to close this conference. One thing that this afternoon's discussion ought to illustrate, as I hope, much of the discussion which we have had in the last two days illustrates, is that the problems which exist are of enormous complexity. Sometimes you have to sit around and talk about them and examine them from all sides to realize how complex the problems are and how many ramifications the solutions have.

On the other hand, I hope that some of you who came with the idea that there were no problems, only a large number of biases of various kinds, have been disabused of that notion; and, having been disabused, perhaps we can all go back and do some useful thinking, and perhaps come up with some additional alternatives, which I suspect that you, Phil, and you, Dick, and you, Frank, will be delighted to hear. So thank you, and let's adjourn.